Risk Management Manual of Examination Policies

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

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FDIC | DIVISION OF RISK MANAGEMENT SUPERVISION

RATIONALE OF BANK EXAMINATIONS

The Federal Deposit Insurance Corporation conducts bank examinations to ensure public confidence in the banking system and to protect the Deposit Insurance Fund. Maintaining public confidence in the banking system is essential because customer deposits are a primary funding source that depository institutions use to meet fundamental objectives such as providing financial services. Safeguarding the integrity of the Deposit Insurance Fund is necessary to protect customers' deposits and resolve failed banks.

Onsite examinations help ensure the stability of insured depository institutions by identifying undue risks and weak risk management practices. Examination activities center on evaluating an institution's capital, assets, management, earnings, liquidity, and sensitivity to market risk. Evaluating a bank's adherence to laws and regulations is also an important part of bank examinations and is given high priority by Congress and bank supervisors.

Finally, bank examinations play a key role in the supervisory process by helping the FDIC identify the cause and severity of problems at individual banks and emerging risks in the financial-services industry. The accurate identification of existing and emerging risks helps the FDIC develop effective corrective measures for individual institutions and broader supervisory strategies for the industry.

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CONDUCT OF EXAMINATIONS

Given the fundamental reasons for conducting examinations, regulatory personnel must have access to all records and employees of a bank during an examination.

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

Prohibition Against Political Communication

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

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RATING SYSTEM

Introduction

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

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

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

UFIRS Overview

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

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

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

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

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

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

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

Disclosure of Ratings

The FDIC believes it is appropriate to disclose the UFIRS component and composite ratings to bank management. Disclosure of the UFIRS ratings helps ensure banks implement appropriate risk management practices by allowing a more open and complete discussion of examination findings and recommendations.

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

Discussions with Management

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

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

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

Examiners should remind management that all examination findings, including the composite and component ratings whether disclosed verbally or in the written ROE, are subject to the confidentiality rules imposed by Part 309 of the FDIC Rules and Regulations.

The regional office should inform management if there are material processing delays or substantive changes to the ROE that modify the preliminary examination findings or recommendations disclosed at examination exit meetings.

Examination Letters

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

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

Immediate corrective measures, including the issuance of a temporary order requiring an institution to cease and desist, may be appropriate in higher-risk situations. If examiners believe such action should be considered, they should discuss the situation with the field supervisor and regional case manager without delay.

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EXAMINATION FREQUENCY

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

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

Section 337.12 requires a full-scope, onsite examination of every insured state nonmember bank and state savings association at least once during each 12-month period. Annual examination intervals may be extended to 18 months under the following conditions:

- The bank has total assets of less than $3 billion;
- The bank is well capitalized as defined in Section 324.403(b)(1) of the FDIC Rules and Regulations;
- The bank was assigned a management component rating of 1 or 2 at the most recent FDIC or applicable state examination;
- The bank was assigned a composite rating of 1 or 2 at the most recent FDIC or applicable state examination;
- The bank currently is not subject to a formal enforcement proceeding or order by the FDIC, OCC, or Federal Reserve System; and
- No person acquired control of the bank during the preceding 12-month period in which a full-scope, onsite examination would have been required but for the above noted exceptions.

These rules apply similarly to U.S. branches or agencies of a foreign bank with total assets less than $3 billion if the office received a composite Federal Reserve ROCA[1] rating of 1 or 2 at its most recent examination. In all cases, the FDIC reserves the right to examine more frequently if the agency deems it necessary.

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

Alternate Examinations

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

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

Specialty Examination Intervals

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

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

When the state supervisory authority has responsibility for conducting the safety and soundness examination, the FDIC is not required to conduct any specialty examinations that the state authority does not conduct, with the exception of Bank Secrecy Act (BSA) examinations. The FDIC is required to conduct a BSA examination if the state does not conduct a BSA examination.

Insured Branches of Foreign Banks

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

- Have total assets of less than $3 billion;
- Have a composite ROCA supervisory rating of 1 or 2 at its most recent examination;
- Not be subject to a formal enforcement action;
- Not have undergone a change in control during the preceding 12 months; and

1 The ROCA components are: Risk management, Operational controls, Compliance, and Asset quality.

- Have Tier 1 and total risk-based capital ratios (at the foreign bank) of at least 6 percent and 10 percent, respectively, when reported on a consolidated basis; or
- Have maintained on a daily basis (over the previous three quarters) eligible assets in an amount not less than 108 percent of the preceding quarter's average third-party liabilities, and have sufficient liquidity currently available to meet its obligations to third parties.

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

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EXAMINATION TYPES

Risk-Focused Supervision

Effective risk management is central to safe and sound banking. The objective of a risk-focused examination is to efficiently evaluate the safety and soundness of a bank. Examiners should focus their resources on a bank's high-risk areas when assessing risk management programs, financial conditions, internal controls, etc. The exercise of examiner judgment to determine the scope and depth of review in each functional area is crucial to the success of the risk-focused supervisory process. Examiners should make risk-scoping decisions on a case-by-case basis in consultation with their supervisory examiner, field supervisor, or the bank's case manager.

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

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

The FDIC's long-standing philosophy and methods for examining institutions are fully described within this manual in Section 20.1 Risk-Focused, Forward-Looking Safety and Soundness Supervision. Examiners should be conducting examination activities consistent with Section 20.1.

Full-Scope Examinations

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

In a full-scope examination, all examination activities are considered in the overall assessment of the institution. These activities include the Risk Management, IT, BSA/Anti-Money Laundering (AML)/ Office of Foreign Assets Control, Trust, Registered Transfer Agent, Municipal Securities Dealer, and Government Securities Dealer examination programs. Examination ratings (when assigned) and summary comments should be included in the risk management ROE. Compliance and Community Reinvestment Act examination activities are included in the overall supervision program with separate reports and examination cycles.

Point-in-Time and Continuous Examination Processes

For most institutions, full-scope examinations are performed at a point in time. Examiners plan the examination; conduct examination procedures over a discrete period of time; complete ROE pages, assign the UFIRS ratings, and communicate examination findings. At the conclusion of this process and after appropriate review, an ROE is issued to the institution.

For certain institutions that are larger, more complex, or present a higher risk profile, full-scope examinations are performed continuously over the course of a year. For continuous examinations, the planning phase describes the types of activities to be performed and evaluation of the UFIRS components over the year.

The continuous examination process includes onsite targeted reviews of areas the examiner determines are necessary to complete a full-scope examination; ongoing monitoring and assessment of institution risks, policies, procedures, and financial condition; and frequent communication with institution management. A dedicated or designated EIC oversees the continuous examination process and may be supported by additional dedicated examination staff and other staff depending on the size, complexity, and risk profile of the institution being examined. In addition to frequent communication with institution management, supervisory letters are issued to the board and institution management after each targeted review that convey the findings (including supervisory recommendations when appropriate). Other, ad hoc written communications to institution management may also be issued based on ongoing monitoring activities or other intervening supervisory events or activities. Additionally, at the end of the continuous examination cycle, an ROE is issued to the institution that aggregates and summarizes findings from examination and other supervisory activities performed throughout the cycle and assigns the UFIRS ratings.

Limited-Scope Examinations and Visitations

The terms *limited-scope examination* and *visitation* are interchangeable and may be defined as any review that does not meet the minimum requirements of a full-scope examination. Because the reviews are not full-scope examinations, they do not satisfy the requirements of Section 10(d) of the FDI Act. Examiners may conduct the reviews for a variety of reasons, such as to assess changes in an institution's risk profile or to monitor compliance with corrective programs. Examiners may also conduct the reviews to investigate adverse or unusual situations, to determine progress in correcting deficiencies, or to assess compliance with supervisory requirements established through an order.

Limited-scope reviews may address the overall condition of the institution, material changes since the previous examination, or areas that exhibit more than normal risk. Depending on the scope, purpose, and sufficiency of the reviews, examiners can assign composite ratings and component ratings. Component ratings for areas that were not sufficiently reviewed should be brought forward from the previous examination.

Examiners are not required to complete standard ROE schedules when completing limited-scope reviews. However, they may include applicable schedules in their report to clarify findings or recommendations. Results should generally be conveyed in a memorandum from the EIC to the regional director. The results of a review, if sent to the institution, can be in any appropriate format.

Institutions Subject to Corrective Actions

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

Newly Chartered Insured Institutions

Adverse economic conditions and other factors often affect newly chartered institutions more than established institutions, and the failure rates of de novo institutions exceed those of established institutions. Therefore, unseasoned institutions pose a material risk to the Deposit Insurance Fund (DIF) and warrant close regulatory oversight.

Among noted concerns, de novo institutions that deviate from approved business plans, especially with respect to real estate and development loans, are of particular concern to supervisory personnel. Other, common risk factors observed at troubled or failed de novo institutions during their first three years of operation include:

- Non-compliance with orders approving deposit insurance,
- Inadequate risk management controls,
- Rapid growth,
- Concentrations in higher risk assets,
- Over reliance on volatile funding sources,
- Problematic third-party relationships,
- Weak compliance management systems, and
- Unseasoned loan portfolios.

In all cases, major deviations from, or material changes to, approved business plans by newly insured institutions warrant in-depth analysis to assess risks to the institution and the DIF. In order to better identify risks and strengthen supervisory responses to identified risks, supervisory personnel should:

- Employ appropriate onsite and offsite supervisory practices;
- Carefully coordinate risk management, compliance, and interagency activities;
- Monitor activities, at least quarterly, for changes to, or deviations from, established business plans; and

- Clearly define expectations to management regarding the timing, type, and documentation required to satisfy supervisory monitoring activities.

Orders granting federal deposit insurance require bank management to seek prior approval for any major deviation, or material change, from the institution's approved business plan. To ensure that this requirement is met, the board should monitor the institution's performance for early signs that correction is needed or that a request for a change in business plan is necessary.

If a major deviation or material change to approved business plans is identified by the FDIC during an examination or other review, the case manager or examiner-in-charge should document the deviation/change in a memorandum to the regional director and include an assessment of the riskiness of the deviation/change. In such circumstances, prompt communication to bank management is necessary, and proactive, supervisory action is appropriate.

Examination and Visitation Cycles

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

Monitoring Activities

During the three-year de novo period, examiners should emphasize the need for management to seek prior approval for any proposed material change(s) from the approved business plans. Regional offices have a responsibility to monitor de novo institutions' activities, review compliance with any conditions of deposit insurance orders, and track performance in relation to approved business plans. Significant changes to business plans must be submitted to the appropriate regional office for approval. Examiners assist in monitoring activities by:

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

Changes in Business Plans

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

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

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

Converting to Insured Nonmember Status

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

Change of Ownership Control

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

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COORDINATING EXAMINATION SCHEDULES

State Authorities

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

Holding Company Inspections and Subsidiary Institution Examinations

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

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

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

Interstate Banking and Chain Banks

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

Regional directors are responsible for designating a lead region to design an appropriate supervisory strategy for interstate banking organizations and for ensuring pertinent information is conveyed in a timely manner to other regions and to appropriate federal and state agencies.

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

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SCHEDULING GUIDELINES

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

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

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

Forward-Looking Supervision

Risk-focused supervision employs a forward-looking supervisory approach where control weaknesses or other risk management conditions or problems are assessed early, and when necessary, corrected, in order to prevent or mitigate serious problems to an institution's financial condition in the future.

To address minor issues identified during an examination, examiners may present suggestions to management during discussions. For more significant problems, examiners should discuss the deficiencies with management and the board of directors during the examination and at subsequent exit meetings, and address the problems in the ROE. Such discussions and written commentary should clearly convey the issue that is cause for concern and explain the risks to the institution's operations or financial performance if not addressed in a timely manner. Significant issues that require immediate attention should be identified as Matters Requiring Board Attention in the ROE. If circumstances warrant and after discussing with appropriate FDIC regional management, examiners should make recommendations for informal or formal agreements or actions if they identify unacceptable risk levels or risk management practices, even in 1 or 2 rated institutions.

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

Scheduling Considerations

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

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

The following lists include sources of information that may influence examination schedules or activities. In some instances, the information may identify concerns that lead to immediate examinations. In less severe situations, the information may help identify risks that require follow-up or impact the scheduling of future examinations. The lists, while not all-inclusive, highlight the need for forward-looking supervision.

Offsite Analysis and Monitoring

- Statistical CAMELS Offsite Rating System
- Comprehensive Analytical Reports
- Interim Financial Reports
- Growth Monitoring System

- UBPR Analysis
- Press Releases

Other Financial Indicators

- Unusually high or fluctuating profit levels
- Significant operating losses
- Significant provision expenses to the allowance for loan and lease losses (ALLL) or allowance for credit losses (ACL), as applicable
- Significant levels of delinquent loans
- Significant changes in balance sheet composition
- Unusually elevated or rapidly growing asset concentrations
- High reliance on brokered funds
- Excessive trading
- Excessive dividends
- Unusually high or low ratios or numbers

Applications or Other Bank-Provided Data

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

Known Characteristics

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

Other Bank Regulators

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

Media

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

Observations/Other

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

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RELYING ON STATE EXAMINATIONS

Section 10(d)(9) of the FDI Act requires the FFIEC to issue guidelines establishing standards for the purpose of determining the acceptability of state reports of examination. Under Section 10(d)(3-4), a federal banking agency may conduct an annual, onsite examination of an insured depository institution in alternate 12- or 18-month periods if the agency determines that a state examination conducted during the intervening period is adequate. The standards issued by the FFIEC are to be used at the discretion of the appropriate federal banking agency.

The FDIC and the Federal Reserve Board of Governors have a history of coordinating examination activities with state banking departments. This close cooperation improves the supervisory process by promoting a safe and sound banking system, maximizing examination efficiencies, and reducing the regulatory burden on state-chartered, depository institutions.

The federal and state banking agencies have worked together in the following areas:

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

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

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

These arrangements are structured to permit federal and state agencies flexibility in conducting independent examinations, subject only to notification to the other party. The flexibility allows the agencies to tailor activities based on the particulars of each state and the individual banks within a state. Generally, only institutions rated 1 or 2 are examined on an alternating basis allowing for a reasonable interval between examinations.

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

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

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

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

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

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COMMUNICATION BETWEEN EXAMINATIONS

Interim contact with bank management is a critical form of communication and should be conducted within 30 days of the midpoint between risk management examinations (FDIC or state). Interim contacts provide a way to monitor the institution's financial condition and gather insight into trends regarding the nature, scope, and risk of an institution's activities. Interim contacts also help supervisory staff (including examiners) establish an appropriate examination scope and identify resources required for the next examination.

The objective of an interim contact is to build and maintain effective communication with the institution. The contacts provide an opportunity for management to discuss financial trends, strategic initiatives, developing risks, and regulatory changes that may affect the institution. The contacts also help identify changes in the bank's risk profile that may require an alteration in supervisory strategies. Supervisory staff can conduct interim contacts by phone or in person, depending on the matters to be discussed and travel proximity.

Information derived from interim contacts and supervisory activities can be used as part of the risk-focused examination process. The process seeks to strike an appropriate balance between evaluating the condition of an institution at a certain point in time and evaluating the soundness of the institution's risk management processes in all phases of the economic cycle. Given the purpose of this communication, the FDIC should coordinate with state supervisory counterparts who may also have interim contact procedures. The FDIC is also encouraged to share information with state banking departments if significant items are identified during contacts.

Because case managers and other supervisory staff contact institutions that are under a supervisory action periodically between examinations, only institutions with Risk Management and specialty examination composite ratings of 1 or 2 require an "interim" contact. Regional directors have the discretion to designate regional- or field-office staff to be responsible for contacting bank management. A brief file memorandum summarizing the contact should be prepared and entered into the correspondence file as an *Interim Bank Contact*. The memo is an important, formal record of the Corporation's supervisory efforts; comments should be brief and factual. Case managers should review the contact memorandum if they are responsible for oversight of the institution and did not perform the contact themselves.

Topics discussed during interim contacts generally focus on the nature of the institution's operations and risks. The following topics are provided for illustrative purposes.

- Significant changes in bank products or services;
- Changes in bank management or key personnel;
- Changes in the strategic plan, business plan, or operations;
- Significant trends or changes in the local economy or business conditions as detailed in publicly available information, Division of Insurance and Research data, or other means;
- Purchase, acquisition, or merger strategies;
- Changes in technology, including operational systems, or plans for new products/activities that involve new technologies;
- Financial performance and trends, particularly unfavorable factors identified during off-site analysis;
- Progress in addressing any matters requiring board attention issued by the FDIC or the state banking authority, violations, or enforcement actions;
- Recent Financial Institution Letters, laws, rules, and regulations that may affect the institution's operations;
- Any matters that may be of interest to regulators, including significant audit or security incidents; and
- Institution management's concerns about the bank or FDIC supervisory activities.

Other contacts with an institution that occur near the midpoint of examinations, such as a visitation or other direct communication with institution management, may serve as the interim contact. In such cases, the system of record should be updated by case managers to indicate that an interim contact was completed via alternate means.

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EXAMINATION PLANNING ACTIVITIES

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

Examiners should consider the need for branch examinations when planning examinations. The FDIC examines branch offices on an as-needed basis only, and the regional director is responsible for deciding if a branch examination is necessary. The decision to conduct a branch examination may be delegated to the field supervisor or EIC of a particular examination.

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

As a general rule, field supervisors (FS) or supervisory examiners (SE) must call institution management at least 90 days ahead of the projected start date of the examination to inform them of the upcoming safety and soundness examination. The FS or SE will provide notice that profile scripts for general safety and soundness, which includes BSA, Trust (when applicable), and IT, will be sent to the institution. Exceptions to this general policy (such as no-notice examinations, which require regional director approval) may include problem institutions, situations where management and ownership of the institution are identical, or in situations where conditions appear to be deteriorating rapidly.

Supervisors should be mindful of an institution's space and personnel limitations and schedule the number of examiners working on bank premises accordingly. Additionally, throughout the examination, examiners should make every effort to conduct as many examination activities as reasonably possible offsite in order to minimize disruptions to an institution's normal business activities.

The following items, while not all-inclusive, are well suited for offsite review when the related information is available.

- Policies and procedures
- Audit plan
- Audit reports and responses
- Strategic plan
- Board and committee minutes/reports
- Financial data
- Asset-related reports and documents

An examination procedures module titled Risk Scoping Activities is included in the Examination Documentation Modules. This module identifies and lists several activities that may be completed by examiners during the examination planning process.

Reviewing External Audit Workpapers

An external audit workpaper review is intended to provide information relating to an institution's internal control environment and its financial reporting practices. Thus, a workpaper review assists examiners in determining the scope of the examination and the procedures to be applied to different areas of operations.

Examiners should review the workpapers of the independent public accountant or other auditor performing the institution's external auditing program when an FDIC-supervised institution has undergone a financial statement or balance sheet audit, and:

- Significant concerns exist regarding matters that would fall within the scope of the work performed by the institution's external auditors, or
- The institution has been, or is expected to be, assigned a UFIRS composite rating of 4 or 5.

However, when considering how best to use examination resources, examiners should exercise reasonable judgment with respect to performing an external audit workpaper review for these institutions. For example, it would be appropriate to conduct an external audit workpaper review for FDIC-supervised institutions when significant matters exist and the review is reasonably expected to provide an examination benefit. If examiners determine that a benefit would not be derived from performing an external audit workpaper review for an FDIC-supervised institution, examiners must document, and include in the examination workpapers, the reasons for not conducting the review.

Shared-Loss Agreements

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

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

The FDIC uses different types of agreements for commercial loans and residential mortgages. Both types cover credit losses and certain related expenses. However, for commercial assets, SLAs generally cover losses for five years and recoveries for eight years. For residential mortgages, SLAs generally cover losses and recoveries for ten years. At the inception of either type of agreement, the acquiring institution records an indemnification asset to reflect the expected FDIC loss reimbursement under the life of the SLA.

Shared-loss agreements are designed to keep assets in the private sector, place failed bank assets with local acquirers, and preserve asset values while reducing resolution costs. Banks should not allow shared-loss considerations to unduly impact foreclosure decisions. Banks should only foreclose on properties after exhausting other loss-mitigation and workout options. To avoid unnecessary home foreclosures, most residential SLAs specifically require institutions to engage in loss-mitigation efforts in accordance with the FDIC's Mortgage Loan Modification Program or the national Home Affordable Modification Program.

Examination Considerations

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

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

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

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

Risk management examiners should review management's plans and efforts to ensure that the indemnification asset has a zero balance when the period for loss protection under an SLA expires. Examiners should discuss any potential SLA concerns with a regional SLA subject matter expert.

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

Other Examination Considerations

As noted above, if any of a bank's assets are covered by an SLA, examiners should review the agreement and consider its implications during examinations or visitations. The following scheduling considerations apply to FDIC-supervised institutions that received FDIC assistance, or were involved in purchase and assumption or deposit transfer transactions. Acquiring institutions with total assets in excess of ten times the deposits acquired, which are rated composite 2 or better are exempt from the following requirements.

A visitation or limited-scope examination should be conducted at state nonmember institutions within 30 days of the transaction date to determine how funds from the FDIC are being used and whether the bank is in compliance with any applicable assistance agreement. A second visitation or limited-scope examination should be conducted within six months of the transaction. A full-scope examination should be conducted within twelve months of the transaction. Thereafter, standard examination frequency schedules apply.

A cooperative program should be established with the appropriate federal agency for national, state member, and thrift institutions to ensure that all institutions receiving FDIC funds are properly monitored and that the FDIC regional director is informed of important developments.

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MEETINGS WITH BANK PERSONNEL

Open dialogue with institution management is critical to forward-looking, risk-focused supervision. Open communication helps ensure examination requests are met and disruptions to an institution's daily activities are minimized. The EIC should extend an invitation (through senior management or directly to a board member if they meet a director during the examination) for directors to participate in regularly scheduled meetings with examiners or to schedule individual meetings with the EIC.

Director attendance at examination meetings increases their knowledge of the examination process and provides directors with an opportunity to discuss their views on bank-related matters with examiners. The meetings also allow examiners to gain insight into the experience levels and leadership qualities of bank management. While encouraging participation in examination meetings, the EIC should emphasize that director attendance is voluntary and that a lack of participation will not be viewed negatively.

Examiners should promote open communication at board meetings and encourage director participation in future examination meetings. Other ways to inform bankers and promote open communication includes references in the ROE transmittal letter and discussions during interim contacts and outreach events, such as Directors' Colleges.

Meetings with Management

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

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

Examination Planning The EIC should contact institution management approximately six to eight weeks ahead of the examination. The purpose of this contact is to discuss the preliminary description of the institution's business model, risk profile, and complexity, and to describe how those definitions are being used to determine the planned examination scope and request list content. The meeting provides an opportunity to get management's perspective on economic conditions, key challenges/risks, significant audit findings since the prior examination, and key risk-management processes. Primary topics of conversation should generally include current financial conditions; significant changes (planned or completed) to bank policies, personnel, or strategic direction; and any other significant changes since the previous examination.
The EIC should also discuss how and when information requests will be sent to the bank (electronic or hard copies), and the method and timing for any requested information to be delivered to examiners (FDIC*connect*, external media, or hard copies). Importantly, the EIC should facilitate the secure exchange of information between institution management and examiners, by ensuring that the delivery method(s) used meet the security measures discussed in the FDIC's e-Exam policies for the exchange, use, and storage of electronic information.

Finally, the EIC should conduct an onsite meeting with bank management, or conduct a telephone conversation with management if an onsite meeting is not feasible, in advance of the examination after reviewing the requested materials provided by management. The discussion should focus on examination logistics, including the size of the examination team; and plans for work to be completed off-site and on-site.

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

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

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

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

Material Preliminary Findings Normally, the EIC should notify senior management of major findings and possible recommendations before the final management meeting. This is to ensure that management has the opportunity to provide any additional information or clarification for examiner consideration before the conclusion of the examination.

Management Meetings The EIC is expected to communicate with institution management regularly during the examination to inform management of the examination progress and findings. Further, all major examination issues should be discussed with senior management as soon as practical during an examination. Additionally, all significant issues should be discussed again at the end of the examination, prior to meeting with the board of directors.

As noted in the Examination Letters for Troubled Institutions section above, the FDIC's expectations for troubled institutions should be clearly communicated to bank management between the close of an examination and the issuance of an enforcement action.

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

Meetings with Directors

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

Banks Assigned a Composite Rating of 4 or 5

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

Banks Assigned a Composite Rating of 3

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

Banks Assigned a Composite Rating of 1 or 2

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

Matters Requiring Board Attention (MRBA)

The EIC will meet with the board of directors, or a board committee, during or subsequent to the examination whenever the EIC recommends including a MRBA in the ROE. To assist directors in prioritizing their efforts to address MRBA, discussions should cover the reasons for the MRBA, highlight the benefits and importance of addressing issues and the possible consequences of not taking action.

Other Considerations

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

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

The success of a board meeting is highly dependent upon the examiner's preparation. The EIC should notify bank management as soon as possible of any plans to meet with the board to present overall examination findings. A written agenda that lists all areas to be discussed and provides supporting documents or schedules generally enhances examiners' explanations of findings and recommendations. Failure to adequately prepare for a meeting can substantially diminish the supervisory value of an examination. Both the written agenda, and the EIC discussions at the meeting, should be clear regarding items that senior management and the board are expected to address.

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

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OTHER SOURCES OF INFORMATION

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

Specialty examination findings should be addressed in the ECC section of the risk management ROE. The placement and length of related comments should be commensurate with the significance of the findings and the impact on the UFIRS ratings. Inclusion of specific specialty examination pages in the ROE in support of findings in the ECC section is addressed in Manual Section 16.1 – Report of Examination Instructions.

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

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

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

Trust Department

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

Information Technology

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

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

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

Most IT examinations should be embedded in risk management ROEs. The URSIT composite and component ratings should be assigned at each IT examination and included in the ROE in accordance with Section 16.1 of the RMS Manual.

Bank Secrecy Act

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

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

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

Consumer Protection

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

Summary

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

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DISCLOSING REPORTS OF EXAMINATION

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

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

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

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EXAMINATION WORKPAPERS

Introduction

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

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

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

- Detail examination findings and recommendations,
- Describe supporting facts and logic, and
- Record management responses and completion dates for promised corrective actions.

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

Safeguarding Examination Information

Examination information may contain non-public customer information as defined in Section 501(b) of the Gramm-Leach-Bliley Act. Therefore, examiners must carefully safeguard information and follow established procedures for accessing, transporting, storing, and disposing of electronic and paper information. The procedures, which may involve Washington-, regional-, and field-office practices, should include technical, physical, and administrative safeguards and an incident response program.

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

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

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

Examination Documentation (ED) Modules

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

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

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

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

Substance of Workpapers

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

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

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

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

Filing of Workpapers

Historically examiners maintained paper copies of documents to support examination findings. Generally, information can now be obtained electronically, or be captured electronically, using portable scanners. Examiners should scan documents that support examination findings unless technical or other issues require hard copies. Examiners should scan documents in a secure location within a reasonable time after receiving or developing them. Scanners should be turned off when not in use to clear the scanner's memory of previously scanned information. Examiners should return hardcopy documents to their source or destroy them in a secure manner (onsite when possible) after completing the scanning process.

Electronic documentation must be appropriately secured throughout the supervisory process to prevent disclosure of confidential or sensitive information to unauthorized individuals. Examiners should manage and store general examination documents using the Electronic Workpapers Module in the Regional Automated Document Distribution and Imaging System (RADD).

Examiners must exercise sound judgment in determining which electronic workpapers to retain. Examiners should only retain final documents that support examination or other supervisory findings (not multiple versions of a document) and delete all other documents. The examiner-in-charge is responsible for ensuring that only appropriate electronic workpapers are retained and that the workpapers are retained in accordance with existing policies and procedures.

At the conclusion of an examination or visitation, examiners should generally delete a bank's electronic workpapers from their laptops. However, electronic workpapers can be retained for longer periods if the information is needed to support ongoing business needs. In such instances, examiners should delete the electronic workpapers as soon as practical.

Note: Non-FDIC issued laptops, desktops, or other electronic devices may not be used to store institution-provided information or examination workpapers.

If hardcopy documents are maintained, the documents should be appropriately stored and secured. Each folder, envelope, or binder should be labeled with the institution's name and location, the date of examination, and a list of documents that were prepared for each category. At its discretion, each region and field office may designate the major documentation categories and supplemental lists for their respective office(s). The EIC is responsible for ensuring outdated workpapers are appropriately purged and current workpapers are properly organized and filed.

If hardcopy documents are physically transported to another location, examiners must follow existing procedures to create logs of hardcopy documents that contain personally identifiable information.

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

Retention of Workpapers

Line sheets should generally be retained for one examination cycle, after which they may be purged from the active loan deck. Risk Management and Trust Officer's Questionnaires should be retained for a minimum of ten years from the examination start date. Officer's Questionnaires should be retained indefinitely when irregularities are discovered or suspected, especially if the signed questionnaire may provide evidence of these irregularities. The examiner may submit a copy of the Officer's Questionnaire with the ROE if circumstances warrant, such as when the examiner suspects that an officer knowingly provided incorrect information on the document.

Retention of other workpapers beyond one examination should generally be confined to those banks with existing or pending administrative actions, special documents relating to past insider abuse, documents that are the subject of previous criminal referral letters, or other such sensitive documents. While the retention of workpapers beyond one examination cycle is generally discouraged, major schedules and other pertinent workpapers can be retained if deemed useful. Additionally, if a bank's composite rating is 3 or worse, most workpapers should be maintained until the bank returns to a satisfactory condition.

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ADDENDUM TO SECTION 1.1

UFIRS RATINGS DEFINITIONS

Composite Ratings

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

Composite 1

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

Composite 2

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

Composite 3

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

Composite 4

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

Composite 5

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

Component Ratings

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

Capital Adequacy

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

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

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

Ratings

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

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

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

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

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

Asset Quality

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

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

- The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices;
- The level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions;
- The adequacy of the allowance for loan and lease losses and other asset valuation reserves;

- The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit;
- The diversification and quality of the loan and investment portfolios;
- The extent of securities underwriting activities and exposure to counter-parties in trading activities;
- The existence of asset concentrations;
- The adequacy of loan and investment policies, procedures, and practices;
- The ability of management to properly administer its assets, including the timely identification and collection of problem assets;
- The adequacy of internal controls and management information systems; and
- The volume and nature of credit-documentation exceptions.

Ratings

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

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

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

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

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

Management

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

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

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

- The level and quality of oversight and support of all institution activities by the board of directors and management;
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products;
- The adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities;
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile;
- The adequacy of audits and internal controls to promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure

compliance with laws, regulations, and internal policies;
- Compliance with laws and regulations;
- Responsiveness to recommendations from auditors and supervisory authorities;
- Management depth and succession;
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority;
- Reasonableness of compensation policies and avoidance of self-dealing;
- Demonstrated willingness to serve the legitimate banking needs of the community; and
- The overall performance of the institution and its risk profile.

Ratings

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

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

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

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

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

Earnings

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

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

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

Ratings

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

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

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

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

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

Liquidity

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

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

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

Ratings

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

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

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

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

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

Sensitivity to Market Risk

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

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

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

- The sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices, or equity prices;
- The ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile;
- The nature and complexity of interest rate risk exposure arising from nontrading positions; and
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

Ratings

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

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

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

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

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

INTRODUCTION

Capital serves four essential functions:

- **Absorbs Losses**: Capital allows institutions to continue operating as going concerns during periods when operating losses or other adverse financial results are experienced.
- **Promotes Public Confidence**: Capital provides a measure of assurance to the public that an institution will continue to provide financial services even when losses have been incurred, thereby helping to maintain confidence in the banking system and minimize liquidity concerns.
- **Restricts Excessive Asset Growth**: Capital, along with minimum capital ratio standards, can act as a constraint on expansion by requiring that asset growth be funded by a commensurate amount of capital.
- **Protects Depositors and the Deposit Insurance Fund**: Placing owners at significant risk of loss, should the institution fail, helps to minimize the potential for moral hazard, and promotes safe and sound banking practices.

As federal deposit insurer and supervisor of state nonmember institutions, the FDIC places high importance on capital adequacy. Capital supports prudent asset growth and promotes public confidence, while helping banking institutions absorb unexpected losses and remain viable in times of stress. In addition, capital is the lifeblood of the credit intermediation process as it provides institutions with the capacity to gather deposits and make loans in their markets. Since capital adequacy assessments are central to the supervisory process, examiners evaluate all aspects of a financial institution's risk profile and activities to determine whether its capital levels are appropriate and in compliance with minimum regulatory requirements.

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CAPITAL PLANNING

Institution management performs capital planning to ensure that capital protection is commensurate with the institution's financial condition, business and growth plans, holding company support (if applicable), and projected capital distributions. The sophistication of capital planning can vary depending on an institution's size and complexity, as well as its products and business lines. In many cases, institutions base their strategic planning and budget processes on expectations for capital levels and earnings retention. Therefore, capital planning is essential for setting an institution's capital cushion, establishing asset growth and funding targets, pursuing new products or markets, and determining whether dividends returning capital to shareholders are appropriate and reasonable.

Institution management typically supports capital plans with realistic assumptions about prospective asset quality, earnings performance, and other business considerations. Management has a number of matters to consider when devising a capital plan, including budgets and strategic plans, expectations for loan quality through a full economic cycle, merger and acquisition objectives, and competition within the institution's markets. Management of large and complex institutions, in particular, use stress testing to help inform their capital plans by assessing the impact of plausible events or circumstances that could increase exposure to losses. Community institutions are not subject to capital stress testing, but some institutions have developed their own analyses of asset concentrations or commercial real estate loan exposures to better inform their planning.

During supervisory reviews, examiners discuss the capital planning process with management to understand how they established current and prospective capital levels. Examiners consider the board of directors' involvement in developing these plans, and whether capital levels can support asset exposures, various business cycles, and potential stress conditions.

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REGULATORY CAPITAL REQUIREMENTS

Regulatory capital requirements have evolved as innovations in financial instruments and investment activities introduced greater complexity to the banking industry. Regulatory capital rules set forth minimum capital ratio requirements and generally follow a framework of standards adopted by the Basel Committee on Banking Supervision (BCBS), an international standard-setting body that deals with various aspects of bank supervision. The FDIC is a member of the BCBS and works with the Board of Governors of the Federal Reserve System (FRB) and the Office of the Comptroller of the Currency (OCC) to establish domestic capital regulations. Additionally, statutory actions by Congress can set the direction and content of regulatory capital regulations and policy for banking organizations in the United States. Standards set forth by the Financial Accounting Standards Board may also influence domestic regulatory capital regulations.

In 2013, the FDIC, FRB, and OCC issued a comprehensive set of post-crisis regulations for U.S. institutions that align with Basel III capital standards (2013 capital rule). These regulations are designed to strengthen the quality and quantity of capital, and promote a stronger financial industry that is more resilient to economic stress. The purpose of these regulations is to promote the highest quality forms of perpetual, loss absorbing capital (like common equity, related surplus, and retained earnings), while limiting the reliance on and permissibility of lower quality forms of capital (such as hybrid or debt-like issuances and trust preferred securities). The 2013 capital rule promotes the use of capital instruments that have no maturity, no obligation to make cash or cumulative cash dividend payments, no liquidation preference, and expose shareholders to loss.

Therefore, the 2013 capital rule emphasizes common equity tier 1 capital as the predominant form of institution capital. Common equity tier 1 capital is widely recognized as the most loss-absorbing form of capital, as it is permanent and places shareholders' funds at risk of loss in the event of insolvency. Moreover, the 2013 capital rule strengthens minimum capital ratio requirements and risk-weighting definitions, increases Prompt Corrective Action (PCA) thresholds, establishes a capital conservation buffer, and provides a mechanism to mandate counter-cyclical capital buffers for the largest U.S. institutions. Some of the requirements have since been revisited to make technical amendments and incorporate statutory changes, but the overarching provisions of the 2013 capital rule remain intact.

The 2013 capital rule applies to all insured depository institutions. For FDIC-supervised institutions, the capital rules are contained in Part 324 of the FDIC Rules and Regulations. Part 324 defines capital elements, establishes risk-weighting approaches for determining capital requirements under the standardized and advanced approaches, and sets PCA standards that prescribe supervisory action for institutions that are not adequately capitalized. Part 324 also established requirements to maintain a capital conservation buffer that affects capital distributions and discretionary payments. The capital requirements included in Part 324 that apply to all insured depository institutions are collectively referred to as the generally applicable requirements or the generally applicable capital rule. Capital requirements such as the supplementary leverage ratio (SLR) or the requirement to use internal models to calculate risk-weighted assets (advanced approaches) are additional requirements that apply only to a subset of the largest U.S. institutions and are not part of the generally applicable capital rule.

This chapter is only meant to provide an overview of the capital rules; examiners should refer to Part 324 for detailed requirements.

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COMPONENTS OF CAPITAL

Part 324 establishes two broad components of capital which are known as tier 1 capital and tier 2 capital. Tier 1 capital is the predominant form of capital in the U.S. and represents the sum of common equity tier 1 capital and additional tier 1 capital. Tier 2 capital includes several less subordinated capital instruments (i.e., less subordinated than tier 1 capital instruments) and balance sheet items that are not allowable in tier 1 capital.[1] Components of tier 1 and tier 2 capital are used to calculate minimum regulatory capital ratios described in Part 324 and are described in more detail below.

Common Equity Tier 1 Capital

Common equity tier 1 capital is the most loss-absorbing form of capital. It includes qualifying common stock and related surplus net of treasury stock; retained earnings; certain accumulated other comprehensive income (AOCI) elements if institution management does not make an AOCI opt-out election, plus or minus regulatory deductions or adjustments as appropriate; and qualifying common equity tier 1 minority interests. The federal banking agencies expect the majority of common equity tier 1 capital to be in the form of common voting shares and retained earnings.

Part 324 allowed all non-advanced approach institutions to make a permanent, one-time opt-out election, enabling them to calculate regulatory capital without AOCI. Such an election neutralizes the impact of unrealized gains or losses on balance sheet instruments, including available-for-sale bond portfolios, in the context of regulatory capital levels. To opt-out, institutions must have made a one-time permanent election on the March 31, 2015 Call Report. For institutions that did not or cannot opt-out, the AOCI adjustment to common equity tier 1 capital could have an impact on regulatory capital ratios if significant bond portfolio appreciation or depreciation is encountered.

Part 324 requires that several items be fully deducted from common equity tier 1 capital, such as goodwill, deferred tax assets (DTAs) that arise from net operating loss and tax credit carry-forwards, other intangible assets (except for mortgage servicing assets (MSAs)), certain DTAs arising from temporary differences (temporary difference DTAs), gains on sale of securitization exposures, and certain investments in another financial institution's capital instruments. Additionally, management must adjust for unrealized gains or losses on certain cash flow hedges.

[1] Institutions that elect the Community Bank Leverage Ratio (CBLR) framework do not calculate tier 2 capital (refer to the Community Bank Leverage Ratio section for details about the CBLR).

Finally, non-advanced approaches institution management must consider threshold deductions for three specific types of assets: investments in the capital of unconsolidated financial institutions, MSAs, and temporary difference DTAs. Generally, management must deduct the amount of exposure to these types of assets, by category that exceeds 25 percent of a base common equity tier 1 capital calculation. The amounts of MSAs and temporary difference DTA threshold items not deducted are assigned a 250 percent risk-weight, while investments in the capital of unconsolidated financial institutions that are not deducted get assigned a risk-weight determined by the type of asset exposure (e.g., common stock, preferred stock, sub-debt).

Additional Tier 1 Capital

Additional tier 1 capital includes qualifying noncumulative perpetual preferred stock, bank-issued Small Business Lending Fund (SBLF) and Troubled Asset Relief Program (TARP) instruments that previously qualified for tier 1 capital,[2] and qualifying tier 1 minority interests, less certain investments in other unconsolidated financial institutions' instruments that would otherwise qualify as additional tier 1 capital.

Tier 2 Capital

Under the generally applicable rule, tier 2 capital includes the allowance for loan and lease losses (ALLL)[3] up to 1.25 percent of risk-weighted assets, qualifying preferred stock, subordinated debt, and qualifying tier 2 minority interests, less any deductions in the tier 2 instruments of an unconsolidated financial institution. Effective April 1, 2019, the agencies revised the regulatory capital rules to include a new term, adjusted allowances for credit losses (AACL), which replaces the term ALLL in the capital rules upon an institution's adoption of Accounting Standards Codification (ASC) Topic 326, Financial Instruments – Credit Losses, which includes the Current Expected Credit Losses or CECL allowance methodology. The term allowance for credit losses (ACL) as used in ASC Topic 326 applies to most financial assets, including available-for-sale (AFS) debt securities. In contrast, the term AACL, as used in the regulatory capital rules, excludes credit loss allowances on purchased credit deteriorated assets and AFS debt securities.[4] The AACL also excludes an institution's allocated transfer risk reserves, if any.

Part 324 eliminates previous limits on term subordinated debt, limited-life preferred stock, and the amount of tier 2 capital includable in total capital.

Deductions and Limits

The 2013 capital rule introduced a number of limitations and deductions that were generally in response to issues recognized during the financial crisis of 2008 and were adopted to enhance the quality of capital. Investments in the capital instruments of another financial institution, such as common stock, preferred stock, subordinated debt, and trust preferred securities might need to be deducted from each tier of capital.

For advanced approaches institutions only, investments in the capital of unconsolidated financial institutions must be analyzed to determine whether they are significant or non-significant, which depends on the percentage of common stock that an institution owns in the other financial institution. If the institution owns 10 percent or less of the other institution's common shares, then all of that investment is non-significant. If an institution owns more than 10 percent, then all of the investment in that company is significant. Part 324 contains separate deduction requirements for significant and non-significant investments.

In most cases, threshold-based deductions for all institutions will be made from the tier of capital for which an investment would otherwise be eligible. To illustrate, if an institution's investment is an instrument that qualifies as tier 2 capital, it is deducted from tier 2 capital. If it qualifies as an additional tier 1 capital instrument, it is deducted from additional tier 1 capital. If it qualifies as a common equity tier 1 capital instrument, it is deducted from common equity tier 1 capital. If the institution does not have sufficient tier 2 capital to absorb a deduction, then the excess amount is deducted from additional tier 1 capital or from common equity tier 1 capital if there is insufficient additional tier 1 capital.

Part 324 limits the amount of minority interest in a subsidiary that may be included in each tier of capital. To be included in capital, the instrument that gives rise to minority interest must qualify for a particular tier of capital. Non-advanced approaches institutions are allowed to include common equity tier 1, tier 1, and total capital minority interest up to 10 percent of the banking organization's total capital (before the inclusion of any

[2] SBLF and TARP were federal financial stability programs that provided capital support to financial institutions in response to the 2008 financial crisis.

[3] Adjusted allowances for credit losses replaces the term ALLL for institutions that have adopted ASC Topic 326. Such institutions may also elect to apply a Current Expected Credit Losses (CECL) transition provision over three or five years, if applicable. See the section below titled CECL Transition Period.

[4] Purchased credit deteriorated assets and AFS debt securities are risk-weighted net of credit loss allowances as measured under ASC Topic 326.

minority interest). Minority interest is further limited for non-advanced approaches institutions to 10 percent of each tier of capital (before the inclusion of any minority interest).

For advanced approaches banking organizations, limitations for common equity tier 1 minority interest, tier 1 minority interest, and total capital minority interest are based on the capital requirements and capital ratios of each of the banking organization's consolidated subsidiaries that have issued capital instruments held by third parties.

CECL Transition Period

The capital rule provides the option to phase in over a three-year period the day-one adverse effects on regulatory capital that may result when an institution adopts the new accounting standard ASC Topic 326, which includes the CECL methodology. Institutions can elect the CECL transition provision to transition the day-one impact of adopting ASC Topic 326 in regulatory capital through transition adjustments to retained earnings, average total consolidated assets, temporary difference DTAs, and the AACL. The date of CECL adoption by institutions may range between 2019 for early adopters, to as late as 2023 for some institutions. An institution that does not elect to use the CECL transition provision in the regulatory report for the quarter in which it first reports its credit loss allowances as measured under CECL will not be permitted to make an election in subsequent reporting periods.

Institutions that adopted CECL in 2020 had the option to mitigate the estimated regulatory capital effects of CECL for two years, followed by a three-year transition period. Taken together, these measures offered these institutions a transition period of up to five years.

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CAPITAL RATIOS

Minimum regulatory capital requirements for insured depository institutions are based on a combination of risk-based and leverage ratio calculations. Part 324's risk-based requirements set minimum ratios for the Common Equity Tier 1, Tier 1 Risk-Based, and Total Risk-Based Capital Ratios as described in the following sections. A single leverage ratio of Tier 1 Capital to Average Total Assets is also required. If an institution qualifies for and elects the CBLR framework, it only has one minimum regulatory capital ratio—the CBLR.

A major difference between risk-based and leverage capital ratios is the denominator. The three risk-based ratios use risk-weightings to measure on- and off-balance sheet exposures and are aggregated as "total risk-weighted assets." These risk-weightings can vary across asset classes and exposures depending on their inherent risk. For instance, U.S. Treasury securities have a 0 percent risk weight, while a commercial loan to a private business would generally receive a risk-weight of 100 percent under the Standardized Approach. Separately, leverage ratios are based on average total assets. The numerator for the leverage capital ratio is tier 1 capital. The numerators for the risk-based capital ratios are common equity tier 1 capital, additional tier 1 capital, and total capital. Total capital includes the ALLL or AACL up to regulatory limits, as applicable.

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RISK-WEIGHTED ASSETS

Part 324 prescribes two approaches to risk weighting assets. The standardized approach, which all institutions must use, and the advanced approaches, which are used by larger, more complex institutions. This section is not applicable to institutions electing the CBLR framework, since those institutions are not required to calculate or report risk-based capital. As a result, examiners should not apply risk-based calculations to CBLR-electing institutions or indicate to management in any way that such computations are required. The CBLR is described in more detail below.

Standardized Approach

An institution's balance sheet assets and credit equivalent amounts of off-balance sheet items are generally assigned to one of four risk categories (0, 20, 50, and 100 percent) according to the obligor, or if relevant, the guarantor or the nature of the collateral. Part 324, Subpart D (Risk-weighted Assets-Standardized Approach) sets forth the criteria for categorizing non-advanced approach institutions' assets and off-balance sheet exposures for risk-weighting purposes.

Since the risk-weighting system was first introduced in the United States in the early 1990s, the general process of risk weighting assets has not changed. However, several changes implemented by the standardized approach involve risk-weights other than the 0, 20, 50, and 100 percent categories. These changes are individually outlined below and include high volatility commercial real estate (HVCRE) loans; past due asset exposures; securitizations or structured investments; equity exposures; and collateralized and guaranteed exposures.

HVCRE Loans

An HVCRE loan generally refers to a subset of acquisition, development, and construction loans that is assigned a risk-weight of 150 percent. HVCRE loans include:

- A credit facility that is secured by real property and primarily finances, has financed, or refinances acquisition, development, or construction of real property;
- An extension of credit that provides financing to acquire, develop, or improve such real property into income-producing property; and
- A credit facility that is dependent on future income or sales proceeds from, or refinancing of, such real property for repayment.

The HVCRE definition provides several exclusions, including:

- One-to four-family residential properties;
- Community development projects;
- Agricultural land;
- Existing income-producing property secured by permanent financings;
- Certain commercial real property projects where the borrower has contributed at least 15 percent of the as-completed value of the project;
- Real property where the loan has been reclassified as a non-HVCRE loan; and
- Real estate where the loan was made before January 1, 2015.

The HVCRE definition does not apply in any manner to institutions that elect the CBLR.

Past-Due Asset Risk-Weights

The standardized approach requires financial institutions to transition assets that are 90 days or more past due or on nonaccrual from their original risk-weight to 150 percent. For example, if the institution held a revenue bond that was on nonaccrual, Part 324 requires the bond to be risk weighted at 150 percent compared to its original 50 percent risk-weight. This treatment could potentially apply to commercial, agricultural, multi-family, and consumer loans as well as fixed-income securities. However, this requirement does not apply to past due 1-4 family residential real estate loans (which would be risk weighted at 100 percent), HVCRE (risk weighted at 150 percent), exposures to sovereign entities, and the portion of loan balances with eligible guarantees or collateral where the risk-weight can vary.

Structured Securities and Securitizations

Part 324 establishes sophisticated risk-weight approaches for securitization exposures and structured security exposures that are retained on- or off-balance sheet. Typical examples of securitization exposures include private label collateralized mortgage obligations (CMOs), trust preferred collateralized debt obligations, and asset-backed securities, provided there is tranching of credit risk. Generally, pass-through and government agency CMOs are excluded from the securitization exposure risk-weight approaches. In general, Part 324 requires FDIC-supervised institutions to calculate the risk-weight of securitization exposures using either the *gross-up approach* or the *Simplified Supervisory Formula Approach* (SSFA) consistently across all securitization exposures, except in certain cases. For instance, the institution can, at any time, risk weight a securitization exposure at 1,250 percent.

The gross-up approach is similar to earlier risk-based capital rules, where capital is required on the credit exposure of the institution's investment in the subordinate tranche, as well as its pro rata share of the more senior tranches it supports. The gross-up approach calculates a capital requirement based on the weighted-average risk-weights of the underlying exposures in the securitization pool.

The SSFA is designed to assign a lower risk-weight to more senior-class securities and higher risk-weights to support tranches. The SSFA is both risk sensitive and forward looking. The formula adjusts the risk-weight for a security's underlying collateral based on key risk factors, such as incurred losses, nonperforming loans, and the ability of subordinate tranches to absorb losses. In any case, a securitization is assigned at least a minimum risk-weight of 20 percent.

Securitization Due Diligence

Section 324.41(c) implements due diligence requirements for securitization exposures. The analysis must be commensurate with the complexity of the securitization exposure and the materiality of the exposure in relation to capital.

Under these requirements, management must demonstrate a comprehensive understanding of the features of a securitization exposure that would materially affect its performance. The due diligence analysis must be conducted prior to acquisition and at least quarterly as long as the instrument is in the institution's portfolio.

When conducting analysis of a securitization exposure, management typically considers structural features, such as:

- Credit enhancements,
- Performance of servicing organizations,
- Deal-specific definitions of default, and
- Any other features that could materially impact the performance of the exposure.

Management also typically assesses relevant performance information of the underlying credit exposures, such as:

- Past due payments;
- Prepayment rates;
- Property types;
- Average loan-to-value ratios;
- Geographic and industry diversification;
- Relevant market data information, such as bid-ask spreads;
- Recent sale prices;
- Trading volumes;
- Historic price volatility;
- Implied market volatility; and
- The size, depth, and concentration level of the market for the securitization.

For re-securitization exposures, management will typically assess the performance on underlying securitization exposures.

If management is not able to demonstrate sufficient understanding of a securitization exposure, per Section 324.41(c)(1) the institution must assign the exposure a 1,250 percent risk-weight.

Equity Risk-Weights

Part 324 assigns various risk-weights for equity investments. For institutions that are permitted to hold publicly traded equities, the risk-weight for these assets ranges from 100 to 300 percent. A risk-weight of 400 percent is assigned to non-publicly traded equity exposures. A risk-weight of 600 percent is assigned to investments in a hedge fund or investment fund that has greater than immaterial leverage. In addition, under Part 324, institutions may assign a 100 percent risk-weight to the aggregate adjusted carrying value of certain equity exposures that do not exceed 10 percent of the institution's total capital. To qualify for the 100percent risk-weight, an institution must include the following equity exposures in the following order up to 10 percent of total capital: first include equity exposures to unconsolidated small business investment companies or held through consolidated small business investment companies described in section 302 of the Small Business Investment Act, then include publicly traded equity exposures (including those held indirectly through investment funds), and then include non-publicly traded equity exposures (including those held indirectly through investment funds). For non-advanced approaches institutions, the equity exposure risk-weights similarly apply to investments in the capital of unconsolidated financial institutions that are not deducted from capital.

Part 324 also contains various look-through approaches for equity exposures to investment funds. For example, if an institution has an equity investment in a mutual fund that invests in various types of bonds, the regulation directs how to assign proportional risk-weights based on the underlying investments. In addition, generally lower risk-weights apply to a few specific classes of equity securities. The risk-weight for Federal Reserve Bank stock is 0 percent, Federal Home Loan Bank stock receives a 20 percent risk-weight, and community development exposures, including Community Development Financial Institutions, are assigned 100 percent risk-weights. Examiners should refer to Sections 324.51, 324.52, and 324.53 for additional information regarding risk-weights for equity exposures.

Collateralized Transactions

In certain circumstances, management has the option to recognize the risk-mitigating effects of financial collateral to reduce the risk-based capital requirements associated with a collateralized transaction. Financial collateral includes cash on deposit (or held for the institution by a third party trustee), gold bullion, certain investment grade[5] securities, publicly traded equity securities, publicly traded convertible bonds, and certain money market fund shares.

Part 324 permits two general approaches to recognize financial collateral for risk-weighting purposes. The simple approach generally allows substituting the risk-weight of the financial collateral for the risk-weight of any exposure. In order to use the simple approach, the collateral must be subject to a collateral agreement for at least the life of the exposure, the collateral must be revalued at least every six months, and the collateral (other than gold) and the exposure must be denominated in the same currency. The second approach, the collateral haircut (discount) approach, allows management to calculate the exposure for repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions using a mathematical formula and supervisory haircut factors. Refer to Section 324.37 for additional details.

Most institutions are likely to use the simple approach; however, regardless of the approach chosen, it must be applied consistently for similar exposures or transactions.

The following are examples under the simple approach. Management may assign a 0 percent risk-weight to the

[5] *Investment grade* means that the issuer has adequate capacity to meet financial commitments for the projected life of the asset or exposure.

collateralized portion of an exposure where the financial collateral is cash on deposit. Management may also assign a 0 percent risk-weight if the financial collateral is an exposure to a sovereign[6] that qualifies for a 0 percent risk-weight and management has discounted the market value of the collateral by 20 percent. Transactions collateralized by debt securities of government-sponsored entities receive a 20 percent risk-weight, while risk-weights for transactions collateralized by money market funds will vary according to the funds' investments. Finally, for transactions collateralized by investment grade securities, such as general obligation municipal, revenue, and corporate bonds, management may use collateral risk-weights of 20, 50, and 100 percent, respectively.

Treatment of Guarantees

Under Part 324, management has the option to substitute the risk-weight of an eligible guarantee or guarantor for the risk-weight of the underlying exposure. For example, if the institution has a loan guaranteed by an eligible guarantor, management can use the risk-weight of the guarantor. Eligible guarantors include entities such as depository institutions and holding companies, the International Monetary Fund, Federal Home Loan Banks, the Federal Agricultural Mortgage Corporation, entities with investment grade debt, sovereign entities, and foreign institutions. An eligible guarantee must be written, be either unconditional or a contingent obligation of the U.S. government or its agencies, cover all or a pro rata share of all contractual payments, give the beneficiary a direct claim against the protection provider, and meet other requirements outlined in the definition of eligible guarantees under Section 324.2.

Off-Balance Sheet Exposures

The risk-weighted amounts for all off-balance sheet items are determined by a two-step process. First, the "credit equivalent amount" is determined by multiplying the face value or notional amount of the off-balance sheet item by a credit conversion factor. A table contained in Part 324 shows the conversion factors. This process effectively turns an off-balance sheet exposure into an on-balance sheet amount for risk-based calculation purposes only. Next, the appropriate risk-weight (based on the risk category of the exposure) is applied to the credit equivalent amount, like any other balance sheet asset. Refer to Part 324 for more details.

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REGULATORY CAPITAL REQUIREMENTS

As defined by Section 324.10(a), FDIC-supervised institutions must maintain the following minimum capital ratios under the generally applicable capital rule. These requirements are identical to those for national and state member institutions.

- Common equity tier 1 capital to total risk-weighted assets ratio of 4.5 percent,
- Tier 1 capital to total risk-weighted assets ratio of 6 percent,
- Total capital to total risk-weighted assets ratio of 8 percent, and
- Tier 1 capital to average total assets ratio (tier 1 leverage ratio) of 4 percent.

Qualifying institutions that elect the CBLR framework are subject to a single leverage ratio of greater than 9 percent. Institutions meeting or exceeding these minimum requirements are considered to be compliant with the generally applicable capital rule. Therefore, risk-based capital requirements would not apply; refer to the section below titled, Community Bank Leverage Ratio for more information.

Section 324.4(b) indicates that any insured institution that has less than its minimum leverage capital requirement may be deemed to be engaged in an unsafe and unsound practice pursuant to Section 8 of the FDI Act, unless the institution has entered into and is in compliance with a written agreement or has submitted and is in compliance with a plan approved by the FDIC to increase its leverage capital ratio and take other action as may be necessary. Separately, Section 324.4(c) mandates that any insured depository institution with a tier 1 capital to total assets[7] ratio of less than 2 percent may be deemed to be operating in an unsafe and unsound condition.

Notwithstanding the minimum capital requirements under the generally applicable capital rule and the CBLR, an FDIC-supervised institution must maintain capital commensurate with the level and nature of all risks to which the institution is exposed. Furthermore, an FDIC-supervised institution must have a process for assessing its overall capital adequacy in relation to its risk profile and a

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[6] *Sovereign* means a central government (including the U.S. government) or an agency, department, ministry, or central bank.

[7] Total assets means the quarterly average total assets as reported in an FDIC-supervised institution's Call Report, minus amounts deducted from tier 1 capital under Sections 324.22(a), (c), and (d). At its discretion, the FDIC may calculate total assets using an FDIC-supervised institution's period-end assets rather than quarterly average assets.

comprehensive strategy for maintaining an appropriate level of capital. The FDIC is not precluded from taking formal enforcement actions against an insured depository institution with capital above the minimum requirements if the specific circumstances indicate such action is appropriate.

Additionally, FDIC-supervised institutions that fail to maintain capital at or above minimum leverage capital requirements may be issued a capital directive by the FDIC. Capital directives generally require institution management to restore the institution's capital to the minimum leverage requirement within a specified time period. Refer to this manual's Section 15.1 – Formal Administrative Actions for further discussion on capital directives.

Capital Conservation Buffer

The capital conservation buffer is designed to strengthen an institution's financial resilience during economic cycles. Financial institutions under the generally applicable capital rule are required to maintain a capital conservation buffer of greater than 2.5 percent in order to avoid restrictions on capital distributions and other payments. Part 324 requires institutions to meet their capital conservation buffer requirement with common equity tier 1 capital. Again, because qualifying institutions using the CBLR framework are considered in compliance with the generally applicable capital rule, they are not subject to the capital conservation buffer.

Under Section 324.11, if an institution's capital conservation buffer falls below the amount listed in the table below, its maximum payout amount for capital distributions and discretionary payments declines to a set percentage of eligible retained income based on the size of the institution's buffer.

Capital Conservation Buffer (% of RWA)	Maximum Payout Ratio (% of Eligible Retained Income)
Greater than 2.5%	No payout limitation
Less than or equal to 2.5% and greater than 1.875%	60%
Less than or equal to 1.875% and greater than 1.25%	40%
Less than or equal to 1.25% and greater than 0.625%	20%
Less than or equal to 0.625%	0%

The types of payments subject to the restrictions include dividends, share buybacks, discretionary payments on tier 1 instruments, and discretionary bonus payments. It is important to note that the FDIC maintains the authority to impose further restrictions to help ensure that capital is commensurate with the institution's risk profile.

An institution cannot make capital distributions or certain discretionary bonus payments during the current calendar quarter if its eligible retained income is negative and its capital conservation buffer was less than 2.5 percent as of the end of the previous quarter. Eligible retained income is the greater of (1) an institution's net income, calculated in accordance with the instructions to the Call Report, for the four calendar quarters preceding the current calendar quarter, net of any distributions and associated tax effects not already reflected in net income; and (2) the average of the institution's net income, calculated in accordance with the instructions to Call Report, for the four calendar quarters preceding the current calendar quarter.

To calculate the capital conservation buffer for a given quarter, each minimum risk-based capital requirement in Part 324 is subtracted from the institution's corresponding capital ratios. The following ratios would be subtracted from the institution's corresponding ratio to derive the buffer amount:

- Common equity tier 1 risk-based capital ratio minus 4.5 percent;
- Tier 1 risk-based capital ratio minus 6 percent; and
- Total risk-based capital ratio minus 8 percent.

The lowest of the three measures would represent the institution's capital conservation buffer and is used to determine its maximum payout for the current quarter. To the extent an institution's capital conservation buffer is 2.5 percent or less of risk-weighted assets, the institution's maximum payout amount for capital distributions and discretionary payments would decline. Examiners should be aware that an institution's minimum capital ratios plus a capital conservation buffer of 2.5 percent results in a capital requirement that is 50 basis points greater than the PCA well-capitalized ratio levels. For example, to avoid restrictions under the capital conservation buffer, an institution must have a total risk-based capital ratio of 10.5 percent, whereas to be well-capitalized under PCA an institution must have a total risk-based capital ratio of 10 percent.

The FDIC may permit an FDIC-supervised institution that is otherwise limited from making distributions and discretionary bonus payments to make a distribution or discretionary bonus payment upon an institution's request, if the FDIC determines that the distribution or discretionary bonus payment would not be contrary to the purposes of this section, or to the safety and soundness of the FDIC-supervised institution. The FDIC issued Financial

Institution Letter 40-2014 (Requests from S-Corporation Banks for Dividend Exceptions to the Capital Conservation Buffer) to describe how the FDIC will consider requests from S-corporation banks or savings associations to pay dividends to shareholders to cover taxes on their pass-through share of the bank's earnings, when these dividends would otherwise not be permitted under the capital conservation buffer requirements.

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COMMUNITY BANK LEVERAGE RATIO

Statutory and Regulatory Background

The Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 introduced the CBLR framework for qualifying institutions as a simple, optional methodology for calculating a single regulatory capital ratio. These institutions would receive burden relief by not having to calculate and report risk-weighted assets. Qualifying institutions may elect the CBLR framework at any time through their Call Report filings. To be a qualifying community banking organization, an insured depository institution must not be an advanced approaches banking organization and must meet the following qualifying criteria:

- A leverage ratio of greater than 9 percent;
- Total consolidated assets of less than $10 billion;
- Total off-balance sheet exposures (excluding derivatives other than sold credit derivatives and unconditionally cancelable commitments) of 25 percent or less of total consolidated assets; and
- The sum of total trading assets and trading liabilities of 5 percent or less of total consolidated assets.

If an institution has a ratio above the CBLR requirement, the regulatory agencies would consider it to have met:

- The generally applicable risk-based and leverage capital requirements;
- The capital ratio requirements to be considered well capitalized under the PCA framework, with some exclusions (see the PCA and CBLR Institutions section); and
- Any other applicable capital or leverage requirements, such as the capital conservation buffer.

As long as they meet the requirements, electing institutions will not be required to report any risk-based or capital conservation buffer calculations, including for example risk-based capital requirements for HVCRE loan exposures.

The CBLR Calculation

The CBLR is calculated as the ratio of tier 1 capital divided by average total consolidated assets, consistent with the generally applicable leverage ratio. The calculation takes into account the modifications made in relation to the capital simplifications rule and the CECL transitions final rule, and it is anticipated that the numerator will reflect any future modifications to the tier 1 capital definition applicable to non-advanced approaches organizations.

Maintaining CBLR Eligibility

Under the CBLR framework, there are four ways that an electing institution might be required to revert to the risk-based capital requirements in the generally applicable capital rule:

- Failing to meet any of the CBLR eligibility requirements and not returning to compliance by the end of the two-quarter grace period which includes:
  - Reporting a CBLR of 9 percent or lower but greater than 8 percent,
  - Holding trading assets and liabilities exceeding 5 percent of total consolidated assets,
  - Reporting off-balance sheet exposures of more than 25 percent of total consolidated assets, or
  - Exceeding $10 billion in total consolidated assets;
- Becoming an advanced approaches banking organization;
- Reporting a CBLR of 8 percent or less; or
- Ceasing to satisfy the qualifying criteria due to consummation of a merger transaction.

Management weaknesses, non-capital financial problems, or the existence of a corrective program, as well as other supervisory issues that are significant for capital adequacy assessment purposes, are not qualifying conditions for the CBLR and have no bearing on whether an institution can remain eligible for the CBLR framework. Supervisory issues with no bearing on CBLR eligibility can include:

- Adverse CAMELS component and composite ratings or downgrades,
- Consent orders,
- Undue concentrations,
- Adverse consumer protection and Community Reinvestment Act ratings,
- Anti-Money Laundering/Counter the Financing of Terrorism deficiencies, or
- Information technology weaknesses.

Additional Capital and Administrative Actions

In certain circumstances, the FDIC can direct electing institutions to hold additional capital above the 9 percent

CBLR to address high-risk exposures or significant supervisory matters in accordance with Part 324. CBLR implementation has no effect on the FDIC's authority to pursue administrative actions or require a higher CBLR when appropriate to promote safety and soundness.

Compliance Grace Period

If an electing institution does not satisfy one or more of the qualifying criteria but continues to report a leverage ratio of greater than 8 percent, it can continue to use the CBLR and be deemed to meet the "well-capitalized" capital ratio requirements for a grace period of up to two quarters. If the institution is able to return to compliance with all the qualifying criteria within two quarters, it will continue to meet the "well-capitalized" ratio requirements and the generally applicable capital rule.

An electing institution will be required to comply with the generally applicable capital rule, including risk-based and capital conservation buffer requirements, and must file relevant regulatory reports if it meets any of the following:

- Is unable to restore compliance with all qualifying criteria during the two-quarter grace period (including compliance with the greater than 9 percent leverage ratio requirement),
- Reports a leverage ratio of 8 percent or less, or
- Does not satisfy the qualifying criteria due to consummation of a merger transaction.

There is no grace period for institutions with a CBLR of 8 percent or less as the CBLR framework automatically makes such institutions ineligible. These institutions may re-elect the CBLR framework once their CBLR is back above 9 percent, assuming all other qualifying criteria are met.

Discretionary Opt Out from the CBLR

An electing institution can opt out of the CBLR framework at any time, without restriction, and revert to the generally applicable capital rule by providing the required leverage and risk-based capital ratios to its primary federal regulator at the time of opting out. This means that an FDIC-supervised institution may opt out of the framework through its Call Report filing, and also between quarters by providing a letter notice to the regional director that details the institution's applicable leverage and risk-based capital ratios at the time of opting out.

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PROMPT CORRECTIVE ACTION

Institutions that are Subject to the Generally Applicable Capital Rule

Part 324, Subpart H (Prompt Corrective Action) was issued by the FDIC pursuant to Section 38 of the FDI Act. Its purpose is to establish the capital measures and levels that are used to determine supervisory actions authorized under Section 38 of the FDI Act. Subpart H also outlines the procedures for the submission and review of capital restoration plans and other directives pursuant to Section 38. Neither Subpart H nor Section 38 limits the FDIC's authority to take supervisory actions to address unsafe or unsound practices or conditions, deficient capital levels, or violations of law. Actions under this Subpart and Section 38 may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the FDIC.

The following table summarizes the PCA categories for non-CBLR institutions.

PCA Category	Total RBC Ratio	Tier 1 RBC Ratio	Common Equity Tier 1 RBC Ratio	Tier 1 Leverage Ratio
Well Capitalized	≥ 10%	≥ 8%	≥ 6.5%	≥ 5%
Adequately Capitalized	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%
Undercapitalized	< 8%	< 6%	<4.5%	< 4%
Significantly Undercapitalized	< 6%	< 4%	< 3%	< 3%
Critically Undercapitalized	Tangible Equity/Total Assets ≤ 2%			

Any institution that does not meet the minimum PCA requirements may be deemed to be in violation of Part 324, and engaged in an unsafe or unsound practice, unless institution management has entered into and is in compliance with a written plan approved by the FDIC. In addition, under Subpart H, the FDIC may reclassify a well-capitalized FDIC-supervised institution as adequately capitalized, or require an adequately capitalized or undercapitalized FDIC-supervised institution to comply with certain mandatory or discretionary supervisory actions as if the institution were in the next lower PCA category. Refer to Part 324, Subpart H for further details.

CBLR Institutions

Institutions electing the CBLR framework are considered to have met the "well-capitalized" ratio requirements for PCA purposes. However, an electing institution can meet the PCA "well-capitalized" ratio requirements but be classified as something other than well-capitalized. For example, if an electing institution is subject to a consent order with a capital maintenance provision, it would be reclassified as "adequately capitalized" for PCA purposes pursuant to Section 324.403(b)(1)(i)(E) of the capital rule. In such situations, the electing institution can remain in the CBLR framework as long as it continues to meet the qualification standards.

Additionally, pursuant to Section 324.403(d) of the capital rule, the FDIC can reclassify a qualified, electing institution to "adequately capitalized" for PCA purposes based on supervisory criteria *other* than capital. Again, such an "adequately capitalized" institution can remain in the CBLR framework.

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CAPITAL RULES APPLICABLE TO THE LARGEST INSURED DEPOSITORY INSTITUTIONS

While all banking organizations are subject to the generally applicable capital rule, beginning in 2020, the applicability of certain capital requirements are tailored for the largest banking organizations with total consolidated assets of $100 billion or more. These regulatory changes apply to capital as well as liquidity requirements and are often referred to as the "tailoring rule." The tailoring rule sets forth four categories for large banking organizations (depending on size and other factors), and institution subsidiaries are included in the same category as their parent. The rule applies more complex aspects of the capital rule, such as the advanced approaches according to risk profile. Category I institutions are U.S. Global Systemically Important Banks (GSIBs) and are considered the most complex and systemic in the hierarchy of the tailoring rule. As such, Category I organizations are subject to the most stringent requirements. The table below summarizes the additional capital requirements for Category I – IV institutions.

Category	Requirements
Category I: U.S. Global Systemically Important Banks (GSIBs)	Advanced approaches; countercyclical capital buffer; no opt out of accumulated other comprehensive income (AOCI) capital impact; GSIB surcharge for BHCs; enhanced SLR; Total Loss Absorbing Capacity and Long Term Debt requirements for BHCs; Federal Reserve's Comprehensive Capital Analysis and Review process for BHCs.
Category II: Banking organizations with $700 billion or more in total assets or $75 billion or more in cross-jurisdictional activity that are not GSIBs.	Advanced approaches; countercyclical capital buffer; no opt out of AOCI capital impact; SLR; Federal Reserve's Comprehensive Capital Analysis and Review process for BHCs.
Banks in Categories I and II are known as "advanced approaches banks"	
Category III: Banking organizations that are not subject to Category I or Category II thresholds and that have either: $250 billion or more in total assets; or $100 billion but less than $250 billion in total assets and $75 billion or more of any of the following nonbank assets, weighted short-term wholesale funding (STWF), or off-balance-sheet exposures	Countercyclical capital buffer; allow opt out of AOCI capital impact; SLR; Federal Reserve's Comprehensive Capital Analysis and Review process for BHCs.
Category IV: Banking organizations that are U.S. depository institution holding companies or U.S. intermediate holding companies with at least $100 billion in total assets that do not meet any of the thresholds specified for Categories I-III.	Allow opt out of AOCI capital impact; Federal Reserve's Comprehensive Capital Analysis and Review process for BHCs.

Supplementary Leverage Ratio

For advanced approaches institutions, as well as institutions that are part of a Category III banking organization, an SLR ratio of 3 percent is required. The SLR is calculated differently than the tier 1 leverage ratio. The SLR is a stand-alone ratio that must be calculated by dividing tier 1 capital by total leverage exposure. Total leverage exposure consists of on-balance sheet items, less amounts deducted from tier 1 capital, plus certain off-balance sheet exposures including:

- Potential future credit exposure related to derivatives contracts;
- Cash collateral for derivative transactions not meeting certain criteria;
- Effective notional amounts of sold credit derivatives;

- Gross value of receivables of repo-style transactions not meeting certain criteria;
- Ten percent of the notional amount of unconditionally cancellable commitments; and
- The notional amount of all other off-balance sheet exposures multiplied by standardized credit conversion factors, excluding securities lending and borrowing transactions, reverse repurchase agreements, and derivatives.

The supplementary leverage ratio is derived by calculating the arithmetic mean of this measure for the last day of each month in the reporting period.

Custody Banks

Certain deposits of custody banks with qualifying central banks are excluded from the supplementary leverage ratio. For purposes of the supplementary leverage ratio, a custody bank is defined as any U.S. top-tier depository institution holding company with a ratio of assets-under-custody-to-total-assets of at least 30:1. Any depository institution subsidiary of such a holding company would be considered a custody bank. The amount of central bank deposits that can be excluded from total leverage exposure cannot exceed the amount of deposit liabilities that are linked to fiduciary or custody and safekeeping accounts.

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OTHER REGULATORY REQUIREMENTS

Examiners should be aware of other regulatory requirements that may address capital, which include but are not limited to:

Topic	Rule
Risk-Based Insurance Premiums	Part 327 of the FDIC Rules and Regulations
Brokered Deposits and Interest Rate Restrictions	Sections 337.6 and 337.7 of the FDIC Rules and Regulations
Limits on Extensions of Credit to Insiders	Section 337.3 of the FDIC Rules and Regulations and FRB Regulation O
Activities and Investments Insured State Nonmember	Part 362 of the FDIC Rules and Regulations
Limitations on Interbank Liabilities	Part 206 of FRB Regulations
Limitations on Federal Reserve Discount Window Advances	Section 10B of the Federal Reserve Act
Grounds for Appointing of Conservator or Receiver	Section 11(c)(5) of the Federal Deposit Insurance Act (FDI Act)

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EXAMINATION-IDENTIFIED DEDUCTIONS FROM COMMON EQUITY CAPITAL

Identified Losses and Insufficient Allowances

Part 324 provides that, on a case-by-case basis and in conjunction with supervisory examinations of an FDIC-supervised institution, deductions from capital may be required. The definition of common equity tier 1 capital specifically provides for the deduction of identified losses, such as items classified Loss, any provision expenses that are necessary to replenish the ALLL or ACL, as applicable, to an appropriate level, estimated losses in contingent liabilities, differences in accounts which represent shortages, and liabilities not shown on books. Losses attributed to a criminal violation may also need to be deducted from capital. Additionally, for the calculation of capital ratios, assets may need to be adjusted for certain identified losses. Refer to this manual's Section 16.1 – Report of Examination Instructions for the Capital Calculations page for details.

When it is deemed appropriate during an examination to adjust capital for items classified Loss or for an insufficient ALLL or ACL, as applicable, the following method should be used.

- Deduct the amount of Loss for items other than held-for-investment loans and leases in the calculation of common equity tier 1 capital. If other real estate (ORE) valuation allowances exist, refer to the discussion of Other Real Estate Valuation Allowances below.
- Deduct the amount of Loss for held-for-investment loans and leases from the ALLL or ACL, as applicable, in the calculation of tier 2 capital.
- If the ALLL or ACL, as applicable, is considered insufficient, an estimate of the provision expense needed for an appropriate ALLL or ACL, as applicable, should be made. The estimate is made after identified losses have been deducted from the ALLL or ACL, as applicable. Loans and leases classified Doubtful should not be directly deducted from capital. Rather, any deficiency in the ALLL or ACL, as applicable, related to assets classified Doubtful should be included in the evaluation and accounted for as part of the insufficient ALLL or ACL adjustment. An adjustment from common equity tier

1 capital to tier 2 capital for the provision expenses necessary to adjust the ALLL or ACL, as applicable, to an appropriate level should be made when the amount is significant.

This method avoids adjustments that may otherwise result in a double deduction (e.g., for loans classified Loss), particularly when common equity tier 1 capital already has been effectively reduced through provision expenses recorded in the ALLL or ACL, as applicable. Additionally, this method addresses situations where institution management overstated the amount of common equity tier 1 capital by failing to take necessary provision expenses to establish and maintain an appropriate ALLL or ACL, as applicable.

Other Real Estate Valuation Allowances

ORE valuation allowances are not recognized as a component of regulatory capital. However, these valuation allowances should be considered when accounting for ORE that is classified Loss. To the extent ORE valuation allowances appropriately cover the risks inherent in any individual ORE properties classified Loss, there would not be a deduction from common equity tier 1 capital. The ORE Loss in excess of ORE valuation allowances should be deducted from common equity tier 1 capital under Assets Other Than Held-for-Investment Loans and Leases Classified Loss.

Liabilities Not Shown on Books

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

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CAPITAL ADEQUACY

The FDIC's authority to enforce capital standards at financial institutions includes the use of written agreements, capital directives, and discretionary actions. A discussion on the use of these powers is included in this manual's Section 15.1 - Formal Administrative Actions. Specific recommendations regarding capital adequacy should not be made solely on the examiner's initiative. Coordination between the examiner and the regional office is essential in this area. If the level or trend of the institution's capital position is adverse, the matter should be discussed with management with a comment included in the examination report. It is particularly important that management's plans to correct the capital deficiency be accurately assessed and noted in the report, along with the examiner's assessment of the feasibility and sufficiency of those plans.

Fundamentally Sound and Well-Managed Institutions

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

Less Than Adequately Capitalized Institutions

Institutions that fail to meet the applicable minimum capital requirements are often subject to CAMELS component and composite downgrades, corrective programs with a provision to increase capital, and other supervisory measures. Less than well capitalized institutions can increase risk to the FDIC's Deposit Insurance Fund and are usually subject to heightened examination coverage. The key supervisory objective is to help management return the institution to a well-capitalized, safe and sound financial position.

Problem Institutions

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

Capital Requirements of Primary Regulator

All insured depository institutions are expected to meet any capital requirements established by their primary federal or state regulator that exceed the minimum capital requirements set forth by regulation. The FDIC will consult with the institution's primary state or federal regulator when establishing capital requirements higher than the minimum set forth by regulation.

Capital Plans Required by Corrective Programs

Institutions with insufficient capital in relation to their risk profile are often required to submit a capital plan to the FDIC in conjunction with a formal enforcement action or other directive. The development of a capital plan is frequently recommended by the FDIC to help boards of directors formulate a plan for restoring capital adequacy. Capital plans may be requested informally through the supervisory process, a Memorandum of Understanding, or other mandatory or discretionary supervisory action. Examiners should consider the necessity of recommending a capital plan if the adequacy of the capital position is in question. If a capital plan is in place, examiners should assess compliance with the plan and whether the outstanding capital plan remains appropriate and, if necessary, recommend revisions to the regional office.

Disallowing the Use of Bankruptcy

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

This provision will only be useful to the FDIC if commitments to maintain capital can be obtained from owners of institutions, such as holding companies, or other corporations or financial conglomerates. Examples of situations where opportunities might exist include situations where a prospective owner might be attempting to mitigate a factor, such as potential future risk to the insurance funds or when the FDIC is providing assistance to an acquirer. In addition, in accordance with the PCA provisions in Part 324, undercapitalized FDIC-supervised institutions are required to file a capital plan with the FDIC and, before such a capital plan can be accepted, any company having control over the institution would need to guarantee the institution's compliance with the plan. However, a commitment to maintain capital should be considered only as an additional enhancement and not as a substitute for actual capital.

Increasing Capital in Operating Institutions

To raise capital ratios, management of an institution must increase capital levels or reduce asset growth to the point that the capital formation rate exceeds asset growth. The following sections describe alternatives to increasing the capital level in institutions.

Increased Earnings Retention

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

Sale of Additional Capital Stock

Sometimes increased earnings retention is insufficient to address capital requirements and the sale of new equity must be pursued. One adverse effect of this option is shareholder dilution. If the sale of additional stock is a consideration, examiners should indicate in the examination report the sources from which such funds might be obtained.[8] This notation will be helpful as background data for preliminary discussions with the state banking supervisor and serves to inform the regional director as to the practical possibilities of new stock sales. The following information could be incorporated into the report, at the examiner's discretion:

- A list of present shareholders, indicating amounts of stock held and their financial worth. Small holdings may be aggregated if a complete listing is impractical.
- Information concerning individual directors relative to their capacity and willingness to purchase stock.

[8] For an institution that is part of a holding company, the holding company will typically sell additional stock and downstream capital to the institution.

- A list of prominent customers and depositors who are not shareholders, but who might be interested in acquiring stock.
- A list of other individuals or possible sources of support in the community who, because of known wealth or other reasons, might desire to subscribe to new stock.

Any other data bearing upon the issue of raising new capital, along with the examiner's opinions regarding the most likely prospects for the sale of new equity, should be included in the confidential section of the examination report.

Reduce Asset Growth

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

Contingent Liabilities

Contingent liabilities reflect potential claims on institution assets. Any actual or direct liability that is contingent upon a future event or circumstance may be considered a contingent liability. Contingent liabilities are divided into two general categories. Category I contingent liabilities result in a concomitant increase in institution assets if the contingencies convert to actual liabilities. These contingencies usually result from off-balance sheet lending activities, such as loan commitments and letters of credit. For example, when an institution funds an existing loan commitment or honors a draft drawn on a letter of credit, it generally originates a loan for the amount of liability incurred.

Category II contingent liabilities include those in which a claim on assets arises without an equivalent increase in assets. For example, pending litigation in which the institution is defendant or claims arising from trust operations could reduce an institution's cash or other assets.

Examination interest in contingent liabilities is predicated upon an evaluation of the impact contingencies may have on an institution's condition. Contingent liabilities that are significant in amount or have a high probability of becoming direct liabilities must be considered when the institution's component ratings are assigned. For example, the amount of contingent liabilities and the extent to which they may be funded must be considered in the analysis of liquidity. Determination of the management component may appropriately include consideration of contingencies, particularly off-balance sheet lending practices. Contingent liabilities arising from off-balance sheet fee producing activities may enhance earnings. In rating earnings, the impact of present and future fee income should be analyzed.

The extent to which contingent liabilities may ultimately result in a charge to earnings resulting in a decrease of capital is always part of the examination process and an important consideration in rating capital. Examiners should consider the degree of off-balance sheet risk in their analysis of the institution's overall capital adequacy and the determination of compliance with Part 324 of the FDIC Rules and Regulations.

Potential and Estimated Losses

As described above, Category I contingent liabilities are defined as those that will give rise to a concomitant increase in institution assets if the contingencies convert into actual liabilities. Such contingencies should be evaluated for credit risk and, if appropriate, listed for Special Mention or subjected to adverse classification. If a Category I contingent liability is classified Loss, it would be included in the *Other Adjustments to and Deductions from Common Equity Tier 1 Capital* category on the Capital Calculations page if an allowance has not been established for the classified exposure. To the extent the off-balance sheet credit exposure classified Loss has an associated allowance, the Loss is charged to the allowance on off-balance sheet credit exposures, prior to making any other adjustment to common equity tier 1 capital.

An institution's exposure to Category II contingent liabilities normally depends solely on the probability of the contingencies becoming direct liabilities. To reflect the degree of likelihood that a contingency may result in a charge to the capital accounts, the terms potential loss and estimated loss are used. A loss contingency is an existing condition, situation, or set of circumstances that involves uncertainty as to possible loss that will be resolved when one or more future events occur or fail to occur. Potential loss refers to contingent liabilities in which there is substantial and material risk of loss to the institution. An estimated loss from a loss contingency (for example, pending or threatened litigation) should be recognized if it is probable that an asset has been impaired or a liability incurred as of the examination date and the amount of the loss can be reasonably estimated.

For further information, examiners should refer to ASC Subtopic 450-20, Contingencies– Loss Contingencies.

The memorandum section of the Capital Calculations page of the Report of Examination includes two contingent liability items. The first item, Contingent Liabilities, refers to Category I contingent liabilities. The second item, Potential Loss, refers only to Category II contingent liabilities. Estimated losses related to Category II contingent liabilities are reflected in the Other Adjustments to and Deductions from Common Equity Tier 1 Capital line item. Contingent liability losses are not included as adjustments to assets.

Common Forms of Contingent Liabilities

Common types and characteristics of contingent liabilities encountered in examinations are discussed below. In all cases, the examiner's fundamental objectives are to ascertain the likelihood that such contingencies may result in losses to the institution and assess the pending impact on its financial condition.

Litigation

If the institution is involved in a lawsuit where the outcome may affect the institution's financial condition, the examiner should include the facts in the examination report. Comments should address the essential points upon which the suit is based, the total dollar amount of the plaintiff's claim, the basis of the institution's defense, the status of any negotiations toward a compromise settlement, and the opinion of institution management or counsel relative to the probability of a successful defense. In addition, corroboration of information and opinions provided by institution management regarding significant lawsuits should be obtained from the institution's legal counsel. At the examiner's discretion, reference to suits that are small or otherwise of limited consequence may be omitted from the examination report.

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

Trust Activities

Contingent liabilities may develop within a financial institution's trust department or affiliate due to actions or inactions of the institution acting in its fiduciary capacity. These contingencies may arise from failure to abide by governing instruments, court orders, generally accepted fiduciary standards, or controlling statutes and regulations. Deficiencies in administration by the trust department can lead to lawsuits, surcharges, or other penalties that must be absorbed by the institution's capital accounts. Therefore, the dollar volume and severity of such contingencies must be analyzed during the safety and soundness examination.

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EVALUATING CAPITAL ADEQUACY

Institutions are expected to meet all minimum capital requirements that are established by law and their primary federal and state regulators. Once minimum capital requirements are met, the evaluation of capital adequacy relies on factors that require a combination of analysis and judgment. Institutions are too dissimilar to apply a minimum set of standards based on one or only a few criteria. Rather, each institution's capital is evaluated on its risk profile and overall financial condition. Generally, management of each institution maintains capital commensurate with the nature and extent of the institution's risks, and the ability of management to identify, measure, monitor, and control those risks.

It is important to understand that what is considered an adequate level of capital for safety and soundness purposes may differ significantly from Part 324's minimum leverage and risk-based standards, the definitions used for Prompt Corrective Action (PCA), and certain other capital-based rules. The minimums set forth in the leverage and risk-based capital standards may be sufficient for sound, well-run institutions. However, problem institutions and those with higher risk characteristics often require capital levels that are higher than the regulatory minimums to sufficiently absorb unexpected losses. In all cases, examiners should assess whether financial institution management maintains capital commensurate with the institution's risk profile.

After determining that an institution meets Part 324's minimum leverage or risk-based capital requirements, examiners should use judgment and financial analysis to assess capital adequacy. This analysis is based in large part on the following factors:

- Financial condition of the institution,
- Quality of capital,
- Emerging needs for additional capital,
- Problem assets,
- Balance sheet composition,
- Off-balance sheet risk exposures,
- Earnings and dividends,
- Asset growth, and
- Access to capital sources.

Financial Condition of the Institution

The institution's overall financial condition and risk management practices are important considerations when assessing capital adequacy. For example, asset quality problems can cause losses that deplete capital, and poor earnings can hinder capital formation. Additionally, institutions with weak policies, procedures, or management oversight may be unable to address financial risks. Furthermore, risk may not always be reflected in the current financial condition. Therefore, examiners should not rely solely on an institution's current financial condition when determining capital adequacy and must assess management's ability to identify, measure, monitor, and control all material risks that may affect capital.

Examiners should also review institutions' internal capital adequacy assessments and stress testing, if applicable. Stress tests may be appropriate for certain large or complex institutions, and their results can help examiners understand management's perspective on credit, liquidity, earnings, and market risk. These analyses can also provide insight on an institution's capital planning and distribution (dividends and stock buybacks) strategies.

Quality of Capital

The composition and quality of capital are important considerations when assessing capital adequacy. Higher quality capital that is available to absorb losses on a going-concern basis can enhance an institution's resiliency. For instance, common equity is higher quality than debt instruments because common equity is available to absorb losses as they occur, through retained earnings for example. Debt instruments are limited in their ability to absorb loss because they are not perpetual and so the institution returns the capital to the investors at maturity. Additionally, the institution must impose losses on debt holders by defaulting on coupon payments.

Emerging Needs for Additional Capital

Management's ability to address emerging needs for additional capital depends on many factors. A few of these factors include earnings performance and growth plans, the financial capacity of the directorate, and the holding company's ability to inject capital. A combination of ratio analysis and examiner judgment is needed to evaluate these issues. As part of assessing capital adequacy, the impact of growth and strategic objectives should be considered.

Problem Assets

The nature, trend, and volume of problem assets and the appropriateness of the ALLL or the ACL, as applicable, are vital factors in determining capital adequacy.

Items to consider include:

- The type and level of problem assets,
- The efficacy of loan origination processes and portfolio administration,
- The level of the ALLL or ACL , as applicable, and
- The institution's methodology for establishing an appropriate ALLL or ACL, as applicable.

Examiners should consider current examination findings relative to asset quality when assessing capital adequacy. Uniform Bank Performance Reports can also be useful to review when considering the level and trend of various credit quality indicators. When assessing the appropriateness of the ALLL or ACL, as applicable, examiners should review the institution's methodology in accordance with outstanding regulatory expectations and accounting pronouncements.

Balance Sheet Composition

The quality, type, and diversification of on- and off-balance sheet items must be considered when reviewing capital adequacy. Applicable capital guidelines and minimum regulatory ratios can help examiners determine the level of capital protection, but examiner judgment is required to assess overall capital adequacy. For example, a portfolio of 150 percent risk-weighted high volatility commercial real estate (HVCRE) loans at two different institutions may have different risk characteristics. Additionally, regulatory capital ratios alone do not account for concentration risk, market risk, or risks associated with nontraditional banking activities. Examiner judgment is therefore an integral part of assessing an institution's level of risk and management's ability to oversee those exposures.

Off-Balance Sheet Risk Exposures

Examiners should consider the risks associated with off-balance sheet activities when evaluating capital. For example, an institution's capital needs can be significantly affected by the volume and nature of activities conducted in a fiduciary capacity. Fiduciary activities or other non-banking activities can expose an institution to losses that could affect capital. Similarly, lawsuits against the institution or other contingent liabilities, such as off-balance sheet credit commitments may indicate a need for greater capital protection and must be carefully reviewed.

Earnings and Dividends

An institution's current and historical earnings record is one of the key elements to consider when assessing capital adequacy. Good earnings performance enables an institution to fund asset growth and remain competitive in the marketplace while at the same time retaining sufficient equity to maintain a strong capital position.

The institution's capital distribution practices are also important. Excessive dividends or share repurchases can negate strong earnings performance and result in a weakened capital position. Generally, earnings are first applied to eliminating losses and establishing necessary allowances and prudent capital levels. Thereafter, capital can be distributed in reasonable amounts. Examiners should also consider the extent that the parent relies on cash dividends to service debt and return capital to shareholders, and how this could affect the institution's capital position in both good economic times and periods of stress.

Asset Growth

Management's ability to adequately plan for and manage growth is important with respect to assessing capital adequacy. A review of recent growth and future plans is a good starting point for this review. The examiner may want to compare asset growth to capital formation rates during recent periods, and evaluate current budget and strategic planning in terms of growth plans and their potential impact on capital adequacy. At institutions experiencing rapid asset growth, examiners should closely review capital adequacy in relation to loan seasoning and potential loss exposure, concentrations of credit, and the effect of continued growth.

Access to Capital Sources

An institution's access to capital sources, including existing shareholders and holding company support, is an important factor in analyzing capital. If management has ample access to capital on reasonable terms, the institution may be able to operate with less capital than an institution without such access. Indeed, the financial capacity of existing shareholders and strength of a holding company factor into capital access. If a holding company previously borrowed funds to purchase newly issued stock of a subsidiary institution (a process referred to as double leverage), the holding company may be less able to provide additional capital because of its own debt service requirements. In such instances, the examiner's review should extend beyond standard ratio analysis to assess the institution's access to capital sources including current market conditions for raising capital.

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RATING THE CAPITAL FACTOR

The adequacy of an institution's capital is one of the elements that examiners must determine to arrive at a composite rating in accordance with the Uniform Financial Institutions Rating System. This determination is a judgmental process that requires examiners to consider all of the subjective and objective variables, concepts, and guidelines that have been discussed throughout this section. Ratings are based on a scale of 1 through 5, with a rating of 1 indicating the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile; and the level of least supervisory concern. A 5 rating indicates the most critically deficient level of performance; inadequate risk management practices relative to the institution's size, complexity, and risk profile; and the greatest supervisory concern.

Uniform Financial Institution Rating System

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

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

Ratings

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

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

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

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

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

INTRODUCTION

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

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

Prior to assigning an asset quality rating, several factors should be considered. The factors should be reviewed within the context of any local and regional conditions that might impact bank performance. Also, any systemic weaknesses, as opposed to isolated problems, should be given appropriate considerations. The examiner should never look at things in a vacuum, instead, noting how the current level or status of each factor, described below, relates to previous and expected performance.

EVALUATION OF ASSET QUALITY

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

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

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

RATING THE ASSET QUALITY FACTOR

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

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

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

4 A rating of 4 is assigned to financial institutions with deficient asset quality or credit administration practices. The levels of risk and problem assets are

significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

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

INTRODUCTION

Section 39 of the Federal Deposit Insurance Act, *Standards for Safety and Soundness,* requires each federal banking agency to establish safety and soundness standards for all insured depository institutions. Appendix A to Part 364 of the FDIC Rules and Regulations, *Interagency Guidelines Establishing Standards for Safety and Soundness,* sets out the safety and soundness standards that the agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Operational and managerial safety and soundness standards pertaining to an institution's loan portfolio address areas such as asset quality, internal controls, credit underwriting, and loan documentation.

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

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LOAN ADMINISTRATION

Lending Policies

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

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

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

- Guidelines addressing the institution's review of the Allowance for Loan and Lease Losses (ALLL) or ACL for loans and leases, as appropriate; and
- Guidelines for adequate safeguards to minimize potential environmental liability.

Note: The allowance for credit losses on loans and leases or ACL for loans and leases is the term used for those banks that adopted ASU 2016-13, which implements ASC Topic 326, Financial Instruments – Credit Losses replacing the allowance for loan losses used under the incurred loss methodology.

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

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

Loan Review Systems

The terms *loan review system* or *credit risk review system* refer to the responsibilities assigned to various areas such as credit underwriting, loan administration, problem loan workout, or other areas. Responsibilities may include assigning initial credit grades, ensuring grade changes are made when needed, or compiling information necessary to assess the appropriateness of the ALLL or ACL for loans and leases.

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

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

Credit Risk Rating or Grading Systems

Accurate and timely credit grading is a primary component of an effective loan review system. Credit grading involves an assessment of credit quality, the identification of problem loans, and the assignment of risk ratings. An effective system provides information for use in establishing an allowance when evaluating specific credits and for the determination of an overall ALLL or ACL for loans and leases, as appropriate.

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

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

Loan Review System Elements

Loan review policies are typically reviewed and approved at least annually by the board of directors. Policy guidelines include a written description of the overall credit grading process, and establish responsibilities for the various loan review functions. The policy generally addresses the following items:

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

Qualifications of Loan Review Personnel

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

Loan Review Personnel Independence

Loan officers are generally responsible for ongoing credit analysis and the prompt identification of emerging problems. Because of their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid over reliance upon loan officers. To avoid conflicts of interest, management typically ensures that, when feasible, all significant loans are reviewed by individuals that are not part of, or influenced by anyone associated with, the loan approval process.

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

Frequency of Reviews

The loan review function provides feedback on the effectiveness of the lending process in identifying emerging problems. Reviews of significant credits are generally performed annually, upon renewal, or more frequently when factors indicate a potential for deteriorating credit quality. A system of periodic reviews is particularly important to the process of determining the ALLL or the ACL for loans and leases, as appropriate.

Scope of Reviews

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

Depth of Reviews

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

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

Review of Findings and Follow-up

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

Workpaper and Report Distribution

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

Current Expected Credit Losses (CECL)

The Current Expected Credit Losses (CECL) methodology as implemented by FASB Accounting Standards Codification (ASC) Subtopic 326-20, Financial Instruments – Credit Losses – Measured at Amortized Cost applies to financial assets measured at amortized cost, net investments in leases, and off-balance-sheet credit exposures (collectively, financial assets). For institutions that are SEC filers, excluding those that are "smaller reporting companies" as defined in the SEC's rules, the CECL methodology is effective for fiscal years beginning January 1, 2020, for institutions with calendar year fiscal years. For all other institutions, (i.e., non-public institutions), including those SEC filers that are smaller reporting companies, CECL will take effect for institutions with calendar year fiscal years beginning after December 15, 2022, (i.e., January 1, 2023).

The CECL methodology does not apply to financial assets measured at fair value through net income, including those assets for which the fair value option has been elected; loans held-for-sale; policy loan receivables of an insurance entity; loans and receivables between entities under common control; and receivables arising from operating leases. Available-for-sale debt securities are not covered under the CECL methodology but are covered by ASC Subtopic 326-30, Financial Instruments – Credit Losses – Available-for-Sale Debt Securities for institutions that have adopted ASC Topic 326.

The allowance for credit losses or ACL for loans and leases is a valuation account that is deducted from, or added to, the amortized cost basis of financial assets to present the net amount expected to be collected over the contractual term of the assets, considering expected prepayments. Renewals, extensions, and modifications are excluded from the contractual term of a financial asset for purposes of estimating the ACL for loans and leases unless there is a reasonable expectation of executing a troubled debt restructuring or the renewal and extension options are part of the original or modified contract and are not unconditionally cancellable by the institution.

In estimating the net amount expected to be collected, management should consider the effects of past events, current conditions, and reasonable and supportable forecasts on the collectibility of the institution's financial assets. Under the CECL methodology, inputs will need to change in order to achieve an appropriate estimate of expected credit losses. For example, inputs to a loss rate method would need to reflect expected losses over the contractual term, rather than the annual loss rates commonly used under the existing incurred loss methodology. To properly apply an acceptable estimation method, an institution's credit loss estimates must be well supported.

Similar to the ALLL, the ACL for loans and leases is evaluated as of the end of each reporting period and reported in the Consolidated Reports of Condition and Income (Call Report). The methods used to determine ACLs generally should be applied consistently over time and reflect management's current expectations of credit losses. Changes to ACL for loans and leases resulting from these periodic evaluations are recorded through increases or decreases to the related provisions for credit losses (PCLs).

Throughout this Section 3.2, Loans, references pertaining to the ALLL describe the incurred methodology and apply only to institutions that have not yet adopted ASC Topic 326. As such, the methodology for impairment contained in ASC Subtopic 310-10, Receivables - Overall and collective loan impairment contained in ASC Subtopic 450-20, Contingencies – Loss Contingencies has been superseded and is not applicable for institutions that have adopted ASC Topic 326 (CECL). Therefore, for those institutions that have adopted CECL, examiners should refer to the Call Report Glossary entry for "allowance for credit losses" and the, "Interagency Policy Statement on Credit Losses," issued May 8, 2020, via FIL 54-2020, for additional information on the CECL methodology.

Allowance for Loan and Lease Losses (ALLL)

Each institution must maintain an ALLL that is appropriate to absorb estimated credit losses associated with the held for investment loan and lease portfolio, i.e., loans and leases that the institution has the intent and ability to hold for the foreseeable future or until maturity or payoff. Each institution should also maintain, as a separate liability account, an allowance sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as loan commitments, standby letters of credit, and guarantees. This separate liability account for estimated credit losses on off-balance sheet credit exposures should not be reported as part of the ALLL on an institution's balance sheet. Loans and leases held for sale are carried on the balance sheet at the lower of cost or fair value, with a separate valuation allowance. This separate valuation allowance should not be included as part of the ALLL and accordingly regulatory capital.

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. The estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in generally accepted accounting principles (U.S. GAAP). When available information confirms specific loans and leases, or portions thereof, to be uncollectible, these amounts should be promptly charged-off against the ALLL.

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

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

Responsibility of the Board and Management

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

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

For purposes of Reports of Condition and Income (Call Reports) an appropriate ALLL for loans held for investment should consist of the following items:

- The amount of allowance related to loans individually evaluated and determined to be impaired under ASC (Accounting Standards Codification) Subtopic 310-10, *Receivables - Overall*.
- The amount of allowance related to loans that were individually evaluated for impairment and determined <u>not</u> to be impaired, as well as other loans collectively evaluated under ASC Subtopic 450-20, *Contingencies – Loss Contingencies*.
- The amount of allowance related to loans evaluated under ASC Subtopic 310-30, *Receivables –Loans and Debt Securities Acquired with Deteriorated Credit Quality*.
- The amount of allowance related to international transfer risk associated with its cross-border lending exposure.

Furthermore, management's analysis of an appropriate allowance level requires significant judgement in determining estimates of credit losses. An institution may support its estimate through qualitative factors that adjust historical loss rates or an unallocated portion that can be supported through a similar analysis.

When determining an appropriate allowance, primary reliance should normally be placed on analysis of the various components of a portfolio, including all significant credits reviewed on an individual basis. Examiners should refer to ASC Subtopic 310-10 for guidance in establishing an allowance for individually evaluated loans determined to be impaired and measured under that standard. When analyzing the appropriateness of an allowance, portfolios evaluated collectively should group loans with similar characteristics, such as risk classification, past due status, type of loan, industry, or collateral. A depository institution may, for example, analyze the following groups of loans and provide for them in the ALLL:

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

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

Factors to Consider in Estimating Credit Losses

Estimated credit losses should reflect consideration of all significant factors that affect the portfolio's collectibility as of the evaluation date. While historical loss experience provides a reasonable starting point, historical losses, or even recent trends in losses, are not by themselves, a sufficient basis to determine an appropriate ALLL level.

Management should also consider any relevant qualitative factors that are likely to cause estimated losses to differ from historical loss experience such as:

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

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

Examiner Responsibilities

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

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

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

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

Regulatory Reporting of the ALLL

An ALLL established in accordance with the guidelines provided above should fall within a range of acceptable estimates. When an ALLL is not deemed at an appropriate level, management will be required to increase the provision for loan and lease loss expense sufficiently to restore the ALLL reported in its Call Report to an appropriate level.

Accounting and Reporting Treatment

ASC Subtopic 450-20 provides the basic guidance for recognition of a loss from a contingency that should be accrued through a charge to income (i.e., a provision expense) when available information indicates that it is probable the asset has been impaired and the amount is reasonably estimated. ASC Subtopic 310-10 provides specific guidance about the measurement and disclosure for loans individually evaluated and determined to be impaired. Loans are considered to be 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. This would generally include all loans restructured as a troubled debt and nonaccrual loans.

For individually impaired loans, ASC Subtopic 310-10 provides guidance on the acceptable methods to measure impairment. Specifically, this standard states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future 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. However, the Call Report instructions require an institution to use the fair value of the collateral in its determination of impairment for all impaired collateral dependent loans. When developing the estimate of expected future cash flows for a loan, an institution should consider all available information reflecting past events and current conditions, including the effect of existing qualitative factors.

Large groups of smaller-balance homogenous loans are *not* included in the scope of ASC Subtopic 310-10, unless the loan is a troubled debt restructuring. Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. Examiners should refer to ASC Subtopic 450-20 for loans collectively evaluated for impairment, as well as individual loans that are identified for evaluation on an individual basis and determined not to be impaired.

Institutions should not layer their loan loss allowances. Layering is the inappropriate practice of recording estimates in the ALLL for the same loan under the different accounting standards. Layering can happen when an institution measures impairment on an individually impaired loan and includes that same loan in its estimate of loan losses on a collective basis, thereby estimating the loan loss for the same loan twice.

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

- Include a detailed loan portfolio analysis, performed regularly;
- Consider all loans (whether on an individual or group basis);
- Identify loans to be evaluated for impairment on an individual basis under ASC Subtopic 310-10; loans evaluated under ASC Subtopic 310-30; and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under ASC Subtopic 450-20;
- 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 U.S. GAAP.

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

Examiners are encouraged, with the acknowledgement of management, to communicate with an institution's external auditors and request an explanation of their rationale and findings, when differences in judgment concerning the appropriateness of the institution's ALLL exist. In case of controversy, an institution and its auditor may be reminded when an institution's supervisory agency's interpretation on how U.S. GAAP should be applied to a specified event or transaction (or series of related events or transactions) differs from the institution's interpretation, the supervisory agency may require the institution to reflect the event(s) or transaction(s) in its Call Report in accordance with the agency's interpretation and to amend previously submitted reports.

Additional information on the documentation of the ALLL, including its methodology, and the establishment of loan review systems is provided in the Interagency Statement of Policy on the Allowance for Loan and Lease Losses, (including frequently asked questions) dated December 13, 2006, and the Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations, dated July 2, 2001.

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PORTFOLIO COMPOSITION

Commercial Loans

General

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

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

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

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

Accounts Receivable Financing

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

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

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

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

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

Leveraged Lending

The federal institution regulatory agencies initially issued guidance on April 9, 2001, concerning sound risk management practices for institutions engaged in leveraged financing. In light of the developments and experience gained since the initial guidance was issued, the federal institution regulatory agencies issued new Interagency Guidance on Leveraged Lending on May 21, 2013, to update and replace the 2001 guidance. Examiners should also review the related Frequently Asked Questions (FAQ) issued on November 7, 2014.

Applicability

A financial institution's risk management practices should be consistent with the size and risk profile of its leveraged activities relative to its assets, earnings, liquidity, and capital. Institutions that originate or sponsor leveraged transactions can refer to the guidance for suggestions about sound risk management principles.

The agencies do not intend for a financial institution that originates a small number of less complex, leveraged loans to have policies and procedures commensurate with a larger, more complex leveraged loan origination business. However, any financial institution that participates in leveraged lending transactions may refer to and consider supervisory guidance provided in the "Participations Purchased" section of the guidance.

General

Leveraged lending is an important type of financing for national and global economies, and the U.S. financial industry plays an integral role in making credit available and syndicating that credit to investors. In particular, financial institutions should ensure they do not unnecessarily heighten risks by originating poorly underwritten loans. For example, a poorly underwritten leveraged loan that is pooled with other loans or is participated with other institutions may generate risks for the financial system.

Numerous definitions of leveraged lending exist throughout the financial services industry and commonly contain some combination of the following:

- Proceeds used for buyouts, acquisitions, or capital distributions.
- Transactions where the borrower's Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt divided by EBITDA exceed 4.0X EBITDA or 3.0X EBITDA, respectively, or other defined levels appropriate to the industry or sector.
- A borrower recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio.
- Transactions when the borrower's post-financing leverage, as measured by its leverage ratios (for example, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors), significantly exceeds industry norms or historical levels.

A financial institution engaging in leveraged lending typically defines the activity within its policies and procedures in a manner sufficiently detailed to ensure consistent application across all business lines. An appropriate definition describes clearly the purposes and financial characteristics common to these transactions, and covers risk from both direct exposure and indirect exposure via limited recourse financing secured by leveraged loans, or financing extended to financial intermediaries (such as conduits and special purpose entities (SPEs)) that hold leveraged loans.

In general, sound risk management of leveraged lending activities places importance on institutions developing and maintaining the following:

- Transactions structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with supportable performance projections, these elements of a safe-and-sound loan structure should clearly support a borrower's capacity to repay and to de-lever to a sustainable level over a reasonable period, whether underwritten to hold or distribute;
- A definition of leveraged lending that facilitates consistent application across all business lines;
- Well-defined underwriting standards that, among other things, define acceptable leverage levels and describe amortization expectations for senior and subordinate debt;
- A credit limit and concentration framework consistent with the institution's risk appetite;
- Sound Management Information Systems (MIS) that enable management to identify, aggregate, and monitor leveraged exposures and comply with policy across all business lines;
- Strong pipeline management policies and procedures that, among other things, provide for real-time information on exposures and limits, and exceptions to the timing of expected distributions and approved hold levels; and
- Guidelines for conducting periodic portfolio and pipeline stress tests to quantify the potential impact of economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.

Risk Management Framework

Given the high-risk profile of leveraged transactions, prudent financial institutions engaged in leveraged lending adopt a risk management framework that has an intensive and frequent review and monitoring process. The framework has as its foundation written risk objectives, risk acceptance criteria, and risk controls. A lack of robust risk management processes and controls at a financial institution with significant leveraged lending activities could contribute to supervisory findings that the financial institution is engaged in unsafe-and-unsound banking practices.

General Policies

A financial institution's credit policies and procedures for leveraged lending generally address the following:

- Identification of the financial institution's risk appetite including clearly defined amounts of leveraged lending that the institution is willing to underwrite (for example, pipeline limits) and is willing to retain (for example, transaction and aggregate hold levels). The designated risk appetite is commonly supported by an analysis of the potential effect on earnings, capital, liquidity, and other risks that result from these positions, and is approved by the board of directors;
- A limit framework that includes limits or guidelines for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure, and industry and geographic concentrations. This limit framework identifies the related management approval authorities and exception tracking provisions. In addition to notional pipeline limits, financial institutions with significant leveraged transactions implement underwriting limit frameworks that assess stress losses, flex terms, economic capital usage, and earnings at risk or that otherwise provide a more nuanced view of potential risk;
- Procedures for ensuring the risks of leveraged lending activities are appropriately reflected in an institution's allowance for loan and lease losses (ALLL) and capital adequacy analyses;
- Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms;
- Guidelines for appropriate oversight by senior management, including adequate and timely reporting to the board of directors;
- Expected risk-adjusted returns for leveraged transactions;
- Minimum underwriting standards (see "Underwriting Standards" section below); and,
- Effective underwriting practices for primary loan origination and secondary loan acquisition.

Participations Purchased

Well-managed financial institutions purchasing participations and assignments in leveraged lending transactions 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. Policies typically 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, Uniform Commercial Code (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 document.

Underwriting Standards

A financial institution's underwriting standards should be clear, written and measurable, and should accurately reflect the institution's risk appetite for leveraged lending transactions. Examiners should review whether a financial institution has clear underwriting limits regarding leveraged transactions, including the size that the institution will arrange both individually and in the aggregate for distribution. Legal and other risks associated with poorly underwritten transactions may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy. An institution's underwriting standards typically consider the following:

- Whether the business premise for each transaction is sound and the borrower's capital structure is sustainable regardless of whether the transaction is underwritten for the institution's own portfolio or with the intent to distribute.
- A borrower's capacity to repay and ability to de-lever to a sustainable level over a reasonable period.
- Expectations for the depth and breadth of due diligence on leveraged transactions.
- Standards for evaluating expected risk-adjusted returns.
- The degree of reliance on enterprise value and other intangible assets for loan repayment, along with acceptable valuation methodologies, and guidelines for the frequency of periodic reviews of those values;

- Expectations for the degree of support provided by the sponsor (if any), taking into consideration the sponsor's financial capacity, the extent of its capital contribution at inception, and other motivating factors.
- Whether credit agreement terms allow for the material dilution, sale, or exchange of collateral or cash flow-producing assets without lender approval;
- Credit agreement covenant protections, including financial performance (such as debt-to-cash flow, interest coverage, or fixed charge coverage), reporting requirements, and compliance monitoring.
- Collateral requirements in credit agreements that specify acceptable collateral and risk-appropriate measures and controls, including acceptable collateral types, loan-to-value guidelines, and appropriate collateral valuation methodologies. Standards for asset-based loans that are part of the entire debt structure outline expectations for the use of collateral controls (for example, inspections, independent valuations, and payment lockbox), other types of collateral and account maintenance agreements, and periodic reporting requirements; and
- Whether loan agreements provide for distribution of ongoing financial and other relevant credit information to all participants and investors.

Credit Analysis

Effective underwriting and management of leveraged lending risk is highly dependent on the quality of analysis employed during the approval process as well as ongoing monitoring. An institution's analysis of leveraged lending transactions typically ensures that:

- Cash flow analyses do not rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;
- Liquidity analyses include performance metrics appropriate for the borrower's industry; predictability of the borrower's cash flow; measurement of the borrower's operating cash needs; and ability to meet debt maturities;
- Projections exhibit an adequate margin for unanticipated merger-related integration costs;
- Projections are stress tested for one or two downside scenarios, including a covenant breach;
- Transactions are reviewed at least quarterly to determine variance from plan, the related risk implications, and the accuracy of risk ratings and accrual status;
- Enterprise and collateral valuations are independently derived or validated outside of the origination function, are timely, and consider potential value erosion;
- Collateral liquidation and asset sale estimates are based on current market conditions and trends;
- 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 the issuance of new equity; and
- The borrower is adequately protected from interest rate and foreign exchange risk.

Valuation Standards

Institutions often rely on enterprise value and other intangibles when (1) evaluating the feasibility of a loan request; (2) determining the debt reduction potential of planned asset sales; (3) assessing a borrower's ability to access the capital markets; and, (4) estimating the strength of a secondary source of repayment. Institutions may also view enterprise value as a useful benchmark for assessing a sponsor's economic incentive to provide financial support. Given the specialized knowledge needed for the development of a credible enterprise valuation and the importance of enterprise valuations in the underwriting and ongoing risk assessment processes, enterprise valuations should be performed by qualified persons independent of an institution's origination function.

There are several methods used for valuing businesses. The most common valuation methods are assets, income, and market. Asset valuation methods consider an enterprise's underlying assets in terms of its net going-concern or liquidation value. Income valuation methods consider an enterprise's ongoing cash flows or earnings and apply appropriate capitalization or discounting techniques. Market valuation methods derive value multiples from comparable company data or sales transactions. However, final value estimates should be based on the method or methods that give supportable and credible results. In many cases, the income method is generally considered the most reliable.

There are two common approaches employed when using the income method. The "capitalized cash flow" method determines the value of a company as the present value of all future cash flows the business can generate in perpetuity. An appropriate cash flow is determined and then divided by a risk-adjusted capitalization rate, most commonly the weighted average cost of capital. This method is most appropriate when cash flows are predictable and stable. The "discounted cash flow" method is a multiple-period valuation model that converts a future series of cash flows into current value by discounting those cash flows at a rate of return (referred to as the "discount rate") that reflects the risk inherent therein. This method is most appropriate when future cash flows are cyclical or variable over time. Both income methods involve numerous assumptions, and therefore, supporting documentation should fully explain the evaluator's reasoning and conclusions.

When a borrower is experiencing a financial downturn or facing adverse market conditions, a prudent lender will reflect those adverse conditions in its assumptions for key variables such as cash flow, earnings, and sales multiples when assessing enterprise value as a potential source of repayment. Changes in the value of a borrower's assets are typically tested under a range of stress scenarios, including business conditions more adverse than the base case scenario. Stress tests of enterprise values and their underlying assumptions are generally conducted and documented at origination of the transaction and periodically thereafter, incorporating the actual performance of the borrower and any adjustments to projections. Prudent institutions perform their own discounted cash flow analysis to validate the enterprise value implied by proxy measures such as multiples of cash flow, earnings, or sales.

Enterprise value estimates derived from even the most rigorous procedures are imprecise and ultimately may not be realized. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral typically have policies that provide for appropriate loan-to-value ratios, discount rates, and collateral margins. Based on the nature of an institution's leveraged lending activities, the prudent institution establishes limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value. Regardless of the methodology used, the assumptions underlying enterprise-value estimates typically are clearly documented, well supported, and understood by the institution's appropriate decision-makers and risk oversight units. Further, an institution's valuation methods are appropriate for the borrower's industry and condition.

Risk Rating Leveraged Loans

The risk rating of leveraged loans involves the use of realistic repayment assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period of time. For example, supervisors commonly assume that the ability to fully amortize senior secured debt or the ability to repay at least 50 percent of total debt over a five-to-seven year period provides evidence of adequate repayment capacity. If the projected capacity to pay down debt from cash flow is nominal with refinancing the only viable option, the credit will usually be adversely rated even if it has been recently underwritten. In cases when leveraged loan transactions have no reasonable or realistic prospects to de-lever, a Substandard rating is likely. Furthermore, when assessing debt service capacity, extensions and restructures should be scrutinized to ensure that the institution is not merely masking repayment capacity problems by extending or restructuring the loan.

If the primary source of repayment becomes inadequate, it would generally be inappropriate for an institution to consider enterprise value as a secondary source of repayment unless that value is well supported. Evidence of well-supported value may include binding purchase and sale agreements with qualified third parties or thorough asset valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, when a portion of the loan may not be protected by pledged assets or a well-supported enterprise value, examiners generally will rate that portion Doubtful or Loss and place the loan on nonaccrual status.

Risks in leveraged lending activities are considered in the ALLL and capital adequacy analysis. For allowance purposes, leverage exposures are typically taken into account either through analysis of the estimated credit 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 are typically scrutinized to determine the need for and adequacy of specific allocations.

Problem Credit Management

Individual action plans are typically formulated by management when working with borrowers experiencing diminished operating cash flows, depreciated collateral values, or other significant plan variances. Weak initial underwriting of transactions, coupled with poor structure and limited covenants, may make problem credit discussions and eventual restructurings more difficult for an institution as well as result in less favorable outcomes.

A financial institution generally formulates credit policies that define expectations for the management of adversely rated and other high-risk borrowers whose performance departs significantly from planned cash flows, asset sales, collateral values, or other important targets. These policies typically stress the need for workout plans that contain quantifiable objectives and measureable time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale of the credit in the secondary market, or liquidation of collateral. Problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

Reporting and Analytics

Diligent financial institutions regularly monitor higher risk credits, including leveraged loans. Monitoring includes management's review of comprehensive reports about the characteristics and trends in such exposures at least quarterly, with summaries provided to the board of directors. Policies and procedures typically identify the fields to be populated and captured by a financial institution's MIS, which then yields accurate and timely reporting to management and the board of directors that may include the following:

- Individual and portfolio exposures within and across all business lines and legal vehicles, including the pipeline;
- Risk rating distribution and migration analysis, including maintenance of a list of those borrowers who have been removed from the leveraged portfolio due to improvements in their financial characteristics and overall risk profile;
- Industry mix and maturity profile;
- Metrics derived from probabilities of default and loss given default;
- Portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, non-performing amounts, and charge-offs;
- Amount of impaired assets and the nature of impairment, and the amount of the ALLL attributable to leveraged lending;
- The aggregate level of policy exceptions and the performance of that portfolio;
- Exposures by collateral type, including unsecured transactions and those where enterprise value will be the source of repayment for leveraged loans. Reporting also typically considers the implications of defaults that trigger pari-passu treatment for all lenders and, thus, dilute the secondary support from the sale of collateral;
- Secondary market pricing data and trading volume, when available;
- Exposures and performance by deal sponsors. Deals introduced by sponsors may, in some cases, be considered exposure to related borrowers. An institution should identify, aggregate, and monitor potential related exposures;
- Gross and net exposures, hedge counterparty concentrations, and policy exceptions;
- Actual versus projected distribution of the syndicated pipeline, with regular reports of excess levels over the hold targets for the syndication inventory. Well-designed pipeline definitions clearly identify the type of exposure. This includes committed exposures that have not been accepted by the borrower, commitments accepted but not closed, and funded and unfunded commitments that have closed but have not been distributed; and
- Total and segmented leveraged lending exposures, including subordinated debt and equity holdings, alongside established limits. Reports typically provide a detailed and comprehensive view of global exposures, including situations when an institution has indirect exposure to an obligor or is holding a previously sold position as collateral or as a reference asset in a derivative.

Borrower and counterparty leveraged lending reporting typically consider exposures booked in other business units throughout the institution, including indirect exposures such as default swaps and total return swaps, naming the distributed paper as a covered or referenced asset or collateral exposure through repo transactions. Additionally, the positions in the held for sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its subsidiaries or affiliates are typically considered.

Deal Sponsors

A financial institution that relies on sponsor support as a secondary source of repayment typically develops guidelines for evaluating the qualifications of financial sponsors and implements processes to regularly monitor a sponsor's financial condition. Deal sponsors may provide valuable support to borrowers such as strategic planning, management, and other tangible and intangible benefits. Sponsors may also provide sources of financial support for borrowers that fail to achieve projections. Generally, a financial institution rates a borrower based on an analysis of the borrower's standalone financial condition. However, a financial institution may consider support from a sponsor in assigning internal risk ratings when the institution can document the sponsor's history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. However, even with documented capacity and a history of support, the sponsor's potential contributions may not mitigate supervisory concerns absent a documented commitment of continued support. An evaluation of a sponsor's financial support typically includes the following:

- The sponsor's historical performance in supporting its investments, financially and otherwise;
- The sponsor's economic incentive to support, including the nature and amount of capital contributed at inception;
- Documentation of degree of support (for example, a guarantee, comfort letter, or verbal assurance);
- Consideration of the sponsor's contractual investment limitations;
- To the extent feasible, a periodic review of the sponsor's financial statements and trends, and an

analysis of its liquidity, including the ability to fund multiple deals;
- Consideration of the sponsor's dividend and capital contribution practices;
- The likelihood of the sponsor supporting a particular borrower compared to other deals in the sponsor's portfolio; and,
- Guidelines for evaluating the qualifications of a sponsor and a process to regularly monitor the sponsor's performance.

Independent Credit Review

A financial institution with a strong and independent credit review function demonstrates the ability to identify portfolio risks and documented authority to escalate inappropriate risks and other findings to their senior management. Due to the elevated risks inherent in leveraged lending, and depending on the relative size of a financial institution's leveraged lending business, there is greater importance for the institution's credit review function to assess the performance of the leveraged portfolio more frequently and in greater depth than other segments in the loan portfolio. To be most effective, such assessments are performed by individuals with the expertise and experience for these types of loans and the borrower's industry. Portfolio reviews are generally conducted at least annually. For many financial institutions, the risk characteristics of leveraged portfolios, such as high reliance on enterprise value, concentrations, adverse risk rating trends, or portfolio performance, may dictate more frequent reviews.

A financial institution that staffs its internal credit review function appropriately and ensures that the function has sufficient resources is most capable of providing timely, independent, and accurate assessments of leveraged lending transactions. Effective reviews evaluate the level of risk, risk rating integrity, valuation methodologies, and the quality of risk management. Such internal credit reviews that review the institution's leveraged lending practices, policies, and procedures provide management with a complete assessment of the leveraged lending program.

Stress Testing

A financial institution typically develops and implements guidelines for conducting periodic portfolio stress tests on loans originated to hold as well as loans originated to distribute, and sensitivity analyses to quantify the potential impact of changing economic and market conditions on its asset quality, earnings, liquidity, and capital. The sophistication of stress-testing practices and sensitivity analyses are most effective when they are consistent with the size, complexity, and risk characteristics of the institution's leveraged loan portfolio. To the extent a financial institution is required to conduct enterprise-wide stress tests, the leveraged portfolio should be included in any such tests.

Conflicts of Interest

A financial institution typically develops appropriate policies and procedures to address and to prevent potential conflicts of interest when it has both equity and lending positions. For example, an institution may be reluctant to use an aggressive collection strategy with a problem borrower because of the potential impact on the value of an institution's equity interest. A financial institution may encounter pressure to provide financial or other privileged client information that could benefit an affiliated equity investor. Such conflicts also may occur when the underwriting financial institution serves as financial advisor to the seller and simultaneously offers financing to multiple buyers (that is, stapled financing). Similarly, there may be conflicting interests among the different lines of business within a financial institution or between the financial institution and its affiliates. When these situations occur, potential conflicts of interest arise between the financial institution and its customers. Effective policies and procedures clearly define potential conflicts of interest, identify appropriate risk management controls and procedures, enable employees to report potential conflicts of interest to management for action without fear of retribution, and ensure compliance with applicable laws. Further, an established training program for employees on appropriate practices to follow to avoid conflicts of interest is an effective risk management practice.

Oil and Gas Lending

Industry Overview

Oil and gas (O&G) lending is complex and highly specialized due to factors such as global supply and demand, geopolitical uncertainty, weather-related disruptions, fluctuations and volatility in currency markets (i.e. the strength of the U.S. dollar compared to global currency markets), and changes in environmental and other governmental policies. As such, companies and borrowers that are directly or indirectly tied to the O&G industry frequently experience expansion and contraction within key operational areas of their businesses that will directly impact their financial condition and repayment capacity.

The O&G industry has four interconnected segments:

- Upstream - exploration and production (E&P) companies
- Midstream - transporting, treating, processing, storing, and marketing to Upstream companies

- Downstream - refining and marketing
- Support/Services - equipment, services, or support activities (e.g. drilling, workover units, and water hauling services)

O&G lending to Upstream companies for E&P activities is a specialized form of lending, and is the primary focus of this section (see Reserve-Based Lending below). Loans to Midstream, Downstream and Support/Service companies are generally structured similar to other commercial loans. In addition, Midstream companies often raise capital through Master Limited Partnerships that are publicly traded. The highest credit risk is typically found in Support/Services and Upstream lending, which are more directly affected by changes in production and commodity prices.

Reserve-Based Lending

Loans for E&P activities are typically secured by proved reserves and governed by a borrowing base, an arrangement known as reserve-based lending, or RBL. Effective credit risk management in RBL requires conservative underwriting, appropriate structuring, experienced and knowledgeable lending staff, and sound loan administration practices. It is also important for the board and senior management to consider the unique risks associated with this type of lending when developing RBL policies and approving and administering such loans. These risks include, but are not limited to, credit, concentration, market volatility/pricing, limited purpose collateral, production, operational, legal, compliance/environmental, interest rate, liquidity, strategic, and third-party risk.

RBL may appear similar to traditional asset based lending (ABL), but there are notable differences. The primary source of repayment for ABL is the orderly liquidation of the collateral (receivables and inventory) into cash. Such loans are typically structured with strong controls over the collateral, such as a lock box arrangement. In contrast, the primary source of repayment for RBL is the cash flows derived from the extraction of O&G reserves. An independent, third-party reserve engineering report serves as the primary underwriting tool to estimate the future cash stream and establish a "borrowing base," which is a collateral base agreed to by the borrower and lender that is used to limit the amount of funds the lender advances the borrower. The borrowing base is subject to periodic redeterminations, typically semiannually, that can result in the reduction of the borrowing base commitment when commodity prices and reserves are declining.

Types of Reserves

Lenders should generally only consider proved reserves, defined as having at least a 90 percent probability that the quantities actually recovered will equal or exceed the estimate, in determining collateral value. Within the proved reserves category, Proved Developed Producing (PDP), Proved Developed Non-Producing (PDNP), and Proved Undeveloped (PUD) reserves are collectively known as P1. As described below, PDNP and PUD require capital expenditures (CAPEX) to bring the non-producing and undeveloped reserves online as PDP:

- PDP represents reserves that are recoverable from existing wells with existing equipment and operating methods that are producing at the time of the engineering report estimate.
- PDNP reserves include both shut-in (PDSI) and behind the pipe (PDBP) reserves, and production can be initiated or restored with relatively low expenditures compared to the cost of drilling a new well.
    - PDSI reserves are completion intervals that are open, but have not started producing; were shut-in for market conditions or pipeline connections; or not capable of production for mechanical reasons.
    - PDBP reserves are those expected to be recovered from existing wells that require additional completion work or future completion prior to the start of production.
- PUD reserves are expected to be recovered only after making future investment. These reserves have been proved by independent engineering reports, but do not have a well infrastructure in place.

Other categories of reserves include "probable" (P2) and "possible" (P3). Probable reserves are relatively uncertain, while possible reserves are considered speculative in nature. Probable and possible reserves should not receive any value when determining the borrowing base.

Reserve Engineering Reports

Reserve engineering reports are an estimate of the volumes of O&G reserves that are likely to be recovered based on reasonable assumptions regarding physical characteristics of the reservoir, available technology, and operating efficiencies. The significant reliance on engineering reports in underwriting RBL facilities requires sound internal controls over the collateral evaluation process. Reserve reports must be objective; based on reasonable, well-documented assumptions; and completed independently of the loan origination and collection functions. It is important for management to document the qualifications and independence of the engineer, and to periodically evaluate the production performance, which includes a comparison of production projections to actual results.

RBL collateral value consists of a point-in-time estimate of the present value (PV) of future net revenue (FNR) derived from the production and sale of existing O&G reserves, net of operating expenses, production taxes, royalties, and CAPEX, discounted at an appropriate rate. The engineering reports should contain sufficient information and documentation to support the assumptions and the analysis used to derive the forecasted cash flows and discounted PV. Well-managed banks provide clear guidance to the engineer at engagement regarding discount rates, pricing assumptions, operating expense escalation rates, and risk-adjustment guidelines limiting higher risk reserves. The engineer will conduct an analysis of production reports from the subject properties, and project estimated reserve depletion.

Borrowing Base

The collateral base securing each facility should be primarily comprised of PDP reserves. Inclusion of PDNP reserves in the collateral evaluation should be supported with sufficient documentation to demonstrate that the borrower has the financial capacity to convert PDNP reserves to PDP reserves by making the necessary investments to restore or initiate production within the near-term.

To include PUDs in the borrowing base calculation, the borrower should have sufficient liquidity and positive Free Cash Flow to meet operational needs, and debt service requirements, as well as be able to fund (or obtain the funding for) the CAPEX that would be required to convert these undeveloped reserves into production. Potential sale and/or marketability of the PUDs can also be considered when evaluating collateral values, provided there is adequate documentation of recent PUD sales.

Lenders use risk-adjustment factors to lower the value of unseasoned producing and non-producing reserves before applying borrowing base advance rates. It is important to consider policy limits on production vs. non-production reserves, the oil and gas mix, maximum production coming from one well (single well concentration risk), and other risk-adjustment factors. Ideally, management achieves diversification in the geographic location of reserve fields, and establishes limits on the lowest number of producing wells needed to establish an acceptable borrowing base.

Typically, the advance rate for high-quality proved (P1) reserves rarely exceed 65 percent (a typical range is 50 to 65 percent) of the PV of FNR. If the lender determines that PDNP or PUD reserves are to be considered in the borrowing base, these reserves should generally not exceed 25 to 35 percent of the total borrowing base. In addition, PDNP and PUD reserves should be risk-adjusted (65 to 75 percent for PDNP and 25 to 50 percent for PUD, for example) prior to applying the advance rate. Lenders may apply separate risk-adjusted advance rates for each proved reserve category in the borrowing base. During extended periods of low or declining commodity prices, it is not uncommon for banks to increase the risk adjustment for PDNP and PUD reserves.

As part of the underwriting process, lending personnel typically prepare both base-case and sensitivity-case analyses that focus on the ability of converting the underlying collateral into cash to repay the loan, including an estimate of the impact that sustained adverse changes in market conditions would have on a company's repayment ability. A base-case analysis uses standard assumption scenarios and generally includes a discount to current prices against the forward curve (projected futures pricing estimates of the commodity). A sensitivity case analysis subjects the O&G reserves to adverse external factors such as lower market prices and/or higher operating expenses to ascertain the effect on loan repayment. Full debt service capacity (DSC) is typically analyzed using both the base-case and sensitivity-case scenarios.

Discount Rates

The Securities and Exchange Commission (SEC) requires publicly traded companies to report the value of their reserves using a standard discount rate of 10 percent in accordance with ASC Topic 932, Extractive Activities - Oil and Gas. In evaluating collateral valuations for RBL facilities, banks often utilize alternative discount rates. For creditworthy borrowers and during more benign operating cycles, a 9 percent discount rate is commonly used. For higher-risk borrowers or during volatile or declining market cycles for O&G, higher discount rates are typically used. If a discount rate is selected that significantly differs from generally accepted discount rates, examiners should assess management's documentation supporting its rationale. Some banks may use multiple discount rates under certain circumstances. An example may include establishing a standard discount rate for performing credits and a higher rate for higher risk facilities.

Price Decks

Prudent management regularly evaluates, and updates as necessary, its pricing assumptions for RBL, commonly referred to as the institution's price deck. The price deck is a forecast used to derive cash flow and collateral value assumptions, and typically is approved by the board of directors or a specifically designated board committee. Pricing assumptions typically represent the most significant variable in driving the final estimate of value, and must be well-supported.

Each institution's price deck typically reflects both base-case and sensitivity-case pricing scenarios. Pricing assumptions for the sensitivity case are generally sufficiently conservative and used to determine whether the borrower has the financial capacity to generate adequate cash flow to repay the debt during a prolonged low commodity price environment. Price deck considerations include, for example, current commodity pricing, forward curve projections (future price considerations), cost assumptions, discount rates, and timing of the various reports. Management also typically documents any risk-based adjustments applied to each proved reserve category. While the risk-adjusted base case projections will generally be used to underwrite RBLs, consideration is also given to the ability to repay the debt using the risk-adjusted sensitivity case to determine potential exposure due to adverse market price fluctuations.

Loan Structure

RBL credit facilities are typically structured as a revolving line of credit (RLOC), a reducing revolving line of credit (RRLOC), or an amortizing term loan, governed by a well-supported and fully documented borrowing base. These credit facilities generally fully amortize within the half-life of the reserves (that is, the time in years required to produce one-half of the total estimated recoverable production) with repayment aligning with projected cash flows. In other words, the term of the loans should be tied to the economic life of the underlying asset. This is often represented as the "reserve tail tests" that are based on the economic half-life of the reserves or the cash flow remaining after projected loan payout.

Loan durations should be fairly short-term and directly tied to the economic life of the asset (generally 50 to 60 percent of the economic life of the proved reserves or the proved reserves' half-life). The terms generally depend on the projected and actual reserve production (reserve run data), as well as the type and range of collateral (PDP, PDNP, or PUD). A reasonable portion of the estimated revenues should remain after the debt has fully amortized (reserve tail). Borrowing bases should be re-determined at least semiannually, subject to an updated reserve engineering report.

Covenants

Appropriate use of covenants is imperative in managing credit risk for O&G loans. Lenders typically require financial covenants to instill discipline in the lending relationship, including the borrower's leverage position, repayment capacity, and liquidity. In addition, well-designed covenants limit cash distributions to owners/shareholders, and include standard performance and financial reporting requirements. Examples of commonly used ratios/covenants for evaluating E&P companies include Free Cash Flow (FCF), Interest Coverage, Fixed Charge Coverage, Current Ratio, Quick Ratio, Senior Debt/EBITDA(X), and Total Debt/EBITDA(X). The calculation of earnings before interest, taxes, depreciation, and amortization (EBITDA) typically incorporates maintenance CAPEX (X) due to its impact on the amount of projected FCF that is available after debt service to support operations.

Hedging

When used properly, hedging may be an effective tool to help protect the borrower and the lender from sharp commodity price declines by providing a stable cash flow stream. E&P companies frequently use hedging instruments such as futures contracts, swaps, collars, and put options to reduce price risk exposure. Generally, hedges should be limited to no more than 85 percent of projected production volumes. Counterparties are typically limited to reputable, financially sound companies that are approved in accordance with the institution's O&G loan policy. If the hedges are taken as collateral or part of the borrowing base, the advance rate and any limitations on the hedging position should be documented in the loan agreement. If hedges are sold or monetized, the proceeds of such are generally applied to the respective debt.

Borrower and Financial Analysis

Management should have a clear understanding of the overall financial health of the borrower that includes an assessment of the borrower's ability to maintain operations through adverse market conditions. E&P companies in sound financial condition should have strong cash flow from reliable revenue sources and well-controlled operating expenses. Companies should also have adequate sources of liquidity and effective working capital management, sound reserve development practices, well-defined criteria for divestiture, adequate capital structure, manageable levels of debt, and appropriate financial reporting. As part of the overall financial analysis of the relationship, updated engineering data should be well-documented and should enable the lender to determine the borrower's capacity to service the debt. Any over-advance situation should have a reasonable plan and timeframe to cure the over-advance.

The principals of successful E&P companies should be experienced and have a well-documented track record of managing through all stages of the business cycle. In good times, company management should be able to identify, acquire, and develop reserves profitably and in line with expectations. During declining price cycles, company management should be able to demonstrate the ability to streamline operations, maintain reasonable production, manage working capital, strategically reduce CAPEX, and make sound divestitures to ensure repayment of debt. Bank management should evaluate the borrower's cost cycle, which reflects not only the ability to generate cash flow from production, but also the CAPEX necessary to replace depleted reserves. Working capital management is critically important, as delinquent payments to vendors can result in a negative working capital position (due to accounts payable increasing) and an increased leverage ratio.

Financial analysis typically includes the following:

- Adequacy of operating cash flows to service existing total debt;
- Overall compliance with financial covenants, including borrowing base limitations as detailed in the loan agreement;
- Reasonableness of the company's budget assumptions and projections;
- Comparison of borrower provided production projections with actual results;
- Working capital, tangible net worth, and leverage positions; and
- Impact of capital expenses and recent acquisitions.

O&G Loan Policy Guidelines

The O&G loan policy should provide sufficient guidance to loan officers, clearly convey appropriate policy limitations and monitoring procedures, and detail appropriate underwriting standards and practices. The O&G policy should clearly indicate those industry segments (Upstream, Midstream, Downstream, and Support/Services) the board chooses to lend to and include guidance on each of those segments.

For institutions engaged in RBL, appropriate policies address reserve measurement and valuation analysis, borrowing base determinations, production history analysis, financial statement and ratio analysis, commitment advances, discount rates, price deck formulation, financial covenants, steps to cure an over-advance situation, and ALLL considerations. Specific guidelines typically cover the following areas:

- Lending objectives, risk appetite, portfolio limits, target market, and concentration limits;
- Methodology and requirements for monitoring O&G markets, including pricing, supply and demand trends, overall market trends, and industry analysis;
- Board and committee oversight over the O&G lending and engineering departments;
- Officer and committee lending limits;
- Borrowing base calculations and risk-adjustments;
- Price deck considerations and adjustments;
- Advance rates, risk-adjusted values for PDP, PDNP, and PUD reserves, and requirement to risk adjust the discount value of nonproducing reserves before applying advance rates;
- Frequency and required details of borrowing base redeterminations and price deck revaluations;
- Requirements for independent engineering reports and analysis thereof;
- Well concentration guidelines and maximum per single well limits;
- Financial covenants, minimum ratio and other financial information requirements, and review requirements (e.g. current ratio, fixed charge coverage, cash flow coverage, leverage ratios);
- Collateral valuation requirements, including required remaining collateral at payout;
- Renewal and restructuring guidelines, including nonaccrual and troubled debt restructuring implications;
- Remedies for declining collateral or over-advanced situations, such as Monthly Commitment Reductions, pledge of additional reserves as collateral, and sale of non-productive reserves;
- Minimum required insurance (including property, liability, and environmental);
- Defined loan safety or coverage factors and/or loan value policies, including other debt that is "pari-passu" (i.e. all debts sharing equally in the production cash flows available to amortize debt);
- Typical amortization, payout, and loan repayment terms, including maximum terms for production revolvers and term loans;
- Guarantor requirements;
- Hedging requirements, policies, and limitations;
- Stress-testing and sensitivity analysis and requirements thereof; and
- Monitoring requirements for the risks inherent in loans dependent on royalty interests in production revenues for repayment.

Credit Risk Rating Assessment and Classification Guidelines

An appropriate O&G loan policy also addresses specific credit risk review procedures for the O&G portfolio and O&G loan grading criteria. Risk rating definitions should be clearly defined. RBL that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or underlying collateral generally will not be adversely classified for supervisory purposes. However, if any of the following circumstances are present, a more in-depth and comprehensive analysis of the credit is needed to determine whether the loan has potential or well-defined weaknesses:

- The loan balance exceeds 65 percent of the PV of FNR of PDP, or the cash flow analysis indicates that the loan will not amortize within the reserve half-life;
- The credit is not performing in accordance with contractual terms (repayment of interest and principal);
- Advance rates exceed the institution's limits or industry standards for proved reserves;
- Frequent over-advances occur at subsequent borrowing base redeterminations;
- Excessive operating leverage;
- Covenant defaults;
- Delinquent payables, or other evidence of poor working capital management;
- Significant current or likely future disruptions in production;
- Frequent financial statement revisions or changes in chosen accounting method;
- Maintenance or capital expenditures significantly exceed budgeted forecasts; or
- The credit is identified by the institution as a "distressed" credit.

Examiners are to consider all information relevant to evaluating the prospects that the loan will be repaid, including the borrower's creditworthiness, the cash flow provided by the borrower's operation, the collateral supporting the loan, integrity and reliability of the engineering data, borrowing base considerations, primary source of repayment, and any support provided by financially responsible guarantors and co-borrowers. If the borrower's circumstances reveal well-defined weaknesses, adverse classification of the loan relationship is likely warranted. The level and severity of classification of distressed, collateral-dependent RBLs will depend on the quality of the underlying collateral, based on the most recent re-determined and risk-adjusted borrowing base that is contractually obligated to be funded.

The portion of the loan commitment(s) secured by the NPV of total risk-adjusted proved reserves should be classified Substandard. When the potential for loss may be mitigated by the outcome of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined, the remaining balance secured by the NPV of total unrisked proved reserves should be classified Doubtful. The portion of the loan commitment(s) that exceeds 100 percent of the NPV of total unrisked proved reserves, and is uncollectible, should be classified Loss. These guidelines may be adjusted depending on the borrower's specific situation and should not replace examiner judgment.

The following tables illustrate an example of the rating methodology for a classified borrower. Actual pricing, discount rates, and risk adjustment factors applied by the institution may vary according to current market conditions and the nature of the reserves. Examiners should closely review the key assumptions made by the institution in arriving at the current collateral valuation.

Example: Collateral Valuation ($ Million)
Discounted NPV at 9% and using NYMEX Strip Pricing

Valuation Basis	Hedges	PDP	PDNP	PUD	Total Proved
Unrisked NPV	$10	$50	$20	$40	$120
Risk adjustment factors	100%	100%	75%	50%	
Risked & Adjusted NPV	$10	$50	$15	$20	$95
		Total collateral value:			$95

Example: Classification ($ Million)
Borrowing base commitment on RBL is $125 million

	TC	Pass	SM	II	III	IV
RBL	$125			$95	$25	$5
Total	$125			$95	$25	$5

TC: Total Commitment SM: Special Mention
II: Substandard III: Doubtful IV: Loss

Note: The $25 million of Doubtful represents the difference between the unrisked NPV and the risked NPV. If the borrower's prospects for further developing PDNP and PUD reserves to producing status are unlikely or not supported by a pending event, this amount should be reflected as Loss.

Institutions should follow accounting principles when determining whether a loan should be placed on nonaccrual. Each extension should be independently evaluated to determine whether it should be on nonaccrual; that is, nonaccrual status should not be automatically applied to multiple loans or extensions of credit to a single borrower if only one loan meets the criteria for nonaccrual status. However, multiple loans to one borrower that are structured as pari-passu to principal and interest and supported by the same repayment source should not be treated differently for nonaccrual or troubled debt restructuring purposes, regardless of collateral lien position.

Real Estate Loans

General

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

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

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

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

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

Real Estate Lending Standards

Section 18(o) of the FDI Act requires the federal banking agencies to adopt uniform regulations prescribing standards for loans secured by liens on real estate or made for the purpose of financing permanent improvements to real estate. For FDIC-supervised institutions, Part 365 of the FDIC Rules and Regulations requires each institution to adopt and maintain written real estate lending policies that are consistent with sound lending principles, appropriate for the size of the institution and the nature and scope of its operations. These policies generally enable management to effectively identify, measure, monitor, and control the risks associated with real estate lending. The level and complexity of risk-monitoring techniques for real estate lending typically is commensurate with the level of real estate activity and the nature and complexity of the institution’s market. Within these general parameters, the regulation specifically requires an institution to establish policies that include:

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

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

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

The Interagency Guidelines for Real Estate Lending Policies indicate that institutions should establish their own internal LTV limits consistent with their needs. These internal limits should not exceed the following recommended supervisory limits:

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

appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

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

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

Management and the board at each institution typically establish an appropriate internal process for the review and approval of loans that do not conform to internal policy standards. The approval of any loan that is an exception to policy typically is supported by a written justification that clearly details all of the relevant credit factors supporting the underwriting decision. Exception loans of a significant size often are individually reported to the board.

Prudent management and boards monitor compliance with internal policies and maintain reports of all exceptions to policy. Examiners should review loan policy exception reports to determine whether exceptions are adequately documented and appropriate in light of all the relevant credit considerations.

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

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

The institution should not be considered in nonconformance of the standards as a result of minor exceptions or inconsistencies. Rather, examiners are to assess management's overall practices and performance when assessing conformance with the standards.

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

Commercial Real Estate Loans

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

There are several warning signs that real estate markets or projects are experiencing problems that may result in real estate values decreasing from original appraisals or projections. Adverse economic developments and/or an overbuilt market can cause real estate projects and loans to become troubled. Signs of troubled real estate markets or projects include, but are not limited to:

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

Real Estate Construction Loans

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

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

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

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

The following are the basic types of construction lending:

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

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

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

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

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

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

Home Equity Loans

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

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

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

Institutions that make these kinds of loans typically adopt specific policies and procedures for dealing with this product line. Management expertise in mortgage lending and open-end credit procedures is critical to the appropriate administration of the portfolio. Another major concern is that borrowers will become overextended and the institution will have to initiate foreclosure proceedings. Therefore, underwriting standards should emphasize the borrower's ability to service the line from cash flow rather than the sale of the collateral, especially if the home equity line is written on a variable rate basis. If the institution has offered a low introductory interest rate, repayment capacity should be analyzed at the rate that could be in effect at the conclusion of the initial term.

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

The variation in contract characteristics of home equity debt affects the liquidity of this form of lending. For debt to be easily pooled and sold in the secondary market, it needs to be fairly consistent in its credit and interest rate characteristics. The complexity of the collateral structures, coupled with the uncertain maturity of revolving credit, makes home equity loans considerably less liquid than straight first lien, fixed maturity mortgage loans.
While home equity lending is considered to be fairly low-risk, subprime home equity loans and lending programs exist at some banks. These programs have a higher level of risk than traditional home equity lending programs. Individual or pooled home equity loans that have subprime characteristics should be analyzed using the information provided in the subprime section of this Manual.

Agricultural Loans

Introduction

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

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

Agricultural Loan Types and Maturities

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

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

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

<u>Machinery and Equipment Loans</u> **-** Intermediate-term loans for the purchase of a wide array of equipment used in the

production and handling of crops and livestock. Cash flow from farm earnings is the primary repayment source. Loans for grain handling and storage facilities are also sometimes included in this category, especially if the facilities are not permanently affixed to real estate.

Farm Real Estate Acquisition Loans - Long-term credits for the purchase of farm real estate, with cash flow from earnings representing the primary repayment source. Significant, permanent improvements to the real estate, such as for livestock housing or grain storage, may also be included within this group.

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

Agricultural Loan Underwriting Guidelines

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

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

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

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

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

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

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

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

Administration of Agricultural Loans

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

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

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

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

supported. Generally, this means that a current inspection report will be available.

Classification Guidelines for Agricultural Credit

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

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

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

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

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

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

<u>Production Loans</u> **-** These loans are generally not subject to adverse classification if the debtor has good liquidity and/or significant fixed asset equities, or if the cash flow information suggests that current year's operations should be sufficient to repay the advances. The examiner should also take into account any governmental support programs or federal crop insurance benefits from which the borrower

may benefit. If cash flow from ongoing operations appears insufficient to repay production loans, adverse classification may be in order, depending upon the secondary repayment sources and collateral, and the borrower's overall financial condition and trends.

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

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

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

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

Installment Loans

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

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

Lease Accounting

ASC Topic 840, *Leases*, is the current lease accounting standard for non-public business entities and entities that have not adopted ASC Topic 842, *Leases*. ASC Topic 842 is effective for public business entities (as defined in U.S. GAAP) and will become effective for banks that are not public business entities, for fiscal years beginning after December 15, 2021, and interim reporting periods within fiscal years beginning after December 15, 2022. As such, a calendar year end non-public business entity's first reporting period will be December 31, 2022. Early adoption is permitted.

Direct Lease Financing

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

Lessor Accounting under ASC Topic 840

The types of assets that may be leased are numerous, and the accounting for direct leasing is a complex subject which is discussed in detail in ASC Topic 840, *Leases*. Familiarity with ASC Topic 840 is a prerequisite for the management of any institution engaging in or planning to engage in direct lease financing. The following terms are commonly encountered in direct lease financing:

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

Lessor Accounting under ASC Topic 842

ASC Topic 842, *Leases* does not fundamentally change lessor accounting; however, it aligns terminology between lessee and lessor accounting and brings key aspects of lessor accounting into alignment with the FASB's new revenue recognition guidance in ASC Topic 606. As a result, the classification difference between direct financing leases and sales-type leases for lessors moves from a risk-and-rewards principle to a transfer of control principle. As such, an institution as lessor is required to classify a lease as a sales-type, direct financing, or operating leases. Additionally, there is no longer a distinction in the treatment of real estate and non-real estate leases by lessors.

Leases classified as leveraged leases prior to the adoption of ASC Topic 842 may continue to be accounted for under ASC Topic 840 unless subsequently modified. ASC Topic 842 eliminates leveraged lease accounting for leases that commence after an institution adopts the new accounting standard.

For more information refer to the Call Report Glossary for the accounting for leases or ASC Topic 842.

Examiner Consideration

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

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

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

Floor Plan Loans

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

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

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

Check Credit and Credit Card Loans

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

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

- Agent Bank, which receives credit card applications from customers and sales drafts from merchants and forwards such documents to banks described below, and is accountable for such documents during the process of receiving and forwarding.
- Sublicensee Bank, which maintains accountability for credit card loans and merchant's accounts; may maintain its own center for processing payments and drafts; and may maintain facilities for embossing credit cards.
- Licensee Bank, which is the same as sublicensee institution, but in addition may perform transaction processing and credit card embossing services for sublicensee banks, and also acts as a regional or national clearinghouse for sublicensee banks.

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

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

Credit Card-related Merchant Activities

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

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

- Scrutinizing prospective merchants using the same care and diligence used in evaluating prospective borrowers.
- Closely monitoring merchants with controls to ensure that early warning signs are recognized so that problem merchants can be removed from a clearing institution's program promptly to minimize loss exposure.
- Establishing an account administration program that incorporates periodic reviews of merchants' financial statements and business activities in cases of merchants clearing large dollar volumes.
- Establishing an internal periodic reporting system of merchant account activities regardless of the amount or number of transactions cleared, with these reports reviewed for irregularities so problematic merchant activity is identified quickly.
- Developing policies that follow the guidelines established by the card issuing networks.

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

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

Examination procedures for reviewing credit card related merchant activities are included in the ED Modules in the Supplemental Modules Section and in the Credit Card Activities Manual.

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OTHER CREDIT ISSUES

Appraisals

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

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

Valuation of Troubled Income-Producing Properties

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

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

Appraisal Regulation

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

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

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

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

(1) The transaction is a residential real estate transaction that has a transaction value of $400,000 or less;
(2) A lien on real estate 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: (i) has a transaction value of $1 million or less; and (ii) is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
(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: (i) There has been no obvious and material change in the market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or (ii) There is no advancement of new monies, other than funds necessary to cover reasonable closing costs;
(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 FDIC regulatory requirements for appraisals at the time of origination;
(9) The transaction is wholly or partially insured or guaranteed by a United States government agency or United States government sponsored agency;
(10) The transaction either; (i) Qualifies for sale to a United States government agency or United States government sponsored agency; or (ii) Involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;
(11) The regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law;
(12) The FDIC determines that the services of an appraiser are not necessary in order to protect federal financial and public policy interests in real estate-related financial transaction or to protect the safety and soundness of the institution;
(13) The transaction is a commercial real estate transaction that has a transaction value of $500,000 or less; or
(14) The transaction is exempted from the appraisal requirement pursuant to the rural residential exemption under 12 U.S.C. 3356.

The regulation also requires an institution to obtain an appropriate evaluation of the real property collateral that is consistent with safe and sound banking practices for a transaction that does not require the services of a state certified or licensed appraiser per exemption (1), (5), (7), (13), or (14).

Section 323.4 establishes minimum standards for all appraisals in connection with federally related transactions. Appraisals performed in conformance with the regulation must conform to the requirements of the USPAP and certain other listed standards. The applicable sections of USPAP are the Preamble (ethics and competency), Standard 1 (appraisal techniques), Standard 2 (report content), and Standard 3 (review procedures). USPAP Standards 4 through 10 concerning appraisal services and appraising personal property do not apply to federally related transactions. An appraisal satisfies the regulation if it is performed in accordance with all of its provisions and it is still current and meaningful. The regulation also requires that the appraisal report contain the appraiser's certification that the appraisal was prepared in conformance with USPAP.

In addition, the regulation requires appraisals for federally related transactions to be subject to appropriate review for compliance with USPAP. Specific review procedures in an institution's written appraisal program that produce some form of documented evidence would facilitate meeting this regulatory requirement. Procedures for maintaining some form of documented evidence of the review of other appraisals help ensure those appraisals facilitate making informed lending decisions. Examiners should note that such evidence could take the form of an appraisal checklist that includes the signature of an appropriately trained external person or an internal staff member, indicates the appraisal was reviewed, and finds that all USPAP standards were met. An effective appraisal program's review escalation procedures will facilitate internal staff's ability to take appropriate action to address appraisals that do not comply with USPAP.

Adherence to the appraisal regulations should be part of the examiner's overall review of the lending function. When analyzing individual transactions, examiners should review appraisal reports to determine the institution's conformity to its own internal appraisal policies and for compliance with the regulation. Examiners may need to conduct a more detailed review if the appraisal does not have sufficient information, does not explain assumptions, is not logical, or has other major deficiencies that cast doubt as to the validity of its opinion of value. Examination procedures regarding appraisal reviews are included in the Examination Documentation Modules.

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

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

Interagency Appraisal and Evaluation Guidelines

The Interagency Appraisal and Evaluation Guidelines dated December 2, 2010 address supervisory matters relating to real estate-related financial transactions and provide guidance to examining personnel and federally regulated institutions about prudent appraisal and evaluation policies, procedures, practices, and standards that are consistent with the appraisal regulation.

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 typically are incorporated into an effective appraisal and evaluation program. Examiners will consider the institution's size and the nature of its real estate-related activities when assessing the appropriateness of its program.

When analyzing individual transactions, examiners should review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and comply with the agencies' appraisal regulations and the institution's internal policies. Examiners also will review the steps taken by an institution to ensure that the individuals who perform its appraisals and evaluations are qualified and are not subject to conflicts of interest. Institutions that fail to maintain a sound appraisal or evaluation program or to comply with the agencies' appraisal regulations 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. Effective programs:

- Establish selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals or evaluations;
- Provide for the independence of the person performing appraisals or evaluations;
- Identify the appropriate appraisal for various lending transactions;
- Establish criteria for contents of an evaluation;
- Provide for the receipt of the appraisal or evaluation report in a timely manner to facilitate the underwriting decision;
- Assess the validity of existing appraisals or evaluations to support subsequent transactions;
- Establish criteria for obtaining appraisals or evaluations for transactions that are otherwise exempt from the agencies' appraisal regulations; and
- Establish internal controls that promote compliance with these program standards.

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

- The selection process is non-preferential and unbiased;
- The individual selected possesses the requisite education, expertise and competence to complete the assignment;
- The individual selected is capable of rendering an unbiased opinion; and
- The individual selected is independent and has no direct or indirect interest, financial or otherwise, in the property or the transaction.

Under the agencies' appraisal regulations, the appraiser must be selected and engaged directly by the institution or its agent. The appraiser's client is the institution, not the borrower. Also, an institution may not use an appraisal that has been "readdressed" – appraisal reports that are altered by the appraiser to replace any references to the original client with the institution's name. An institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, as long as the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable.

<u>Independence of the Appraisal and Evaluation Function</u> **-** Because the appraisal and evaluation process is an integral component of the credit underwriting process, it should be isolated from influence by the institution's loan production process. An appraiser and an individual providing evaluation services should be independent of the loan and collection functions of the institution and have no interest, financial or otherwise, in the property or the transaction. In addition, individuals independent from the loan production area should oversee the selection of appraisers and individuals providing evaluation services. If absolute lines of independence cannot be achieved, an institution must be able to clearly demonstrate that it has prudent safeguards to isolate its collateral evaluation process from influence or interference from the loan production process. That is, no single person should have sole authority to render credit decisions on loans which they ordered or reviewed appraisals or evaluations.

The agencies recognize, however, that it is not always possible or practical to separate the loan and collection functions from the appraisal or evaluation process. In some cases, such as in a small or rural institution or branch, the only individual qualified to analyze the real estate collateral may also be a loan officer, other officer, or director of the institution. To ensure their independence, such lending officials, officers, or directors 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 $400,000 ($500,000 for commercial real estate transactions) are considered federally related transactions and thus require appraisals. A "federally related transaction" means any real estate-related financial transaction, in which the agencies engage, contract for, or regulate and that requires the services of an appraiser. An agency also may impose more stringent appraisal requirements than the appraisal regulations require, such as when an institution's troubled condition is attributable to real estate loan underwriting problems.

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, non-market lease terms, and tract developments with unsold units. This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods. For federally related transactions, an appraisal is to include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal. For properties where improvements are to be constructed or rehabilitated, the regulated institution may also request a prospective market value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development for the purpose of the agencies' appraisal regulations. For proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs and entrepreneurial profit. For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commission, rent losses, and tenant improvements from an estimate based on stabilized occupancy;
- Be based upon the definition of market value set forth in the regulation. Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations; and
- Be performed by state licensed or certified appraisers in accordance with requirements set forth in the regulation.

Appraisal Options - An appraiser typically uses three market value approaches to analyze the value of a property cost, income, and sales market. The appraiser reconciles the results of each approach to estimate market value. An appraisal will discuss the property's recent sales history and contain an opinion as to the highest and best use of the property. An appraiser must certify that he/she has complied with USPAP and is independent. Also, the appraiser must disclose whether the subject property was inspected and whether anyone provided significant assistance to the person signing the appraisal report.

An institution may engage an appraiser to perform either a Complete or Limited Appraisal. When performing a Complete Appraisal assignment, an appraiser must comply with all USPAP standards - without departing from any binding requirements - and specific guidelines when estimating market value. When performing a Limited Appraisal, the appraiser elects to invoke the Departure Provision which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches to value; however, departure from standards designated as binding requirements is not permitted. There are numerous binding requirements which are detailed in the USPAP. Use of the USPAP Standards publication as a reference is recommended. The book provides details on each appraisal standard and advisory opinions issued by the Appraisal Standards Board.

An institution and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the institution or other intended users of the appraisal report. The agencies do not prohibit the use of a Limited Appraisal for a federally related transaction, but the agencies believe that institutions should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

Complete and Limited Appraisal assignments may be reported in three different report formats: a Self-Contained Report, a Summary Report, or a Restricted Report. The major difference among these three reports relates to the degree of detail presented in the report by the appraiser. The Self-Contained Appraisal Report provides the most detail, while the Summary Appraisal Report presents the information in a condensed manner. The Restricted Report provides a capsulated report with the supporting details maintained in the appraiser's files.

The agencies believe that the Restricted Report format will not be appropriate to underwrite a significant number of federally related transactions due to the lack of sufficient supporting information and analysis in the appraisal report. However, it might be appropriate to use this type of appraisal report for ongoing collateral monitoring of an institution's real estate transactions and under other circumstances when an institution's program requires an evaluation.

Moreover, since the institution is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The institution's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written engagement letter that outlines the institution's expectations and delineates each party's responsibilities, especially for large, complex, or out-of-area properties.

Transactions That Require Evaluations - A formal opinion of market value prepared by a state licensed or certified appraiser is not always necessary. Instead, less formal evaluations of the real estate may suffice for transactions that are exempt from the agencies' appraisal requirements. Additionally, prudent institutions 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 - Prudent standards for preparing evaluations typically require that evaluations:

- 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 appropriate evaluation report includes 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 appropriate evaluation provides an estimate of value to assist the institution in assessing the soundness of the transaction. Prudent practices may include more detailed evaluations as an institution engages in more complex real estate-related financial transactions, or as its overall exposure increases. 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 describes the current and expected use of the property and includes an analysis of the property's rental income and expenses.

Qualifications of Evaluation Providers **-** Individuals who prepare evaluations should have real estate-related training or experience and knowledge of the market relevant to the subject property. Based upon their experience and training, professionals from several fields may be qualified to prepare evaluations of certain types of real estate collateral. Examples include individuals with appraisal experience, real estate lenders, consultants or sales persons, agricultural extension agents, or foresters. Well-managed institutions 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 institution may 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 includes criteria to determine whether an existing appraisal or evaluation remains valid to support a subsequent transaction. Criteria for determining whether an existing appraisal or evaluation remains valid will vary depending upon the condition of the property and the marketplace, and the nature of any subsequent transaction. Factors that could cause changes to originally reported values include: the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; improvements to, or lack of maintenance of, the subject property or competing surrounding properties; changes in zoning; or environmental contamination. The institution must document the information sources and analyses used to conclude that an existing appraisal or evaluation remains valid for subsequent transactions.

Renewals, Refinancings, and Other Subsequent Transactions - The agencies' appraisal regulations generally allow appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings; however, in certain situations an appraisal is required. If new funds are advanced in excess of reasonable closing costs, an institution is expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions or in the physical aspects of the property that threatens the institution's real estate collateral protection.

The decision to reappraise or reevaluate the real estate collateral should be guided by the regulatory 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 would 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 - Appropriate appraisal and evaluation programs establish effective internal controls that promote compliance with the program's standards. An individual familiar with the appraisal regulations should ensure that the institution's appraisals and evaluations comply with the appraisal regulations and the institution's program. Typically, loan administration files 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. Examiners should determine whether corrective action for noted deficiencies was undertaken by the individual who prepared the appraisal or evaluation.

Effective appraisal and evaluation programs have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, non-residential real estate construction loans, or out-of-area real estate. These comprehensive analytical procedures are typically designed to verify that the methods, assumptions, and conclusions are reasonable and appropriate for the transaction and the property. These procedures 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 are 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. Examiners should be mindful that 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 also typically develops criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques, even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

Referrals - Financial institutions are encouraged to make referrals directly to state appraiser regulatory authorities when a state licensed or certified appraiser violates USPAP, applicable state law, or engages in other unethical or unprofessional conduct. Examiners finding evidence of unethical or unprofessional conduct by appraisers will forward their findings and recommendations to their supervisory office for appropriate disposition and referral to the state, as necessary.

Examination Treatment

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

Loan Participations

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

Accounting

The proper accounting treatment for loan participations is governed by ASC Topic 860, *Transfers and Servicing,* that applies to the transferor (seller) of assets and the transferee (purchaser).

Before considering whether the conditions for a sale have been met, the transfer of a portion of an entire financial asset must first meet the definition of a participating interest.

A participating interest in an entire financial asset, as defined in ASC Topic 860, has all of the following characteristics:

- From the date of transfer, it must represent a proportionate (pro-rata) ownership interest in the entire financial asset;
- From the date of the transfer, all cash flows received from the entire financial asset, except any cash flows allocated as compensation for servicing or other services performed (which must not be subordinated and must not significantly exceed an amount that would fairly compensate a substitute service provider should one be required), must be divided proportionately among the participating interest holders in an amount equal to their share of ownership;
- The rights of each participating interest holder (including the lead lender) must have the same priority, no interest is subordinated to another interest, and no participating interest holder has recourse to the lead lender or another participating interest holder other than standard representations and warranties and ongoing contractual servicing and administration obligations; and
- No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to do so.

If the financial asset meets the definition of a participating interest, the institution must then determine if the participating interest qualifies for sale treatment. The sale criteria focus on whether or not control is effectively transferred to the purchaser.

A transfer of an entire financial asset, a group of financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

- The transferred financial assets have been isolated from the seller, meaning that the purchaser's interest in the loan is presumptively beyond the reach of the seller and its creditors, even in bankruptcy or other receivership;

- Each purchaser has the right to pledge or exchange its interest in the loan, and there are no conditions that both constrain the purchaser from taking advantage of that right to pledge or exchange and provide more than a trivial benefit to the seller; and
- The seller or their agents do not maintain effective control over the transferred financial assets. Examples of a seller maintaining effective control include an agreement that both entitles and obligates the seller to repurchase or redeem the purchaser's interest in the loan prior to the loan's maturity, an agreement that provides the seller with the unilateral ability to cause the purchaser to return its interest in the loan to the seller (other than through a cleanup call), or an agreement that permits the purchaser to require the seller to repurchase its interest in the loan at a price so favorable to the purchaser that it is probable that the purchaser will require the seller to repurchase.

Right to Repurchase

Some loan participation agreements may give the seller a contractual right to repurchase the participated interest in the loan at any time. In this case, the seller's right to repurchase the participation effectively provides the seller with a call option on a specific asset that would preclude sale accounting if the asset is not readily obtainable in the marketplace. If a loan participation agreement contains such a provision, freestanding or attached, it constrains the purchaser from pledging or exchanging its participating interest, and results in the seller maintaining effective control over the participating interest. In such cases, the transfer would be accounted for as a secured borrowing.

For additional information on the transfer of loan participations refer to the Call Report Glossary entry: “Transfers of Financial Assets”.

Recourse Arrangements

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

If an originating selling institution has transferred a loan participation to a participating institution with recourse on or before December 31, 2001, the existence of the recourse obligation in and of itself does not preclude sale accounting for the transfer. If a loan participation transferred with recourse on or before December 31, 2001, meets the three conditions then in effect for the transferor to have surrendered control over the transferred assets, the transfer should be accounted for as a sale for financial reporting purposes. However, a loan participation sold with recourse is subject to the banking agencies’ risk-based capital requirements.

If an originating selling institution transfers a loan participation with recourse on or after January 1, 2002, the participation generally will not be considered isolated from the originating lender in an FDIC receivership. Section 360.6 of the FDIC Rules and Regulations limits the FDIC's ability to reclaim loan participations transferred *without recourse* as defined in the regulations, but does not limit the FDIC's ability to reclaim loan participations transferred with recourse. Under Section 360.6, a participation subject to an agreement that requires the originating lender to repurchase the participation or to otherwise compensate the participating institution due to a default on the underlying loan is considered a participation *with recourse*. As a result, a loan participation transferred *with recourse* on or after January 1, 2002, generally should be accounted for as a secured borrowing and not as a sale for financial reporting purposes. This means that the originating lender should not remove the participation from its loan assets on the balance sheet, but should report the loan participation as a secured borrowing.

Call Report Treatment

When a loan participation meets the definition of a participating interest and the conditions for sale treatment are met, the seller removes the participated interest in the loan from the balance sheet. The purchaser reports the participating interest in “Loans” in the Report of Condition, and in Call Report Schedule RC-C - Loans and Lease Financing Receivables, based upon collateral, borrower, or purpose. When a loan participation does not meet the definition of a participating interest, or if a transfer of a participating interest does not meet all of the conditions for sale accounting, the transfer must be reported as a secured borrowing with a pledge of collateral. In these situations, because the transferred loan participation does not qualify for sale accounting, the transferring institution must continue to report the transferred participation (as well as the retained portion of the loan) in “Loans” in the Report of Condition, based upon collateral, borrower, and purpose. As a consequence, the transferred loan participation should be included in the originating lender’s loans and leases for purposes of determining the appropriate level for the institution's allowance for loan and lease losses. The transferring institution should also report the transferred loan participation as a secured borrowing in "Other Borrowed Money" in the Report of Condition.

Independent Credit Analysis

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

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

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

Participation Agreements

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

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

Participations Between Affiliated Institutions

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

Sales of 100 Percent Loan Participations

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

If not appropriately structured, these 100 percent participation programs can present unwarranted risks to the originating institution including legal, and compliance risks. Therefore, agreements to mitigate these risks clearly state the limitations the originating and participating institutions impose on each other and the rights all parties retain. This typically includes the originating institution stating that loan participants are participating in loans and are not investing in a business enterprise. The policies of an institution engaged in these originations typically address safety and soundness concerns and include criteria to address:

- The program's objectives – these should be of a commercial nature (structured as commercial undertakings and not as investments in securities).
- The plan of distribution – participants should be limited to sophisticated financial and commercial

entities and sophisticated persons and the participations should not be sold directly to the public.
- The credit requirements applicable to the borrower - the originating institution should structure 100% loan participation programs only for borrowers who meet the originating institution's credit requirements.
- Access afforded program participants to financial information on the borrower - the originating institution should allow potential loan participants to obtain and review appropriate credit and other information to enable the participants to make an informed credit decision.

Environmental Risk Program

The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws are important factors for institution management to consider in evaluating real estate transactions and making loans secured by real estate. Institutions that establish appropriate environmental risk programs lower their potential liability for certain types of environmental risks and penalties per the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA).[1]

An appropriate environmental risk program is consistent with the safety and soundness standards prescribed in Appendix A to Part 364 of the FDIC Rules and Regulations. The environmental risk program enables institution management to make an informed lending decision and to assess risk, as necessary, and helps provide for consideration of the nature and value of any underlying collateral. Such a program also is consistent with the real estate lending standards prescribed in Part 365 of the FDIC's Rules and Regulations relating to compliance with all real estate related laws and regulations, which include the CERCLA.

Thus, examiners should verify that institutions maintain an environmental risk program to evaluate the potential adverse effect of environmental contamination on the value of real property and the potential environmental liability associated with the real property. An effective environmental risk program aids management's decision-making process by establishing procedures for identifying and evaluating potential environmental concerns associated with lending practices and other actions relating to real property.

Examiners should determine whether the board of directors reviews and approves the program periodically and designates a senior officer knowledgeable in environmental matters to be responsible for program implementation. Examiners should assess whether the environmental risk program is commensurate with the institution's operations. That is, institutions that have a heavier concentration of loans to higher risk industries or localities of known contamination may require a more elaborate and sophisticated environmental risk program than institutions that lend more to lower risk industries or localities. For example, loans collateralized by 1- to 4-family residences normally have less exposure to environmental liability than loans to finance industrial properties.

Elements of an Effective Environmental Risk Program

The environmental risk program typically provides for staff training, sets environmental policy guidelines and procedures, requires an environmental review or analysis during the application or due diligence process, includes loan documentation standards, and establishes appropriate environmental risk assessment safeguards in loan workout situations and foreclosures.

<u>Training</u>

The environmental risk program generally incorporates training sufficient to ensure that the environmental risk program is implemented and followed, and that the appropriate personnel have the knowledge and experience to identify and evaluate potential environmental concerns that might affect the institution, including its interests in real property. Such training programs typically address circumstances where the complexity of the environmental issue is beyond the expertise of the institution's staff to adequately assess by instructing staff to consult legal counsel, environmental consultants, or other qualified experts.

<u>Policies</u>

Loan policies and written procedures typically address environmental issues pertinent to the institution's specific lending activities. For example, the lending policy may identify the types of environmental risks associated with industries and real estate in the institution's trade area, provide guidelines for conducting an analysis of potential environmental liability, and describe procedures for the resolution of potential environmental concerns. Procedures for the resolution of environmental concerns might also be developed for credit monitoring, loan workout situations, and foreclosures.

[1] See CERCLA, as amended by the Superfund Amendments and Reauthorization Act of 1986, 42 U.S.C. §§ 9601 *et seq.*, the Resource Conservation and Recovery Act of 1976, as amended, 42 U.S.C. §§ 6901 *et seq.*, and the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 (Asset Conservation Act).

Environmental Risk Analysis

Examiners should determine whether management conducts an initial environmental risk analysis during the application process prior to making a loan. An appropriate analysis helps management to minimize potential environmental liability and facilitates implementation of appropriate mitigation strategies prior to closing a loan. Much of the needed information may be gathered by the account officer when interviewing the loan applicant concerning his or her business activities. Some institutions use the loan application to request relevant environmental information, such as the present and past uses of the property and the occurrence of any contacts by federal, state or local governmental agencies about environmental matters. For some transactions, the loan officer or other representative of an institution may visit the site to evaluate whether there is obvious visual evidence of environmental concerns; such visits are usually documented in the loan file.

Structured Environmental Risk Assessment

Whenever the application, interview, or visitation indicates a possible environmental concern, examiners should determine whether a more detailed structured investigation was conducted by a qualified individual. This investigation may include surveying prior owners of the property, researching past uses of the property, inspecting the site and contiguous parcels, and reviewing company records for past use or disposal of hazardous materials. A review of public records and contact with federal and state environmental protection agencies often helps institution management determine whether the borrower has been cited for violations concerning environmental laws or if the property has been identified on federal and state lists of real property with significant environmental contamination. Examiners should also determine whether the institution's policies and procedures consider the Environmental Protection Agency's (EPA) "All Appropriate Inquiry Rule."

EPA All Appropriate Inquiry Rule – In January 2002, Congress amended the CERCLA to establish, among other things, additional protections from cleanup liability for a new owner of a property. The bona fide prospective purchaser provision establishes that a person may purchase property with the knowledge that the property is contaminated without being held potentially liable for the cleanup of contamination at the property.

The new owner must meet certain statutory requirements to qualify as a bona fide prospective purchaser and, prior to the date of acquiring the property, undertake "all appropriate inquiries" into the prior ownership and uses of the property.

In November 2005, the EPA promulgated its "Standards and Practices for All Appropriate Inquiries" final rule (EPA All Appropriate Inquiry Rule) which establishes the standards and practices that are necessary to meet the requirements for an "all appropriate inquiry" into the prior ownership and uses of a property. The All Appropriate Inquiry Rule became effective on November 1, 2006.

An environmental evaluation of the property that meets the standards and practices of the EPA All Appropriate Inquiry Rule will provide the borrower with added protection from CERCLA cleanup liability, provided the borrower meets the requirements to be a bona fide purchaser and other statutory requirements. This protection, however, is limited to CERCLA and does not apply to the Resource Compensation and Recovery Act (RCRA), including liability associated with underground storage tanks, and other federal environmental statutes, and, depending on state law, state environmental statutes. In addition, such an environmental evaluation may provide a more detailed assessment of the property than an evaluation that does not conform to the EPA All Appropriate Inquiry Rule.

Examiner's should determine whether, as part of its environmental risk analysis of any particular extension of credit, a lender evaluates whether it is appropriate or necessary to require the borrower to perform an environmental evaluation that meets the standards and practices of the EPA All Appropriate Inquiry Rule. This decision involves judgment and is made on a case-by-case basis considering the risk characteristics of the transaction, the type of property, and the environmental information gained during an initial environmental risk analysis. If indications of environmental concern are known or discovered during the loan application process, an institution may decide to require the borrower to perform an environmental evaluation that meets the requirements of the EPA All Appropriate Inquiry Rule.

The decision to require the borrower to perform a property assessment that meets the requirements of the EPA All Appropriate Inquiry Rule is generally made in the context of the institution's environmental risk program. An effective environmental risk program is generally designed to ensure management makes an informed judgment about potential environmental risk and considers such risks in its overall consideration of risks associated with the extension of credit. In addition, an institution's environmental risk program may be tailored to its lending practices. Thus, a lender makes its decision concerning when and under what circumstances to require the borrower to perform an environmental property assessment based on its environmental risk program. Individuals who administer an institution's environmental risk program are typically familiar with these statutory elements. More information concerning the EPA All Appropriate Rule can be found on the EPA website at http://www.epa.gov/brownfields/regneg.htm.

Monitoring

Examiners should assess whether the environmental risk assessment continues during the life of the loan, including monitoring the borrower and the real property collateral for potential environmental concerns. Examiners should assess whether loan officers are aware of changes in the business activities of a borrower that may result in a significant increase in risk of environmental liability associated with real property collateral. When there is a potential for environmental contamination to adversely affect the value of the collateral, management might exercise its rights under the loan covenants to require the borrower to resolve the environmental condition and to take actions to protect the value of the real property.

Loan Documentation

Loan documents typically include language to safeguard the institution against potential environmental losses and liabilities. Such language might require that the borrower comply with environmental laws, disclose information about the environmental status of the real property collateral, and grant the institution the right to acquire additional information about potential hazardous contamination by inspecting the collateral property for environmental concerns. The loan documents might also provide the institution the right to call the loan, refuse to extend funds under a line of credit, or foreclose if hazardous contamination is discovered. The loan documents might also call for an indemnity of the institution by the borrower and guarantors for environmental liability associated with the real property collateral.

Involvement in the Borrower's Operations

Under CERCLA and many state environmental cleanup statutes, an institution may have an exemption from environmental liability as the holder of a security interest in real property collateral. Examiners should determine whether institution management, in monitoring a loan, takes action to resolve environmental situations and evaluates whether its actions may constitute "participating in the management" of the business located on the real property collateral within the meaning of CERCLA. If its actions are considered participation in the management, the institution may lose its exemption from liability under CERCLA or similar state statutes.

Foreclosure

A lender's exposure to environmental liability may increase significantly if it takes title to real property held as collateral. Examiners should determine whether management evaluates the potential costs and liability for environmental contamination in conjunction with an assessment of the value of the collateral in reaching a decision to take title to the property by foreclosure or other means. Based on the type of property involved, a lender often includes as part of this evaluation of potential environmental liability, an assessment of the property that meets the requirements of the EPA All Appropriate Inquiry Rule.

Examination Procedures

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

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LOAN PROBLEMS

It would be impossible to list all sources and causes of problem loans. They cover a multitude of mistakes an institution may permit a borrower to make, as well as mistakes directly attributable to weaknesses in the institution's credit administration and management. Some well-constructed loans may develop problems due to unforeseen circumstances on the part of the borrower; however, institution management must endeavor to protect a loan by every means possible. One or more of the items in the following list is often basic to the development of loan problems.

Many of these items may also be indicative of potential institution fraud and/or insider abuse. Additional information on the warning signs and suggested areas for investigation are included in the Bank Fraud and Insider Abuse Section of this Manual.

Poor Selection of Risks

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

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

Overlending

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

Failure to Establish or Enforce Liquidation Agreements

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

Incomplete Credit Information

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

Overemphasis on Loan Income

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

Self-Dealing

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

Technical Incompetence

Technical incompetence usually is manifested in management's inability to obtain and evaluate credit information or put together a well-conceived loan package. Management weaknesses in this area are almost certain to lead to eventual loan losses. Problems can also develop when management, technically sound in some forms of lending, becomes involved in specialized types of credit in which it lacks expertise and experience.

Lack of Supervision

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

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

Lack of Attention to Changing Economic Conditions

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

Competition

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

Potential Problem Indicators by Document

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

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

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SELECTING A LOAN REVIEW SAMPLE IN A RISK-FOCUSED EXAMINATION

Examiners are expected to select a sample of loans that is of sufficient size, scope, and variety to enable them to reach reliable conclusions about the aforementioned aspects of an institution's overall lending function, and tailor the loan review sample based on an institution's business model, complexity, risk profile, and lending activities. The review may include all sources of credit exposure arising from loans and leases, including guarantees, letters of credit, and other commitments.

Assessing the Risk Profile

Prior to developing the loan review sample, examiners are to assess the risk profile of the loan portfolio by reviewing the institution's management reports and policies as well as agency available information. This includes evaluating concerns detailed in prior Reports of Examination (ROEs), issues detailed in the institution's loan exception reports and internal loan reviews, and the historical accuracy of independent credit rating or grading systems. The Uniform Bank Performance Report provides information relative to loan mix and recent trends, such as concentrations of credit, rapid growth, and loan yields higher or lower than peer in different portfolio segments. Examiners are also to consider changes in local economic or market conditions that could affect the portfolio's risk profile. Numerous economic tools and resources are available to examiners to assist in planning the loan review.

As part of the examination planning activities, examiners are to consider whether management has implemented any material changes in the institution's business lines, loan products, lending policies, markets, or personnel since the prior examination. Additionally, examiners should consider whether activities conducted by a branch, subsidiary, affiliate, or third party partner warrant particular attention.

Examiners are to consider the historical adequacy of the institution's policies and practices relative to credit underwriting, administration, and loan grading for each significant loan type. Examiners should review recent management reports and Board or committee packages before selecting a targeted sample to determine whether the Board of Directors and officers are receiving sufficient information to remain abreast of emerging trends and changes in the loan portfolio's risk profile.

Selecting the Sample

The size and composition of the loan sample should be commensurate with the quantity of credit risk, the adequacy of risk management practices, and the institution's financial condition and business model. There are no established or expected levels of minimum or maximum coverage, or penetration, ratios for loan review samples. Rather, examiners should use judgment when determining the focus and extent of loan sampling. Ensuring that the appropriate types of loans are in the sample is more meaningful than how much of the overall portfolio is reviewed.

Examiners must make the most efficient use of resources, and should sample loans of sufficient size, scope and variety to enable them to form reliable conclusions about overall credit quality and the adequacy of credit risk management and governance. Examiners' understanding of the institution's business model, risk profile, complexity, external and internal reports, as well as discussions with management, will be highly instrumental in identifying loans to be included in a judgmental sample. Examiners may also leverage the institution's external and internal loan reviews when determining the loan sample. For example, examiners may want to exclude loans already covered in institution loan reviews or follow-up on loans identified as problems in the loan reviews.

If information gathered indicates weaknesses in underwriting or credit administration practices, or if the institution is engaging in lending activities with significant or increasing risk, the examiner should select a robust sample to fully assess the risk areas. Conversely, institutions with stable, well-managed loan functions exhibiting few signs of change should have more streamlined reviews, focusing more on newer originations and less on loans that were deemed of satisfactory quality at previous examinations that continue to perform as agreed. However, in all instances, examiners should sample enough credits, including new and various-sized credits, to assess the adequacy of asset quality, underwriting practices, and credit risk management, in order to support ROE findings and assigned ratings.

Nonhomogeneous Loan Sample

Nonhomogeneous loans include acquisition, development and construction, commercial real estate, commercial and industrial, and agricultural credits. The nonhomogeneous loan sample generally should include a sufficient number of loans to transaction test various segments of the loan portfolio, but it is unnecessary to review all loans in a particular segment. Rather, the loan review should encompass enough loans in each portfolio segment to support examination conclusions about credit quality and credit management practices relative to underwriting standards and credit administration.

In general, a sampling of loans in the following segments should be included in the overall loan review sample, as applicable to a particular institution:

- Adversely classified or listed for Special Mention in prior ROEs.
- Delinquent, nonaccrual, impaired, or renegotiated/restructured (particularly loans with multiple renewals).
- Internally adversely classified by the institution.
- Rated by the institution as a marginally acceptable credit.
- Subject to prior supervisory criticism or corrective actions.
- Upgraded or removed from internal adverse classification since the prior examination, to ensure that procedures for managing the watch list are appropriate.
- Insider loans (directors, officers, employees, principal shareholders, or related interests at any insured depository institution).
- Originated since the prior examination, including those in new or expanding product lines.
- Participations.
- Out of territory.
- Part of a significant credit concentration or growth area.
- Flagged for potential fraud.
- Contain outlier characteristics (e.g. higher risk loans, credits with policy exceptions).
- Originated by specific loan officers, particularly those with known concerns or weaknesses.
- In geographic areas exposed to changes in market conditions.
- Various sized loans (larger, mid-sized, and smaller loan amounts).

As part of a risk-focused and forward-looking approach to loan review, loans that had been reviewed at previous examinations that had sufficient performance, collateral and documentation, and continue to amortize as agreed, may be more appropriate for Discuss Only or not included at all, which would allow more resources to be focused on new originations or other loans not previously reviewed that would help evaluate areas of significant or growing risk.

Homogeneous Pool Sample

Assessing the quality of homogeneous retail consumer credit on a loan-by-loan basis is burdensome for both institutions and examiners due to portfolios generally consisting of a large number of loans with relatively low balances. Instead, examiners should assess the quality of retail consumer loans based on the borrowers' repayment performance. Examiners generally should review and classify retail consumer loans in accordance with the procedures discussed later in this section under the Interagency Retail Credit Classification Policy subheading.

The EIC may supplement the classification of retail loans with a direct review of larger consumer loans or by sampling various segments when the risk assessment supports doing so. Such an expansion may be warranted when homogeneous lending is a major business line of the institution or when examiners note rapid growth, new products, weaknesses in the loan review or audit program, weaknesses in management information systems, or other factors that raise concerns. The EIC also may conduct limited transaction testing to focus on specific risk characteristics, such as the underwriting standards for new loans or the revised terms granted in workouts or modifications.

Sampling for Trading and Derivatives Activities. At institutions that are active in such markets, examiners should include an assessment of credit exposures arising from matching loans with derivatives (generally swaps or forwards) to hedge a particular type of risk. For example, an institution can use a swap to contractually exchange a stream of floating-rate payments for a stream of fixed-rate payments to hedge interest rate risk. Such activities create a credit exposure relative to both the loan and the derivative. When warranted, examiners should review a sufficient number of loan relationships with these exposures to assess the institution's overall exposure and management's ability to prudently manage derivatives activities. Examiners also should review a sample of credit relationships established solely for the purpose of facilitating derivatives activities.

Determining the Depth of the Review

Examiners should assign loans to be reviewed into one of three groupings, "In Scope" (full review), "Discuss Only" (limited review), and, when applicable, "Group" (pooled loans).

In Scope. This sample consists of loans that warrant the most comprehensive level of review. Examiners are to review loan files to the extent needed to assess the risk in the credit, conformance to lending risk management policies and procedures, and compliance with applicable laws and regulations. Examiners should document the assessment of the borrower's repayment capacity, collateral protection, and overall risk to the institution on individual linesheets. Documentation should also note underwriting exceptions, administrative weaknesses, and apparent violations.

For institutions with stable, well-managed loan functions, In Scope loans should generally focus on newer originations and insider loans. In these situations, if certain loans from previous examinations are included In Scope, examiners have the ability to leverage documentation from previous reviews and focus on updates to the essential credit information.

Discuss Only. This sample is to consist of loans subject to a limited level of review, and examiners are to discuss these credits with institution management. Such discussions can be an effective method of confirming the adequacy of loan grading systems and credit administration practices, particularly when the In Scope sample indicates the institution has adequate risk management practices, and when the institution has a stable, well-managed loan function and exhibits few signs of change. Examiners should briefly document key issues raised during these discussions, but examiners do not need to complete full linesheets. When warranted, examiners may conduct a limited file review or assessment of specific work-out plans and performance metrics for these loans.

Credits should be reallocated from Discuss Only to In Scope if management disagrees with the classification, material concerns with credit underwriting or administration practices are identified, or the EIC or Asset Manager determines a more comprehensive review is warranted.

Group. This sample could include loans with similar risk characteristics that merit review on a pooled basis. Examiners generally should discuss or classify the loans not on an individual basis but as a pool, and apply the findings and conclusions to the entire Group. Examiners may use multiple Groups to focus on the adequacy of credit underwriting and administration practices or to address different risk attributes in stratified segments. The Group sample may be appropriate for specific categories of homogeneous retail consumer credit, such as automobile, credit card, or residential mortgage loans.

Adjusting Loan Review

The EIC has the flexibility, after communicating with the case manager and receiving concurrence of field management, to adjust the loan review sample at any point during the examination based on findings. The rationale for significant changes in the examination plan will be clearly communicated to institution management, along with any adjustments to the breadth or depth of procedures, personnel, and examination schedule.

Accepting an Institution's Internal Ratings

If the institution's internal grading system (watch list) is determined to be accurate and reliable, examiners can use the institution's data for preparing the applicable examination report pages and schedules, for determining the overall level of classifications, and for providing supporting comments regarding the quality of the loan portfolio.

Loan Penetration Ratio

The FDIC has not established any minimum or maximum loan penetration ratios.

The objectives for loan review on an examination include an analysis of credit quality through transaction testing and an assessment of credit administration practices. Achieving a specific loan penetration ratio is not to be the driving factor in determining the loan review sample. Rather, examiners should focus on reviewing a sufficient number of loans in various segments of the portfolio to assess overall risk in the portfolio and to support examination findings, and then calculate the resultant loan penetration ratio for informational purposes only and enter the ratio in the Summary Analysis of Examination Report.

Large Bank Loan Review

In addition to point-in-time examinations conducted at most community banks, the FDIC utilizes targeted loan reviews conducted under a supervisory plan, guiding a continuous examination program for certain institutions. These targeted programs are generally warranted to ensure effective monitoring and examination activity related to larger and more complex institutions. While the supervisory plan and continuous examination processes and procedures may differ in some respects from the point in time approach, the principles contained in the preceding loan review instructions are applicable to examination activities for all institutions supervised by the FDIC.

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LOAN EVALUATION AND CLASSIFICATION

Loan Evaluation

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

Review of Files and Records

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

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

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

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

Additional Transaction Testing

Part of the assessment of loan administration practices includes transaction testing. Such testing can verify that the institution’s written policies and practices are implemented as intended. Testing can also be useful in detecting potential fraudulent or irregular activity. In particular, examiners are required to verify a sample of loans that paid off during or just prior to the on-site portion of the examination. Such verification would include reviewing the loan file, payoff tickets, and tracing the source of funds for the payoff.

Loan Discussion

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

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

Loan Analysis

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

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

Loan Classification

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

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

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

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

The Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions was issued on October 29, 2013, by the Office of the Comptroller of the Currency, the FDIC, and the Federal Reserve Board. The attachment to this interagency statement provides definitions of Substandard, Doubtful, and Loss categories used for adversely classifying institution assets. Amounts classified Loss should be promptly eliminated from the institution's books.

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

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

Definitions

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

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

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

Special Mention Assets

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

Use of Special Mention - The Special Mention category is not to be used as a means of avoiding a clear decision to adversely classify an asset or pass it without critique. Neither should it include assets listed merely "for the record" when uncertainties and complexities, perhaps coupled with large size, create some reservations about the asset. If potential weaknesses warranting management's close attention are not identified, inclusion of such assets in Special Mention is not justified.

Special Mention assets have characteristics that deserve close attention. These assets pose elevated risk, but their weaknesses do not justify an adverse classification. Weak underwriting, administration, and/or imprudent lending practices may be the cause for the Special Mention designation. However, borrowers with adverse operating trends (declining revenues or margins), ill-proportioned balance sheet (e.g., increasing inventory without an increase in sales, high leverage, tight liquidity), or collateral concerns also are factors to consider when assigning a Special Mention designation. Instances may also be encountered where technical exceptions are a factor in scheduling loans for Special Mention, but examiners should not construe that assets involving less significant technical exceptions belong in this category.

Careful identification of assets that properly belong in this category is important in determining the extent of risk within asset quality and providing constructive criticism for institution management. While Special Mention assets should not be combined with adversely classified asset dollar totals in the Report of Examination, their level and trend should be considered in the assessment of asset quality and management, as appropriate. Therefore, examiners are permitted to use ratios combining Special Mention with adversely classified assets, but only when used in a supplemental fashion and in conjunction with the standard asset quality measure, adversely classified assets ratios.

Comments on assets included on the Items Listed for Special Mention schedule in the Report of Examination should be drafted in a fashion similar to those for adversely classified assets. There is no less of a requirement upon the examiner to clearly record the reasons why the asset is listed. The major emphasis of the comments should be towards identifying potential weaknesses and risks that warrant management's close attention.

Troubled Commercial Real Estate Loan Classification Guidelines

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

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

- **Substandard -** Any such troubled real estate loan or portion thereof should be classified Substandard when well-defined weaknesses are present which jeopardize the orderly liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
- **Doubtful -** Doubtful classifications have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable. A Doubtful classification may be appropriate in cases where significant risk exposures are perceived, but Loss cannot be determined because of specific reasonable pending factors which may strengthen the credit in the near term. Examiners should attempt to identify Loss in the credit where possible thereby limiting the excessive use of the Doubtful classification.
- **Loss -** Advances in excess of calculated current fair value which are considered uncollectible and do not warrant continuance as bankable assets. There is little

or no prospect for near term improvement and no realistic strengthening action of significance pending.

Technical Exceptions

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

Past Due and Nonaccrual

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

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

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

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

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

Nonaccrual Loans That Have Demonstrated Sustained Contractual Performance

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

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

When the regulatory reporting criteria for restoration to accrual status are met, previous charge-offs taken would not have to be fully recovered before such loans are returned to accrual status. Loans that meet the above criteria would continue to be disclosed as past due, as appropriate, until they have been brought fully current.

Troubled Debt Restructuring - Multiple Note Structure

The basic example of a trouble debt restructuring (TDR) multiple note structure is a troubled loan that is restructured into two notes where the first or "A" note represents the portion of the original loan principal amount which is expected to be fully collected along with contractual interest. The second part of the restructured loan, or "B" note, represents the portion of the original loan that has been charged-off.

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

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

- The restructuring qualifies as a TDR as defined by ASC Subtopic 310-40, *Receivables – Troubled Debt Restructurings by Creditors* and there is economic substance to the restructuring.
- The portion of the original loan represented by the "B" note has been charged-off. The charge-off must be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. The charge-off must be recorded before or at the time of the restructuring.
- The "A" note is reasonably assured of repayment and of performance in accordance with the modified terms.
- In general, the borrower must have demonstrated sustained repayment performance (either immediately before or after the restructuring) in accordance with the modified terms for a reasonable period prior to the date on which the "A" note is returned to accrual status. A sustained period of payment performance generally would be a minimum of six months and involve payments in the form of cash or cash equivalents.

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

Interagency Retail Credit Classification Policy

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

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

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

- Open-end and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified Substandard.
- Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be charged-off. The charge-off should be taken by the end of the month in which the 120-or 180-day time period elapses.
- Unless the institution can clearly demonstrate and document that repayment on accounts in bankruptcy is likely to occur, accounts in bankruptcy should be charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the delinquency time frames specified in this classification policy, whichever is shorter. The charge-off should be taken by the end of the month in which the applicable time period elapses. Any loan balance not charged-off should be classified Substandard until the borrower re-establishes the ability and willingness to repay (with demonstrated payment performance for six months at a minimum) or there is a receipt of proceeds from liquidation of collateral.
- Fraudulent loans should be charged off within 90 days of discovery or within the delinquency time frames specified in this classification policy, whichever is shorter. The charge-off should be taken by the end of the month in which the applicable time period elapses.
- Loans of deceased persons should be charged off when the loss is determined or within the delinquency time frames adopted in this classification policy, whichever is shorter. The charge-off should be taken by the end of the month in which the applicable time period elapses.
- One-to-four family residential real estate loans and home equity loans that are delinquent 90 days or more with loan-to-value ratios greater than 60 percent, should be classified Substandard.

When an open- or closed-end residential or home equity loan is 180 days past due, a current assessment of value should be made and any outstanding loan balance in excess of the fair value of the property, less cost to sell, should be classified Loss.

Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent should not be classified. However, home equity loans where the institution does not hold the senior mortgage, that are delinquent 90 days or more should be classified Substandard, even if the loan-to-value ratio is equal to, or less than, 60 percent.

If an institution can clearly document that the delinquent loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities, with an estimated fair value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. In the process of collection means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

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

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

Re-aging is the practice of bringing a delinquent account current after the borrower has demonstrated a renewed willingness and ability to repay the loan by making some, but not all, past due payments. Re-aging of open-end accounts, or extensions, deferrals, renewals, or rewrites of closed-end accounts should only be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use of a policy is acceptable when it is based on recent, satisfactory performance and the true improvement in a borrower's other credit factors, and when it is structured in accordance with internal policies.

The decision to re-age a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that institution personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower shows the ability to repay the loan.

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

- The borrower should show a renewed willingness and ability to repay the loan.
- The account should exist for at least nine months before allowing a re-aging, extension, renewal, referral, or rewrite.
- The borrower should make at least three minimum consecutive monthly payments or the equivalent lump sum payment before an account is re-aged. Funds may not be advanced by the institution for this purpose.
- No loan should be re-aged, extended, deferred, renewed, or rewritten more than once within any twelve-month period; that is, at least twelve months must have elapsed since a prior re-aging. In addition, no loan should be re-aged, extended, deferred, renewed, or rewritten more than two times within any five-year period.
- For open-end credit, an over limit account may be re-aged at its outstanding balance (including the over limit balance, interest, and fees). No new credit may be extended to the borrower until the balance falls below the designated predelinquency credit limit.

Partial Payments on Open-End and Closed-End Credit

Institutions should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing delinquency. Alternatively, the institution may aggregate payments and give credit for any partial payment received. For example, if a regular installment payment is $300 and the borrower makes payments of only $150 per month for a six-month period, the loan would be $900, or three full months delinquent. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

Examination Considerations

Examiners should determine whether institutions' policies and practices consider the Retail Classification Policy, understanding that there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur regardless of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims. Conversely, the Retail Classification Policy does not preclude examiners from reviewing and classifying individual large dollar retail credit loans that exhibit signs of credit weakness regardless of delinquency status.

In addition to reviewing loan classifications, the examiner should review the ALLL to assess whether it is at an appropriate level. Sound risk and account management systems typically include:

- Prudent retail credit lending policies,
- Measures to monitor adherence to policy,
- Detailed operating procedures, and
- Appropriate internal controls.

Institutions lacking sound policies or failing to implement or effectively follow established policies will be subject to criticism.

Examination Treatment

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

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

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

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

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

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

Impaired Loans, Troubled Debt Restructurings, Foreclosures, and Repossessions

Loan Impairment – The accounting standard for impaired loans is ASC Subtopic 310-10. A loan is impaired when, based on current information and events, it is probable that an institution will be unable to collect all amounts due according to the contractual terms of the loan agreement (i.e., principal and interest). Impaired loans encompass all loans that are restructured in a troubled debt restructuring, including smaller balance homogenous loans that are typically exempt from ASC Subtopic 310-10. However, the standard does not include loans that are measured at fair value or the lower of cost or fair value.

When a loan is impaired under ASC Subtopic 310-10, the amount of impairment should be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate (i.e., the contractual interest rate adjusted for any net deferred loan fees or costs and premium or discount existing at the origination or acquisition of the loan). As a practical expedient, impairment may also be measured based on a loan's observable market price. The fair value of the collateral must be used if the loan is collateral dependent. An impaired loan is collateral dependent if repayment would be expected to be provided solely by the sale or continued operation of the underlying collateral.

If the measure of a loan calculated in accordance with ASC Subtopic 310-10 is less than the recorded investment in the loan (typically the face amount of the loan, plus accrued interest, adjusted for any premium or discount, deferred fee or cost, less any charge-offs), impairment on that loan should be recognized as a part of the ALLL. In general, when the amount of the recorded investment in the loan exceeds the amount calculated under ASC Subtopic 310-10 and that amount is determined to be uncollectible, this excess amount should be promptly charged-off against the ALLL. In all cases, when an impaired loan is collateral dependent and the repayment of the loan is expected from the sale of the collateral, any portion of the recorded investment in the loan in excess of the fair value less cost to sell of the collateral should be charged-off.

Troubled Debt Restructuring - The accounting for TDRs is set forth in ASC Subtopic 310-40, *Receivables-Troubled Debt Restructurings by Creditors*. A restructuring constitutes a troubled debt restructuring if the institution for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. A troubled debt restructuring takes place when an institution grants a concession to a debtor in financial difficulty. Examiners are expected to reflect all TDRs in examination reports in accordance with this accounting guidance and institutions are expected to follow these principles when filing the Call Report.

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

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

To illustrate, assume an institution forecloses on a defaulted mortgage loan of $100,000 and takes title to the property. If the fair value of the property at the time of foreclosure is $90,000 and costs to sell are estimated at $10,000, a $20,000 loss should be immediately recognized by a charge to the ALLL. The cost of the foreclosed asset becomes $80,000. If the institution is on an accrual basis of accounting, there may also be adjusting entries necessary to reduce both the accrued interest receivable and loan interest income accounts. Assume further that in order to effect sale of the realty to a third party, the institution is willing to offer a new mortgage loan (e.g., of $100,000) at a concessionary rate of interest (e.g., 10 percent while the market interest rate for new loans with similar risk is 20 percent). Before booking this new transaction, the institution must establish its "economic value" or what would be the cash price paid. Pursuant to ASC Subtopic 835-30, *Interest – Imputation of Interest*, the value is represented by the sum of the present value of the income stream to be received from the new loan, discounted at the current market interest rate for this type of credit, and the present value of the principal to be received, also discounted at the current market interest rate. This economic value (calculated by discounting the cash flows at the current market interest rate) becomes the proper carrying value for the property at its sale date. Since the sales price of $78,000 is less than the property's carrying amount of $80,000), an additional loss has been incurred and should be immediately recognized. This additional loss should be reflected in the allowance if a relatively brief period has elapsed between foreclosure and subsequent resale of the property. However, the loss should be treated as loss on the sale of real estate if the asset has been held for a longer period. The new loan would be placed on the books at its face value ($100,000) and the difference between the new loan amount and the "economic value" ($78,000) is treated as unearned discount ($22,000). For examination and Call Report purposes, the asset would be shown net of the unearned discount which is reduced periodically as it is earned over the life of the new loan. The $22,000 discount is accreted into interest income over the life of the loan as long as the loan remains in accrual status.

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

Modification of Terms - When the terms of a TDR provide for a reduction of interest <u>or</u> principal, the institution should measure any loss on the restructuring in accordance with the guidance for impaired loans as set forth in ASC Subtopic 310-10 unless the loans are measured at fair value or the lower of cost or fair value. The amount of impairment of the restructured loan using the appropriate measurement method in ASC Subtopic 310-10 is reported as a component in determining the overall ALLL. If any amount of the calculated impairment is determined to be uncollectible, that amount should be promptly charged-off against the ALLL.

For example, in lieu of foreclosure, an institution chooses to restructure a $100,000 loan to a borrower which had originally been granted with an interest rate of 10 percent for 10 years. The institution and the borrower have agreed to capitalize the accrued interest ($10,000) into the note balance, but the restructured terms will permit the borrower to repay the debt over 10 years at a six percent interest rate. The institution does not believe the loan is collateral dependent. In this situation, the institution would determine the amount of impairment on the TDR as the difference between the present value of the expected cash flows discounted at the 10 percent rate specified in the original contract and the recorded investment in loan of $110,000. This amount of the calculated impairment becomes a component of the overall ALLL.

Combination Approach - In some instances, the institution may receive assets in partial rather than full satisfaction of a loan or security and may also agree to alter the original repayment terms. In these cases, the recorded investment in the loan should be reduced by the fair value of the assets received (less cost to sell, if appropriate). The remaining recorded investment in the loan is accounted for as a TDR.

Examination Report Treatment - Examiners should continue to classify TDRs, including any impaired collateral dependent loans, based on the definitions of Loss, Doubtful, and Substandard. When an impaired loan is collateral dependent and the loan is expected to be satisfied by the sale of the collateral, any portion of the recorded investment in the loan which exceeds the fair value of the collateral, less cost to sell is the amount of impairment included in the ALLL. This is the amount of Loss on that loan that should be promptly charged-off. For other loans that are impaired loans, the amount of the recorded investment in the loan over the amount of the calculated impairment is recognized as a component of the ALLL. However, when available information confirms that loans and leases (including any recorded accrued interest, net deferred loan fees or costs, and unamortized premium or discount) other than impaired collateral dependent loans (dependent on the sale of the collateral), or portions thereof, are uncollectible, these amounts should be promptly charged-off against the ALLL.

An examiner should not require an additional allowance for credit losses of impaired loans over and above what is calculated in accordance with these standards. An additional allowance on impaired loans may be supported based on consideration of institution-specific factors, such as historical loss experience compared with estimates of such losses and concerns about the reliability of cash flow estimates, the quality of an institution's loan review function, and controls over its process for estimating its ASC Subtopic 310-10 allowance.

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

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

Report of Examination Treatment of Classified Loans

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

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

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

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

different classifications or are not subject to classification, comments should clearly set forth the reasoning for the split treatment.
- **Management's Intentions -** Comments should include any corrective program contemplated by management.

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

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

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

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

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

An institution must request an “express determination" letter before making the election. To continue using the tax-book conformity method, the institution must request a new letter at each subsequent examination that covers the loan review process. If the examiner does not issue an "express determination" letter at the end of such an examination, the institution's election of the tax-book conformity method is revoked automatically as of the beginning of the taxable year that includes the date of examination. However, that examiner's decision not to issue an "express determination" letter does not invalidate an institution's election for any prior years. The supervisory authority is not required to rescind any previously issued "express determination" letters.

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

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

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

An "express determination" letter should be issued to an institution only if:

- The examination indicates that the institution maintains and applies loan loss classification standards that are consistent with the FDIC's standards regarding the identification and charge-off of such loans; and
- There are no material deviations from the FDIC's standards.

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

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

- The institution's loan review process relating to charge-offs is subject to significant criticism;
- Loan charge-offs reported in the Report of Condition and Income (Call Reports) are consistently overstated or understated; or
- There is a pattern of loan charge-offs not being recognized in the appropriate year.

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

Express Determination Letter for IRS Regulation 1.166-2(d)(3)

"In connection with the most recent examination of [Name of Bank], by the Federal Deposit Insurance Corporation, as of [examination date], we reviewed the institution's loan review process as it relates to loan charge-offs. Based on our review, we concluded that the institution, as of that date, maintained and applied loan loss classification standards that were consistent with regulatory standards regarding loan charge-offs.

This statement is made on the basis of a review that was conducted in accordance with our normal examination procedures and criteria. It does not in any way limit or preclude any formal or informal supervisory action (including enforcement actions) by this supervisory authority relating to the institution's loan review process or the level at which it maintains its allowance for loan and lease losses.

[signature]
Examiner-in-charge
[date signed]

When an "express determination" letter is issued to an institution, a copy of the letter as well as documentation of the work performed by examiners in their review of the institution's loan loss classification standards should be maintained in the workpapers. A copy of the letter should also be forwarded to the regional office with the Report of Examination. The issuance of an "express determination" letter should be noted in the Report of Examination according to procedure in the Report of Examination Instructions. An express determination letter should not be issued subsequent to the Report of Examination being finalized and distributed to the institution.

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

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CONCENTRATIONS

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

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

To establish a meaningful tracking system for concentrations of credit, financial institutions should be encouraged to consider the use of codes to track individual borrowers, related groups of borrowers, industries, and individual foreign countries. Financial institutions should also be encouraged to use the North American Industry Classification System (NAICS) or similar code to track industry concentrations. Any monitoring program should be reported regularly to the board of directors.
Refer to the Report of Examination Instructions for guidance in identifying and listing concentrations in the examination report.

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FEDERAL FUNDS SOLD AND REPURCHASE AGREEMENTS

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

Federal funds sold are not "risk free" as is often supposed, and the examiner will need to recognize the elements of risk involved in such transactions. While the selling of funds is on a one-day basis, these transactions may evolve into a continuing situation. This development is usually the result of liability management techniques whereby the buying institution attempts to utilize the acquired funds to support a rapid expansion of its loan-investment posture and as a means of enhancing profits. Of particular concern to the examiner is that, in many cases, the selling institution will automatically conclude that the buying institution's financial condition is above reproach without proper investigation and analysis. If this becomes the case, the selling institution may be taking an unacceptable risk unknowingly.
Another area of potential risk involves selling federal funds to an institution which may be acting as an intermediary between the selling institution and the ultimate buying institution. In this instance, the intermediary institution is acting as agent with the true liability for repayment accruing to the third institution. Therefore, it is particularly important that the original selling institution be aware of this situation, ascertain the ultimate disposition of its funds, and be satisfied as to the creditworthiness of the ultimate buyer of the funds.

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

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

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

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

Assessing Bank-to-Bank Credit

Because of the FDIC's regulatory role, examiners often possess confidential information concerning a bank obligated on unsecured lines, Federal funds, or subordinated notes and debentures to another bank under examination. The files of the bank under examination may contain insufficient information to make an informed assessment of the credit. When this is the case, and when there is information in the public domain to suggest that the line involves more than a normal degree of risk, the matter should be brought to the attention of management and the board of the bank under examination.

However, if the bank's credit files or public record contain sufficient information to justify adverse classification of the debt, then it should be classified in the report of examination.

The following is a statement regarding such credits which may be used in applicable situations:

The foregoing obligation of a federally insured banking institution is listed for special mention because of publicly available information which suggests the obligation contains risk which is some degree greater than normal. The following is a standard statement of the FDIC's position regarding such credits.

"In reviewing bank-to-bank debt, the FDIC is placed in a position of basic conflict. We may or may not be in possession of confidential information arising from our regulatory function with respect to the other institution. The responsibility for properly appraising the assets of the bank under examination in such an instance may suggest the need to disclose adverse information, while the implied arrangement under which we received the information would preclude us, in good faith, from making the disclosure. It is our policy, in view of the foregoing, not to classify such credits adversely except where we can support the classification without the use of information gathered solely through privileged sources. Rather, we bring the existence of this credit to the board's attention for whatever review or other action it believes consistent with its sworn responsibilities to the stockholders and depositors of the bank under examination."

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FUNDAMENTAL LEGAL CONCEPTS AND DEFINITIONS

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

Uniform Commercial Code – Secured Transactions

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

General Provisions

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

Grant of Security Interest

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

Collateral

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

Unless otherwise agreed a security agreement gives the secured party the rights to proceeds from the sale, exchange, collection or disposition of the collateral.
In some cases, the collateral that secures an obligation under one security agreement can be used to secure a new loan, too. This can be done by using a cross-collateralization clause in the security agreement.

Perfecting the Security Interest

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

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

Right to Possess and Dispose of Collateral

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

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

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

Agricultural Liens

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

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

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

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

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

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

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

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

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

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

Borrowing Authorization

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

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

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

Bond and Stock Powers

As mentioned previously, an institution generally obtains a security interest in stocks and bonds by possession. The documents which allow the institution to sell the securities if the borrower defaults are called stock powers and bond powers. The examiner should ensure the institution has, for each borrower who has pledged stocks or bonds, one signed stock power for all stock certificates of a single issuer, and a separate signed bond power for each bond instrument. The signature must agree with the name on the actual stock certificate or bond instrument. Refer to Federal Reserve Board Regulations Part 221 (Reg U) for further information on loans secured by investment securities.

Co-maker

Two or more persons who are parties to a contract or promise to pay are known as co-makers. They are a unit to the performance of one act and are considered primarily liable. In the case of default on an unsecured loan, a judgment would be obtained against all. A release against one is a release against all because there is but one obligation and if that obligation is released as to one obligor, it is released as to all others.

Loan Guarantee

Since banks often condition credit advances upon the backup support provided by third party guarantees, examiners should understand the legal fundamentals governing guarantees. A guarantee may be a guarantee of payment or of collection. "Payment guaranteed" or equivalent words added to a signature means that if the instrument is not paid when due, the guarantor will pay it according to its terms without resort by the holder to any other party. "Collection guaranteed" or equivalent words added to a signature means that if the instrument is not paid when due, the guarantor will pay it, but only after the holder has reduced to judgment a claim against the maker and execution has been returned unsatisfied, or after the maker has become insolvent or it is otherwise useless to proceed against such a party.

Contracts of guarantee are further divided into a limited guarantee which relates to a specific note (often referred to as an "endorsement") or for a fixed period of time, or a continuing guarantee which, in contrast, is represented by a separate instrument and enforceable for future (duration depends upon state law) transactions between the institution and the borrower or until revoked. A well-drawn continuing guarantee contains language substantially similar to the following: "This is an absolute and unconditional guarantee of payment, is unconditionally delivered, and is not subject to the procurement of a guarantee from any person other than the undersigned, or to the performance or happening of any other condition." The aforementioned unambiguous terms are necessary to the enforceability of contracts of guarantee, as they are frequently entered into solely as an accommodation for the borrower and without the guarantor's participation in the benefits of the loan. Thus, courts tend to construe contracts of guarantee strictly against the party claiming under the contract. Unless the guarantee is given prior to or at the time the initial loan is made, the guarantee may not be enforceable because of the difficulty of establishing that consideration was given. Institutions should not disburse funds on such loans until they have the executed guarantee agreement in their possession. Institutions should also require the guarantee be signed in the presence of the loan officer, or, alternatively, that the guarantor's signature be notarized. If the proposed guarantor is a partnership, joint venture, or corporation, the examiner should ensure the signing party has the legal authority to enter into the guarantee agreement. Whenever there is a question concerning a corporation's authority to guarantee a loan, counsel should be consulted and a special corporate resolution passed by the organization's board of directors.

Subordination Agreement

An institution extending credit to a closely held corporation may want to have the company's officers and shareholders subordinate to the institution's loan any indebtedness owed them by the corporation. This is accomplished by execution of a subordination agreement by the officers and shareholders. Subordination agreements are also commonly referred to as standby agreements. Their basic purpose is to prevent diversion of funds from reduction of institution debt to reduction of advances made by the firm's owners or officers.

Hypothecation Agreement

This is an agreement whereby the owner of property grants a security interest in collateral to the institution to secure the indebtedness of a third party. Institutions often take possession of the stock certificates, plus stock powers endorsed in blank, in lieu of a hypothecation agreement. Caution, however, dictates that the institution take a hypothecation agreement setting forth the institution's rights in the event of default.

Real Estate Mortgage

A mortgage may be defined as a conveyance of realty given with the intention of providing security for the payment of debt. There are several different types of mortgage instruments but those commonly encountered are regular mortgages, deeds of trust, equitable mortgages, and deeds absolute given as security.

Regular Mortgages - The regular mortgage involves only two parties, the borrower and the lender. The mortgage document encountered in many states today is referred to as the regular mortgage. It is, in form, a deed or conveyance of realty by the borrower to the lender followed or preceded by a description of the debt and the property, and includes a provision to the effect that the mortgage be released upon full payment of the debt. Content of additional paragraphs and provisions varies considerably.

Deeds of Trust - In the trust deed, also known as the deed of trust, the borrower conveys the realty not to the lender but to a third party, a trustee, in trust for the benefit of the holder of the notes(s) that constitutes the mortgage debt. The deed of trust form of mortgage has certain advantages, the principle being that in a number of states it can be foreclosed by trustee's sale under the power of sale clause without court proceedings.

Equitable Mortgages - As a general rule, any instrument in writing by which the parties show their intention that realty be held as security for the payment of a debt, constitutes an equitable mortgage capable of being foreclosed in a court of equity.

Deeds Absolute Given as Security - Landowners who borrow money may give as security an absolute deed to the land. "Absolute deed" means a quitclaim or warranty deed such as is used in an ordinary realty sale. On its face, the transaction appears to be a sale of the realty; however, the courts treat such a deed as a mortgage where the evidence shows that the instrument was really intended only as security for a debt. If such proof is available, the borrower is entitled to pay the debt and demand reconveyance from the lender, as in the case of an ordinary mortgage. If the debt is not paid, the grantee must foreclose as if a regular mortgage had been made.

The examiner should determine whether the institution has performed a title and lien search of the property prior to taking a mortgage or advancing funds. Proper procedure calls for an abstractor bringing the abstract up to date, and review of the abstract by an attorney or title insurance company. If an attorney performs the task, the abstract will be examined and an opinion prepared indicating with whom title rests, along with any defects and encumbrances disclosed by the abstract. Like an abstractor, an attorney is liable only for damages caused by negligence. If a title insurance company performs the task of reviewing the abstract, it does essentially the same thing; however, when title insurance is obtained, it represents a contract to make good, loss arising through defects in title to real estate or liens or encumbrances thereon. Title insurance covers various items not covered in an abstract and title opinion. Some of the more common are errors by abstractors or attorneys include unauthorized corporate action, mistaken legal interpretations, and unintentional errors in public records by public officials. Once the institution determines title and lien status of the property, the mortgage can be prepared and funds advanced. The institution should record the mortgage immediately after closing the loan. Form, execution, and recording of mortgages vary from state to state and therefore must conform to the requirements of state law.

Collateral Assignment

An assignment is generally considered as the transfer of a legal right from one person to another. The rights acquired under a contract may be assigned if they relate to money or property, but personal services may not be assigned. Collateral assignments are used to establish the institution's rights as lender in the property or asset serving as collateral. It is generally used for loans secured by savings deposits, certificates of deposit or other cash accounts as well as loans backed by cash surrender value of life insurance. In some instances, it is used in financing accounts receivable and contracts. If a third party holder of the collateral is involved, such as life insurance company or the payor of an assigned contract, an acknowledgement should be obtained from that party as to the institution's assigned interest in the asset for collateral purposes.

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CONSIDERATION OF BANKRUPTCY LAW AS IT RELATES TO COLLECTIBILITY OF A DEBT

Introduction

Familiarity with the basic terms and concepts of the federal bankruptcy law (formally known as the Bankruptcy Reform Act of 1978) is necessary in order for examiners to make informed judgments concerning the likelihood of collection of loans to bankrupt individuals or organizations. The following paragraphs present an overview of the subject. Complex situations may arise where more in-depth consideration of the bankruptcy provisions may be necessary and warrant consultation with the institution's attorney, regional counsel or other member of the regional office staff. For the most part, however, knowledge of the following information when coupled with review of credit file data and discussion with institution management should enable examiners to reach sound conclusions as to the eventual repayment of the institution's loans.

Forms of Bankruptcy Relief

Liquidation and rehabilitation are the two basic types of bankruptcy proceedings. Liquidation is pursued under Chapter 7 of the law and involves the bankruptcy trustee collecting all of the debtor's nonexempt property, converting it into cash and distributing the proceeds among the debtor's creditors. In return, the debtor obtains a discharge of all debts outstanding at the time the petition was filed which releases the debtor from all liability for those pre-bankruptcy debts.

Rehabilitation (sometimes known as reorganization) is effected through Chapter 11 or Chapter 13 of the law and in essence provides that creditors' claims are satisfied not via liquidation of the obligor's assets but rather from future earnings. That is, debtors are allowed to retain their assets but their obligations are restructured and a plan is implemented whereby creditors may be paid.

Chapter 11 bankruptcy is available to all debtors, whether individuals, corporations or partnerships. Chapter 13 (sometimes referred to as the "wage earner plan"), on the other hand, may be used only by individuals with regular incomes and when their unsecured debts are under $100,000 and secured debts less than $350,000. The aforementioned rehabilitation plan is essentially a contract between the debtor and the creditors. Before the plan may be confirmed, the bankruptcy court must find it has been proposed in good faith and that creditors will receive an amount at least equal to what would be received in a Chapter 7 proceeding. In Chapter 11 reorganization, all creditors are entitled to vote on whether or not to accept the repayment plan. In Chapter 13 proceedings, only secured creditors are so entitled. A majority vote binds the minority to the plan, provided the latter will receive pursuant to the plan at least the amount they would have received in a straight liquidation. The plan is fashioned so that it may be carried out in three years although the court may extend this to five years.

Most cases in bankruptcy courts are Chapter 7 proceedings, but reorganization cases are increasingly common. From the creditor's point of view, Chapter 11 or 13 filings generally result in greater debt recovery than do liquidation situations under Chapter 7. Nonetheless, the fact that reorganization plans are tailored to the facts and circumstances applicable to each bankrupt situation means that they vary considerably and the amount recovered by the creditor may similarly vary from nominal to virtually complete recovery.

Functions of Bankruptcy Trustees

Trustees are selected by the borrower's creditors and are responsible for administering the affairs of the bankrupt debtor's estate. The bankrupt's property may be viewed as a trust for the benefit of the creditors, consequently it follows the latter should, through their elected representatives, exercise substantial control over this property.

Voluntary and Involuntary Bankruptcy

When a debtor files a bankruptcy petition with the court, the case is described as a voluntary one. It is not necessary the individual or organization be insolvent in order to file a voluntary case. Creditors may also file a petition, in which case the proceeding is known as an involuntary bankruptcy. However, this alternative applies only to Chapter 7 cases and the debtor generally must be insolvent, i.e., unable to pay debts as they mature, in order for an involuntary bankruptcy to be filed.

Automatic Stay

Filing of the bankruptcy petition requires (with limited exceptions) creditors to stop or "stay" further action to collect their claims or enforce their liens or judgements. Actions to accelerate, set off or otherwise collect the debt are prohibited once the petition is filed, as are post- bankruptcy contacts with the obligor. The stay remains in effect until the debtor's property is released from the estate, the bankruptcy case is dismissed, the debtor obtains or is denied a discharge, or the bankruptcy court approves a creditor's request for termination of the stay. Two of the more important grounds applicable to secured creditors under which they may request termination are as follows: (1) The debtor has no equity in the encumbered property, and the property is not necessary to an effective rehabilitation plan; or (2) The creditor's interest in the secured property is not adequately protected. In the latter case, the law provides three methods by which the creditor's interests may be adequately protected: the creditor may receive periodic payments equal to the decrease in value of the creditor's interest in the collateral; an additional or substitute lien on other property may be obtained; or some other protection is arranged (e.g., a guarantee by a third party) to adequately safeguard the creditor's interests. If these alternatives result in the secured creditor being adequately protected, relief from the automatic stay will not be granted. If relief from the stay is obtained, creditors may continue to press their claims upon the bankrupt's property free from interference by the debtor or the bankruptcy court.

Property of the Estate

When a borrower files a bankruptcy petition, an "estate" is created and, under Chapter 7 of the law, the property of the estate is passed to the trustee for distribution to the creditors. Certain of the debtor's property is exempt from distribution under all provisions of the law (not just Chapter 7), as follows: homeowner's equity up to $7,500; automobile equity and household items up to $1,200; jewelry up to $500; cash surrender value of life insurance up to $4,000; Social Security benefits (unlimited); and miscellaneous items up to $400 plus any unused portion of the homeowner's equity. The bankruptcy code recognizes a greater amount of exemptions may be available under state law and, if state law is silent or unless it provides to the contrary, the debtor is given the option of electing either the federal or state exemptions. Examiners should note that some liens on exempt property which would otherwise be enforceable are rendered unenforceable by the bankruptcy. A secured lender may thus become unsecured with respect to the exempt property. The basic rule in these situations is that the debtor can render unenforceable judicial liens on any exempt property and security interests that are both nonpurchase money and nonpossessory on certain household goods, tools of the trade and health aids.

Discharge and Objections to Discharge

The discharge, as mentioned previously, protects the debtor from further liability on the debts discharged. Sometimes, however, a debtor is not discharged at all (i.e., the creditor has successfully obtained an "objection to discharge") or is discharged only as regards to a specific creditor(s) and a specific debt(s) (an action known as "exception to discharge"). The borrower obviously remains liable for all obligations not discharged, and creditors may pursue customary collection procedures with respect thereto. Grounds for an "objection to discharge" include the following actions or inactions by the bankrupt debtor (this is not an all-inclusive list): fraudulent conveyance within 12 months of filing the petition; unjustifiable failure to keep or preserve financial records; false oath or account or presentation of a false claim in the bankruptcy case and estate, respectively; withholding of books or records from the trustee; failure to satisfactorily explain any loss or deficiency of assets; refusal to testify when legally required to do so; and receiving a discharge in bankruptcy within the last six full years. Some of the bases upon which creditors may file "exceptions to discharge" are: nonpayment of income taxes for the three years preceding the bankruptcy; money, property or services obtained through fraud, false pretenses or false representation; debts not scheduled on the bankruptcy petition and which the creditor had no notice; alimony or child support payments (this exception may be asserted only by the debtor's spouse or children, property settlements are dischargeable); and submission of false or incomplete financial statements. If an institution attempts to seek an exception on the basis of false financial information, it must prove the written financial statement was materially false, it reasonably relied on the statement, and the debtor intended to deceive the institution. These assertions can be difficult to prove. Discharges are unavailable to corporations or partnerships. Therefore, after a bankruptcy, corporations and partnerships often dissolve or become defunct.

Reaffirmation

Debtors sometimes promise their creditors after a bankruptcy discharge that they will repay a discharged debt. An example wherein a debtor may be so motivated involves the home mortgage. To keep the home and discourage the mortgagee from foreclosing, a debtor may reaffirm this obligation. This process of reaffirmation is an agreement enforceable through the judicial system. The law sets forth these basic limitations on reaffirmations: the agreement must be signed before the discharge is granted; a hearing is held and the bankruptcy judge informs the borrower there is no requirement to reaffirm; and the debtor has the right to rescind the reaffirmation if such action is taken within 30 days.

Classes of Creditors

The first class of creditors is known as priority creditors. As the name implies, these creditors are entitled to receive payment prior to any others. Priority payments include administrative expenses of the debtor's estate, unsecured claims for wages and salaries up to $2,000 per person, unsecured claims for employee benefit plans, unsecured claims of individuals up to $900 each for deposits in conjunction with rental or lease of property, unsecured claims of governmental units and certain tax liabilities. Secured creditors are only secured up to the extent of the value of their collateral. They become unsecured in the amount by which collateral is insufficient to satisfy the claim. Unsecured creditors are of course the last class in terms of priority.

Preferences

Certain actions taken by a creditor before or during bankruptcy proceedings may be invalidated by the trustee if they result in some creditors receiving more than their share of the debtor's estate. These actions are called "transfers" and fall into two categories. The first involves absolute transfers, such as payments received by a creditor; the trustee may invalidate this action and require the payment be returned and made the property of the bankrupt estate. A transfer of security, such as the granting of a mortgage, may also be invalidated by the trustee. Hence, the trustee may require previously encumbered property be made unencumbered, in which case the secured party becomes an unsecured creditor. This has obvious implications as regards loan collectibility.

Preferences are a potentially troublesome area for banks and examiners should have an understanding of basic principles applicable to them. Some of the more important of these are listed here.

- A preference may be invalidated (also known as "avoided") if it has all of these elements: the transfer was to or for the benefit of a creditor; the transfer was made for or on account of a debt already outstanding; the transfer has the effect of increasing the amount a creditor would receive in Chapter 7 proceedings; the transfer was made within 90 days of the bankruptcy filing, or within one year if the transfer was to an insider who had reasonable cause to believe the debtor was insolvent at the time of transfer; and the debtor was insolvent at the time of the transfer. Under bankruptcy law, borrowers are presumed insolvent for 90 days prior to filing the bankruptcy petition.
- Payment to a fully secured creditor is not a preference because such a transfer would not have the effect of increasing the amount the creditor would otherwise receive in a Chapter 7 proceeding. Payment to a partially secured creditor does, however, have the effect of increasing the creditor's share and is thus deemed a preference which the trustee may avoid.
- Preference rules also apply to a transfer of a lien to secure past debts, if the transfer has all five elements set forth under the first point.
- There are certain situations wherein a debtor has given a preference to a creditor but the trustee is not permitted to invalidate it. A common example concerns floating liens on inventory under the Uniform Commercial Code. These matters are subject to complex rules, however, and consultation with the regional office may be advisable when this issue arises.

Setoffs

Setoffs occur when a party is both a creditor and a debtor of another; amounts which a party owes are netted against amounts which are owed to that party. If an institution exercises its right of setoff properly and before the bankruptcy filing, the action is generally upheld in the bankruptcy proceedings. Setoffs made after the bankruptcy may also be valid but certain requirements must be met of which the following are especially important: First, the debts must be between the same parties in the same right and capacity. For example, it would be improper for the institution to setoff the debtor's loan against a checking account of the estate of the obligor's father, of which the debtor is executor. Second, both the debt and the deposit must precede the bankruptcy petition filing. Third, the setoff may be disallowed if funds were deposited in the institution within 90 days of the bankruptcy filing and for the purpose of creating or increasing the amount to be set off.

Transfers Not Timely Perfected or Recorded

Under most circumstances, an institution which has not recorded its mortgage or otherwise fails to perfect its security interest in a proper timely manner runs great risk of losing its security. This is a complex area of the law but prudence clearly dictates that liens be properly obtained and promptly filed so that the possibility of losing the protection provided by collateral is eliminated.

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SYNDICATED LENDING

Overview

Syndicated loans often represent a substantial portion of the commercial and industrial loan portfolios of large banks. A syndicated loan involves two or more banks contracting with a borrower, typically a large or middle market corporation, to provide funds at specified terms under the same credit facility. The average commercial syndicated credit is in excess of $100 million. Syndicated credits differ from participation loans in that lenders participate jointly in the origination process, as opposed to one originator selling undivided participation interests to third parties. In a syndicated transaction, each financial institution receives a pro rata share of the income based on the level of participation in the credit. Additionally, one or more lenders take on the role of *lead* or *agent* (co-agents in the case of more than one) of the credit and assume responsibility of administering the loan for the other lenders. The agent may retain varying percentages of the credit, which is commonly referred to as the hold *level*.

The syndicated-lending market formed to meet basic needs of lenders and borrowers, such as:

- Raising large amounts of money,
- Enabling geographic diversification,
- Obtaining working capital quickly and efficiently,
- Diversifying credit risk among banks, and
- Gaining attractive pricing advantages.

In times of excess liquidity in the marketplace, spreads typically are quite narrow for investment-grade facilities, thus making it a borrower’s market. This may be accompanied by an easing of the structuring and covenants. In spite of tightening margins, commercial banks are motivated to compete regarding pricing in order to retain other business as well as generate fee income.

Relaxing covenants and pricing may result in lenders relying heavily on market valuations, or so-called "enterprise values" in arriving at credit decisions. These values are derived by applying a current-period multiple to cash flows (which uses data from comparable companies within the same industry), or discounting projected cash flows over several years (which typically uses an average cost of capital as the discount rate). This value represents the intangible business value of a company as a going concern, which often exceeds its underlying hard assets.

Many deals involve merger and acquisition financing. While the primary originators of the syndicated loans are commercial banks, most of the volume is sold and held by other investors.

A subset of syndicated lending is leveraged lending which refers to borrowers with an elevated level of debt and debt service compared with cash flow. By their very nature, these instruments are of higher risk.

Syndication Process

There are four phases in loan syndications: Pre-Launch, Launch, Post-Launch, and Post-Closing.

The Pre-Launch Process - During this phase, the syndicators identify the borrower’s needs and perform their initial due diligence. Industry information is gathered and analyzed, and background checks may be performed. Potential pricing and structure of the transaction takes shape. Formal credit write-ups are sent to credit officers for review and to senior members of the syndication group for pricing approval. Competitive bids are sent to the borrower. The group then prepares for the launch.

An information memorandum is prepared by the agent. This memorandum is a formal and confidential document that should address all principal credit issues relating to the borrower and to the project being financed. It typically contains an overview of the transaction including a term sheet, an overview of the borrower's business, and quarterly and annual certified financial statements. This document acts as both the marketing tool and as the source of information for the syndication.

The Launch Phase - The transaction is launched into the market when banks are sent the information memoranda mentioned above. Legal counsel commences to prepare the documentation. Negotiations take place between the banks and the borrower over pricing, collateral, covenants, and other terms. Often there is an institution meeting so potential participants can discuss the company's business and industry both with the lead agent and with the company.

Post-Launch Phase - Typically there is a two-week period for potential participants to evaluate the transaction and to decide whether or not to participate in the syndication. During this period, banks do their due diligence and credit approval. Often this entails running projection models, including stress tests, doing business and industry research, and presenting the transaction for the approval process once the decision is made to commit to the transaction.

After the commitment due date, participating banks receive a draft credit agreement for their comments. Depending upon the complexity of the agreement, they usually have about a week to make comments. The final credit agreement is then negotiated based on the comments and the loan would then close two to five days after the credit agreement is finalized.

Post-Closing Phase - Post-Closing, there usually is an ongoing dialogue with the borrower about financial/operating performance as well as quarterly credit agreement covenant compliance checks. Annually, a full credit analysis typically is done as well as annual meetings of the participants for updates on financial and operating performance. Both the agent institution and the participants need to assess the loan protection level by analyzing the business risk as well as the financial risk. Each industry has particular dominant risks to be assessed.

Loan Covenants

Loan covenants are special conditions included in a loan agreement that the borrower is required to fulfill in order for the loan agreement to remain valid. Typically, covenants cover several domains but can broadly be divided into financial and non-financial categories. Effective financial covenants establish an operating framework using conditions defined in absolute amounts or ratios. If exceeded by the borrower, the covenants provide lenders the opportunity to further strengthen collateral controls or adjust interest rates. Some examples are:

Net Worth test: restricts the total amount of debt a borrower can incur, expressed as a percentage of net worth.

Current Ratio/ Quick Ratio test: measures liquidity.

Interest, Debt Service or Fixed Charge Coverage test: assures that some level of cash flow is generated by a company above its interest expense and other fixed obligations. The proxy for cash flow is usually EBITDA (earnings before interest, taxes, depreciation and amortization).

Capital Expenditure Limitations: generally set according to the company's business plan and then measured accordingly.

Borrowing Base Limitations: lending formula typically based on eligible accounts receivable and inventory. At times, the formula may also include real estate or other non-current assets.

Leverage test: actual leverage covenant levels vary by industry segment. Typical ratios include Total Debt divided by EBITDA, Senior Debt divided by EBITDA and Net Debt (subtracts cash) divided by EBITDA.

Non-financial covenants may include restrictions on other matters such as management changes, provisions of information, guarantees, disposal of assets, etc.

Credit Rating Agencies

The large credit rating agencies (Standard and Poor's, Moody's, and Fitch Investor Services) provide coverage of many syndicated loans at origination and periodically during the life of the loan. Credit ratings issued by these agencies reflect a qualitative and quantitative evaluation of financial and other information of the prospective borrower, including information provided by the borrower and other non-public information.

Credit ratings may represent the overall corporate credit rating of a borrower or reflect analysis of a borrower's specific financial instruments, such as their syndicated loans. Credit ratings for each financial instrument reflect the general credit risk of the borrower, their ability to repay the debt, and the probability of the borrower defaulting on the instrument in question. Some credit rating agencies also provide separate ratings that consider the financial loss the holder of a financial instrument such as a syndicated loan may incur if a borrower defaults.

Overview of the Shared National Credit (SNC) Program

The Shared National Credit (SNC) Program is an interagency initiative administered jointly by the FDIC, Federal Reserve Board, and the Office of the Comptroller of the Currency. The program was established in the 1970's for the purpose of ensuring consistency among the three federal banking regulators in the classification of large syndicated credits.

Definition of a SNC

Any loan or formal loan commitment, including any asset such as other real estate, stocks, notes, bonds and debentures taken for debts previously contracted, extended to a borrower by a supervised institution, or any of its subsidiaries and affiliates, which in original amount aggregates $100 million or more and, which is shared by three or more unaffiliated institutions under a formal lending agreement; or, a portion of which is sold to two or more unaffiliated institutions, with the purchasing institution(s) assuming its pro rata share of the credit risk.

SNCs generally include:

- Loans administered by a domestic office of a supervised institution;
- Domestic commercial and real estate loans and all international loans to borrowers in the private sector; and
- Acceptances, commercial letters of credit, standby letters of credit or similar bonds or guarantees, note issuance facilities, revolving underwriting facilities, Eurodollar facilities, syndications, and similar extensions or commitments, and lease financing receivables.

SNCs do not include:

- Credits shared solely between affiliated supervised institutions;
- Private sector credits that are 100 percent guaranteed by a sovereign entity;
- International credits or commitments administered in a foreign office; or
- Direct credits to sovereign borrowers.

SNC Review and Rating Process

Teams of interagency examiners review and risk rate a sample of credits at agent banks during the first and third quarters of each year. Of note, SNC reviews occur regularly at agent banks originating a significant level of SNC credits. For agent banks with smaller SNC portfolios, credits are only reviewed through the program on an ad hoc basis. The SNC review sample is based on internal rating, industry, size, and the number of regulated participants. The regulatory rating assigned by an interagency team of examiners is reported to all participating banks shortly after the conclusion of the on-site review voting period. Ratings remain active on a rolling two review basis (approximately 1 year), thus avoiding duplicate reviews of the same loan and ensuring consistent treatment with regard to regulatory credit ratings. Examiners should not change SNC ratings during risk management examinations. Any material change in a borrower's condition should be reported to the national SNC coordinator.

The SNC rating process includes risk rating, accrual and TDR status. Impairment measurement and ALLL treatment are not addressed in the SNC rating and should be reviewed at each participant institution. Current and historical SNC ratings can be accessed through the FDIC's internal systems. Designated SNC credits not reviewed in the current SNC sample will be listed as "Not Rated." These credits may be reviewed separately at the participant institution if significant to the examination scope or an examiner believes that the credit may carry an adverse rating.

The FDIC's SNC office can provide examiners with additional information to facilitate the review of "Not Rated" credits or copies of line sheets used in the interagency SNC review to help examiners explain rating rationales to participant banks. In those situations where a "Not Rated" credit is reviewed at the participant institution and an adverse rating is assigned, examiners should communicate their findings to the national SNC coordinator.

SNC Rating Communication and Distribution Process

At the conclusion of each semi-annual SNC review, electronic reports are generated, and notifications are sent via email to participant institution contacts. They are provided a link to retrieve a summary of ratings, applicable loan write-ups, cover letter and a list of agent institution contacts. These reports are available to examiners upon request and can be retransmitted to the participant institution contact if needed. The notification email also marks the beginning of a 14 day window for banks to file an appeal.

Appeals Process

Agent and participant banks may appeal any preliminary rating. Agent and participant banks have 14 days from the electronic distribution of preliminary results to submit an appeal. The written appeal details the reasons why the institution is disputing the classification and includes documentation supporting the institution's position. The written appeal is sent to the applicable agency of the agent institution for the credit in question. An interagency appeals panel reviews the appeal, determines the final disposition of the credit, and informs the institution of its decision in writing. Ratings changed by the appeals process are communicated electronically to all affected participant banks.

Additional Risks Associated with Syndicated Loan Participations

An institution that purchases a participation interest in large loan syndications faces the same risks as an institution purchasing an ordinary loan participation from another institution. Examiners should reference the manual section on *Loan Participations* for a more in depth discussion of related risks. As discussed in that section, an institution purchasing a participation loan is expected to perform the same degree of independent credit analysis on the loan as if it were the originator. The same holds true for banks purchasing participation interests in large syndications. Institutions that lack the resources or skill sets to perform an independent credit analysis on a complex loan syndication generally refrain from participating in such a transaction.

In some cases, an institution may enter into a sub-participation agreement in which the institution purchases a piece of a participation from another syndicated loan participant rather than directly from the agent institution. As a result, the sub-participant may not be registered with or known to the agent institution and may not receive timely notification of risk ratings or adverse credit actions from either the agent institution or the SNC system. Additionally, sub-participants may not have the same legal rights or remedies as participants of record in the syndicate, which may give rise to other transactional and operational risk concerns.

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CREDIT SCORING

Automated credit scoring systems allow institutions to underwrite and price loans more quickly than was possible in the past. This efficiency has enabled some banks to expand their lending into national markets and originate loan volumes once considered infeasible. Scoring also reduces unit-underwriting costs, while yielding a more consistent loan portfolio that is easily securitized. These benefits have been the primary motivation for the proliferation of credit scoring systems among both large and small institutions.

Credit scoring systems identify specific characteristics that help define predictive variables for acceptable performance (delinquency, amount owed on accounts, length of credit history, home ownership, occupation, income, etc.) and assign point values relative to their overall importance. These values are then totaled to calculate a credit score, which helps institutions to rank order risk for a given population. Generally, an individual with a higher score will perform better relative to an individual with a lower credit score.

Few, if any, institutions have an automated underwriting system where the credit score is used exclusively to make the credit decision. Some level of human review is usually present to provide the flexibility needed to address individual circumstances. Institutions typically establish a minimum cut-off score below which applicants are denied and a second cutoff score above which applicants are approved. However, there is usually a range, or “gray area,” in between the two cut-off scores where credits are manually reviewed and credit decisions are judgmentally determined.

Most, if not all, systems also provide for overrides of established cut-off scores. If the institution’s scoring system effectively predicts loss rates and reflects management’s risk parameters, excessive overrides will negate the benefits of an automated scoring system. Therefore, it is critical for management to monitor and control overrides. Institutions typically develop acceptable override limits and prepare monthly override reports that provide comparisons over time and against the institution’s parameters. Override reports also typically identify the approving officer and include the reason for the override.

Although banks often use more than one type of credit scoring methodology in their underwriting and account management practices, many systems incorporate credit bureau scores. Credit bureau scores are updated periodically and validated on an ongoing basis against performance in credit bureau files. Scores are designed to be comparable across the major credit bureaus; however, the ability of any score to estimate performance outcome probabilities depends on the quality, quantity, and timely submission of lender data to the various credit bureaus. Often, the depth and thoroughness of data available to each credit bureau varies, and as a consequence, the quality of scores varies.

As a precaution, institutions that rely on credit bureau scores often sample and compare credit bureau reports to determine which credit bureau most effectively captures data for the market(s) in which the institution does business. For institutions that acquire credit from multiple regions, use of multiple scorecards may be appropriate, depending on apparent regional credit bureau strength. In some instances, it may be worthwhile for institutions to pull scores from each of the major credit bureaus and establish rules for selecting an average value. By tracking credit bureau scores over time and capturing performance data to differentiate which score seems to best indicate probable performance outcome, institutions can select the best score for any given market. Documenting such efforts to differentiate and select the best credit bureau score supports a deliberative decision process.

Although some institutions develop their own scoring models, most are built by outside vendors and subsequently maintained by the institution. Vendors build scoring models based upon specific information and parameters provided by institution management. Therefore, management must clearly communicate with the vendor and ensure that the scorecard developer clearly understands the institution's objectives. Bank management that adheres closely to vendor manual specifications for system maintenance and management, particularly those that provide guidance for periodically assessing performance of the system, achieve the most reliable results.

Scoring models generally become less predictive as time passes. Certain characteristics about an applicant, such as income, job stability, and age change over time, as do overall demographics. One-by-one, these changes will result in significant shifts in the profile of the population. Once a fundamental change in the profile occurs, the model is less able to identify potentially good and bad applicants. As these changes continue, the model loses its ability to rank order risk. Thus, for the best results, institutions must periodically validate the system's predictability, refine scoring characteristics when necessary, and document these efforts.

Institutions initially used credit scoring for consumer lending applications such as credit card, auto, and mortgage lending. However, credit scoring eventually gained acceptance in the small business sector. Depending on the manner in which it is implemented, credit scoring for small business lending may represent a fundamental shift in underwriting philosophy if institutions view a small business loan as more of a high-end consumer loan and, thus, grant credit more on the strength of the principals' personal credit history and less on the fundamental strength of the business. While this may be appropriate in some cases, it is important to remember that the income from small business remains the primary source of repayment for most loans. Institutions that do not analyze business financial statements or periodically review their lines of credit may lose an opportunity for early detection of credit problems.

The effectiveness of any scoring system directly depends on the policies and procedures established to guide and enforce proper use. The most effective policies include an overview of the institution's scoring objectives and operations; the establishment of authorities and responsibilities over scoring systems; the use of a chronology log to track internal and external events that affect the scoring system; the establishment of institution officials responsible for reporting, monitoring, and reviewing overrides; as well as the provision of a scoring system maintenance program to ensure that the system continues to rank risk and to predict default and loss under the original parameters.

Examiners should refer to the Credit Card Specialty Bank Examination Guidelines and the Credit Card Activities section of the Examination Modules for additional information on credit scoring systems.

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SUBPRIME LENDING

Introduction

There is no universal definition of a subprime loan in the industry, but subprime lending is generally characterized as a lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers. Institutions often refer to subprime lending by other names such as the nonprime, nonconforming, high coupon, or alternative lending market.

Well-managed subprime lending can be a profitable business line; however, it is a high-risk lending activity. Successful subprime lenders carefully control the elevated credit, operating, compliance, legal, market, and other risks as well as the higher overhead costs associated with more labor-intensive underwriting, servicing, and collections. Subprime lending should only be conducted by institutions that have a clear understanding of the business and its inherent risks, and have determined these risks to be acceptable and controllable given the institution's staff, financial condition, size, and level of capital support. In addition, subprime lending should only be conducted within a comprehensive lending program that employs strong risk management practices to identify, measure, monitor, and control the elevated risks that are inherent in this activity. Finally, subprime lenders need to retain capital support that is consistent with the volume and nature of the additional risks assumed. If the risks associated with this activity are not properly controlled, subprime lending may be considered an unsafe and unsound banking practice.

The term, subprime, refers to the credit characteristics of the borrower at the loan's origination, rather than the type of credit or collateral considerations. Subprime borrowers typically have weakened credit histories that may include a combination of payment delinquencies, charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria. Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- Bankruptcy in the last 5 years;
- Relatively high default probability as evidenced by, for example, a Fair Isaac and Co. risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and
- Debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers. Additionally, this definition may not match all market or institution-specific subprime definitions, but should be viewed as a starting point from which examiners should expand their review of the institution's lending program.

Subprime lenders typically use the criteria above to segment prospects into subcategories such as, for example, A, B, C, and D. However, subprime subcategories can vary significantly among lenders based on the credit grading criteria. What may be an "A" grade definition at one institution may be a "B" grade at another institution, but generally each grade represents a different level of credit risk.

While the industry often includes borrowers with limited or no credit histories in the subprime category, these borrowers can represent a substantially different risk profile than those with a derogatory credit history and are not inherently considered subprime. Rather, consideration should be given to underwriting criteria and portfolio performance when determining whether a portfolio of loans to borrowers with limited credit histories should be treated as subprime for examination purposes.

Subprime lending typically refers to a lending program that targets subprime borrowers. Institutions engaging in subprime lending generally have knowingly and purposefully focused on subprime lending through planned business strategies, tailored products, and explicit borrower targeting. An institution's underwriting guidelines and target markets should provide a basis for determining whether it should be considered a subprime lender. The average credit risk profile of subprime loan programs will exhibit the credit risk characteristics listed above, and will likely display significantly higher delinquency and/or loss rates than prime portfolios. High interest rates and fees are a common and relatively easily identifiable characteristic of subprime lending. However, high interest rates and fees by themselves do not constitute subprime lending.

Subprime lending does not include traditional consumer lending that has historically been the mainstay of community banking, nor does it include making loans to subprime borrowers as discretionary exceptions to the institution's prime retail lending policy. In addition, subprime lending does not refer to: prime loans that develop credit problems after acquisition; loans initially extended in subprime programs that are later upgraded, as a result of their performance, to programs targeted to prime borrowers; or community development loans as defined in the CRA regulations.

For supervisory purposes, a subprime lender is defined as an insured institution or institution subsidiary that has a subprime lending program with an aggregate credit exposure greater than or equal to 25 percent of Tier 1 capital plus ALLL. Aggregate exposure includes principal outstanding and committed, accrued and unpaid interest, and any retained residual assets relating to securitized subprime loans.

Capitalization

The FDIC's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles than exist in subprime loan programs. Therefore, these requirements may not be sufficient to reflect the risks associated with subprime portfolios. Each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime lending activities, and for fully documenting the methodology and analysis supporting the amount specified.

Examiners will evaluate the capital adequacy of subprime lenders on a case-by-case basis, considering, among other factors, the institution's own documented analysis of the capital needed to support its subprime lending activities. Capital levels are typically risk sensitive, that is, allocated capital should reflect the level and variability of loss estimates within reasonably conservative parameters. Institutions generally specify a direct link between the estimated loss rates used to determine an appropriate ALLL, and the unexpected loss estimates used to determine capital.

The sophistication of this analysis should be commensurate with the size, concentration level, and relative risk of the institution's subprime lending activities and consider the following elements:

- Portfolio growth rates;
- Trends in the level and volatility of expected losses;

- The level of subprime loan losses incurred over one or more economic downturns, if such data/analyses are available;
- The impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets;
- Any deterioration in the average credit quality over time due to adverse selection or retention;
- The amount, quality, and liquidity of collateral securing the individual loans;
- Any asset, income, or funding source concentrations;
- The degree of concentration of subprime credits;
- The extent to which current capitalization consists of residual assets or other potentially volatile components;
- The degree of legal and other risks associated with the subprime business line(s) pursued; and
- The amount of capital necessary to support the institution's other risks and activities.

Given the higher risk inherent in subprime lending programs, examiners should reasonably expect, as a starting point, that an institution would hold capital against such portfolios in an amount that is one and one half to three times greater than what is appropriate for non-subprime assets of a similar type. Refinements typically depend on the factors analyzed above, with particular emphasis on the trends in the level and volatility of loss rates, and the amount, quality, and liquidity of collateral securing the loans. Institutions with significant subprime programs generally have capital ratios that are well above the averages for their traditional peer groups or other similarly situated institutions that are not engaged in subprime lending.

Some subprime asset pools warrant increased supervisory scrutiny and monitoring, but not necessarily additional capital. For example, well-secured loans to borrowers who are slightly below what is considered prime quality may entail minimal additional risks compared to prime loans, and may not require additional capital if adequate controls are in place to address the additional risks. On the other hand, institutions that underwrite higher-risk subprime pools, such as unsecured loans or high loan-to-value second mortgages, may need significantly higher levels of capital, perhaps as high as 100% of the loans outstanding depending on the level and volatility of risk. Because of the higher inherent risk levels and the increased impact that subprime portfolios may have on an institution's overall capital, examiners should document and reference each institution's subprime capital evaluation in their comments and conclusions regarding capital adequacy.

Stress Testing

An institution's capital adequacy analysis typically includes stress testing as a tool for estimating unexpected losses in its subprime lending pools. Institutions may 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 scenarios may include "shock" testing of basic assumptions such as delinquency rates, loss rates, and recovery rates on collateral. It may also consider other potentially adverse scenarios, such as: changing attrition or prepayment rates; changing utilization rates for revolving products; changes in credit score distribution; and changes in the capital markets demand for whole loans, or asset-backed securities supported by subprime loans.

These are representative examples. Actual factors will vary by product, market segment, and the size and complexity of the portfolio relative to the institution's overall operations. Whether stress test scenarios are performed manually, or through automated modeling techniques, the Regulatory Agencies will expect that:

- The process is clearly documented, rational, and easily understood by the board and senior management;
- The inputs are reliable and relate directly to the subject portfolios;
- Assumptions are well documented and conservative; and
- Any models are subject to a comprehensive validation process.

The results of the stress test exercises should be a documented factor in the analysis and determination of capital adequacy for the subprime portfolios.

Institutions that engage in subprime lending without adequate procedures to estimate and document the level of capital necessary to support their activities should be criticized. Where capital is deemed inadequate to support the risk in subprime lending activities, examiners should consult with their regional office to determine the appropriate course of action.

Risk Management

The following items are essential components of an effective risk management program for subprime lenders.

Planning and Strategy. Prior to engaging in subprime lending, the board and management 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 establishing appropriate feedback and control systems. Appropriate risk assessment processes extend beyond credit risk and appropriately incorporate operating, compliance, market, liquidity, and legal risks.

Institutions establishing an appropriate subprime lending program proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal control problems and to determine if favorable initial profitability estimates are realistic and sustainable. Strategic plan performance analysis is generally conducted frequently in order to detect adverse trends or circumstances and take appropriate action in a timely manner.

Management and Staff. Prior to engaging in subprime lending, the board typically ensures that management and staff possess sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of activity. Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account origination, and collections strategies and techniques often differ from those employed for prime credit; thus it is generally not sufficient to have the same staff responsible for both subprime and prime loans. Servicing and collecting subprime loans can be very labor intensive and requires a greater volume of staff with smaller caseloads. Lenders should monitor staffing levels, staff experience, and the need for additional training as performance is assessed over time. Compensation programs should not depend primarily on volume or growth targets. Any targets used should be weighted towards factors such as portfolio quality and risk-adjusted profitability.

Lending Policies and Procedures. Lenders typically have comprehensive written policies and procedures, specific to each subprime lending product that set limits on the amount of risk that will be assumed and address how the institution will control portfolio quality and avoid excessive exposure. Prudent institutions implement policies and procedures before initiating the activity. Institutions may originate subprime loans through a variety of channels, including dealers, brokers, correspondents, and marketing firms. Regardless of the source, it is critical that underwriting policies and procedures incorporate the risk tolerances established by the board and management and explicitly define underwriting criteria and exception processes. Subprime lending policies and procedures typically address the items outlined in the loan reference module of the ED Modules for subprime lending. If the institution elects to use scoring systems for approvals or pricing, the model should be tailored to address the behavioral and credit characteristics of the subprime population targeted and the products offered. It is generally not acceptable to rely on models developed for standard risk borrowers or products. Furthermore, the models should be reviewed frequently and updated as necessary to ensure assumptions remain valid.

Given the higher credit risk associated with the subprime borrower, effective subprime lenders use mitigating underwriting guidelines and risk-based pricing to reduce the overall risk of the loan. These guidelines include lower loan-to-value ratio requirements and lower maximum loan amounts relative to each risk grade within the portfolio. Given the high-risk nature of subprime lending, the need for thorough analysis and documentation is heightened relative to prime lending. Compromises in analysis or documentation can substantially increase the risk and severity of loss. In addition, successful subprime lenders develop criteria for limiting the risk profile of borrowers selected, giving consideration to factors such as the frequency, recentness, and severity of delinquencies and derogatory items; length of time with re-established credit; and reason for the poor credit history.

Since the past credit deficiencies of subprime borrowers reflect a higher risk profile, appropriate subprime loan programs are based upon the borrowers' current reasonable ability to repay and a prudent debt amortization schedule. Loan repayment should not be based upon foreclosure proceedings or collateral repossession. Institutions are to recognize the additional default risks and determine if these risks are acceptable and controllable without resorting to foreclosure or repossession that could have been predetermined by the loan structure at inception.

Profitability and Pricing. A key consideration for lenders in the subprime market is the ability to earn risk-adjusted yields that appropriately compensate the institution for the increased risk and costs assumed. Successful institutions have a comprehensive framework for pricing decisions and profitability analysis that considers all costs associated with each subprime product, including origination, administrative/servicing, expected charge-offs, funding, and capital. In addition, such pricing frameworks allow for fluctuations in the economic cycle. Fees often comprise a significant portion of revenue in subprime lending. Consideration should be given to the portion of revenues derived from fees and the extent to which the fees are a recurring and viable source of revenue. Profitability projections typically are incorporated into the business plan. Also, effective management teams track actual performance against projections regularly and have a process for addressing variances.

Loan Review and Monitoring. Consistent with the safety and soundness standards prescribed in Appendix A to Part

364 of the FDIC Rules and Regulations, institutions must have comprehensive analysis and information systems that identify, measure, monitor and control the risks associated with subprime lending. Such analysis promotes understanding of the portfolio and early identification of adverse quality/performance trends. Systems employed must possess the level of detail necessary to properly evaluate subprime activity. Examples of portfolio segmentation and trend analyses are discussed in the subprime lending loan reference module of the ED Modules.

Comprehensive analysis considers the effects of portfolio growth and seasoning, which can mask true performance by distorting delinquency and loss ratios. Vintage, lagged delinquency, and lagged loss analysis methods are sometimes used to account for growth, seasoning, and changes in underwriting. Analysis should also take into account the effect of cure programs on portfolio performance. Refer to the glossary of the Credit Card Specialty Bank Examination Guidelines for definitions of vintage, roll rate, and migration analysis.

Servicing and Collections. Defaults occur sooner and in greater volume than in prime lending; thus a well-developed servicing and collections function is essential for the effective management of subprime lending. Strong procedures and controls are necessary throughout the servicing process; however, particular attention is warranted in the areas of new loan setup and collections to ensure the early intervention necessary to properly manage higher risk borrowers. Prudent lenders also have well-defined written collection policies and procedures that address default management (e.g., cure programs and repossessions), collateral disposition, and strategies to minimize delinquencies and losses. This aspect of subprime lending is very labor intensive but critical to the program's success.

Cure programs include practices such as loan restructuring, re-aging, renewal, extension, or consumer credit counseling. Cure programs typically are used only when the institution has substantiated the customer’s renewed willingness and ability to pay. Appropriate controls help ensure cure programs do not mask poor initial credit risk selection or defer losses. Effective subprime lenders may use short-term loan restructure programs to assist borrowers in bringing loans current when warranted, but will often continue to report past due status on a contractual basis. Cure programs that alter the contractual past due status may mask actual portfolio performance and inhibit the ability of management to understand and monitor the true credit quality of the portfolio.

Repossession and resale programs are integral to the subprime business model. Policies and procedures for foreclosure and repossession activities typically specifically address the types of cost/benefit analysis to be performed before pursuing collateral, including valuation methods employed; timing of foreclosure or repossession; and accounting and legal requirements. Effective policies clearly outline whether the institution will finance the sale of the repossessed collateral, and if so, the limitations that apply. Institutions that track the performance of such loans are able to assess the adequacy of these policies.

Compliance and Legal Risks. Subprime lenders generally run a greater risk of incurring legal action given the higher fees, interest rates, and profits; targeting customers who have little experience with credit or damaged credit records; and aggressive collection efforts. Because the risk is dependent, in part, upon the public perception of a lender’s practices, the nature of these risks is inherently unpredictable. Institutions that engage in subprime lending must take special care to avoid violating consumer protection laws. An adequate compliance management program must identify, monitor and control the consumer protection hazards associated with subprime lending. The institution should have a process in place to handle the potential for heightened legal action. In addition, management should have a system in place to monitor consumer complaints for recurring issues and ensure appropriate action is taken to resolve legitimate disputes.

Audit. The institution’s audit scope should provide for comprehensive independent reviews of subprime activities. Appropriate audit procedures include, among other things, a sample of a sufficient volume of accounts to verify the integrity of the records, particularly with respect to payments processing.

Third Parties. Subprime lenders may use third parties for a number of functions from origination to collections. In dealing with high credit-risk products, effective management teams take steps to ensure that exposures from third-party practices or financial instability are minimized. This includes proper due diligence performed prior to contracting with a third party vendor and on an ongoing basis. Appropriate contracts provide the institution with the ability to control and monitor third party activities (e.g. growth restrictions, underwriting guidelines, outside audits, etc.) and discontinue relationships that prove detrimental to the institution.

Special care must be taken when purchasing loans from third party originators. Some originators who sell subprime loans charge borrowers high up-front fees, which may be financed into the loan. These fees provide incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. These fees also increase the likelihood that the originator will attempt to refinance the loans. Appropriate contracts restrict the originator from the churning of customers. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation. Effective management also ensures that third party conflicts of interest are avoided. For example, if a loan originator provides recourse for poorly performing loans purchased by the institution, the originator or related interest thereof should not also be responsible for processing and determining the past due status of the loans.

Securitizations. Securitizing subprime loans carries inherent risks, including interim credit, liquidity, interest rate, and other risks, that are potentially greater than those for securitizing prime loans. The subprime loan secondary market can be volatile, resulting in significant liquidity risk when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions may be forced to sell loan pools at deep discounts. If an institution lacks adequate personnel, risk management procedures, or capital support to hold subprime loans originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans typically develop a contingency plan that addresses back-up purchasers of the securities, whole loans, or the attendant servicing functions, alternate funding sources, and measures for raising additional capital. An institution’s liquidity and funding structure should not be overly dependent upon the sale of subprime loans.

Given some of the unique characteristics of subprime lending, accounting for the securitization process requires assumptions that can be difficult to quantify reliably, and erroneous assumptions can lead to the significant overstatement of an institution's assets. Prudent institutions take a conservative approach when accounting for these transactions and ensure compliance with existing regulatory guidance. Refer to outstanding examination instructions for further information regarding securitizations.

Classification

The Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy) governs the evaluation of consumer loans. This policy establishes general classification thresholds based on delinquency, but also grants examiners the discretion to classify individual retail loans that exhibit signs of credit weakness regardless of delinquency status. An examiner may also classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account management practices that are deficient. Given the high-risk nature of subprime portfolios and their greater potential for loan losses, the delinquency thresholds for classification set forth in the Retail Classification Policy should be considered minimums. Well-managed subprime lenders recognize the heightened risk-of-loss characteristics in their portfolios and, if warranted, internally classify their delinquent accounts well before the timeframes outlined in the interagency policy. If examination classifications are more severe than the Retail Classification Policy suggests, the examination report should explain the weaknesses in the portfolio and fully document the methodology used to determine adverse classifications.

ALLL Analysis

An institution’s appropriately documented ALLL analysis identifies subprime loans as a specific risk exposure separate from the prime portfolio. In addition, the analysis segments the subprime lending portfolios by risk exposure such as specific product, vintage, origination channel, risk grade, loan to value ratio, or other grouping deemed relevant.

Adversely classified subprime loans (to include, at a minimum, all loans past due 90 days or more) should be reviewed for impairment, and an appropriate allowance should be established consistent with accounting requirements. For subprime loans that are not adversely classified, the ALLL should be sufficient to absorb at least all estimated credit losses on outstanding balances over the current operating cycle, typically 12 months. To the extent that the historical net charge-off rate is used to estimate credit losses, it should be adjusted for changes in trends, conditions, and other relevant factors, including business volume, underwriting, risk selection, account management practices, and current economic or business conditions that may alter such experience.

Subprime Auto Lending

Underwriting. Subprime auto lenders use risk-based pricing of loans in addition to more stringent advance rates, discounting, and dealer reserves than those typically used for prime auto loans to mitigate the increased credit risk. As credit risk increases, advance rates on collateral decrease while interest rates, dealer paper discounts, and dealer reserves increase. In addition to lower advance rates, collateral values are typically based on the wholesale value of the car. Lenders will typically treat a new dealer with greater caution, using higher discounts and/or purchasing the dealer’s higher quality paper until a database and working relationship is developed.

Servicing and Collections. Repossession is quick, generally ranging between 30 to 60 days past due and sometimes earlier. The capacity of a repossession and resale operation operated by a prime lender could easily be overwhelmed if the lender begins targeting subprime borrowers, leaving the lender unable to dispose of cars quickly. Resale methods include wholesale auction, retail lot sale, and/or maintaining a database of retail contacts. While retail sale will command a greater price, subprime lenders may consider limiting the time allocated to retail sales before sending cars to auction in order to ensure adequate cash flow and avoid excessive inventory build-up. Refinancing resales are usually limited and tightly controlled, as this practice can mask losses. Lenders typically implement a system for tracking the location of the collateral.

Subprime Residential Real Estate Lending

Underwriting. To mitigate the increased risk, subprime residential real estate lenders use risk-based pricing in addition to more conservative LTV ratio requirements and cash-out restrictions than those typically used for prime mortgage loans. As the credit risk of the borrower increases, the interest rate increases and the loan-to-value ratio and cash-out limit decreases. Prudent loan-to-value ratios are an essential risk mitigant in subprime real estate lending and generally range anywhere from 85 percent to 90 percent for A- loans, to 65 percent for lower grades. High loan-to-value (HLTV) loans are generally not considered prudent in subprime lending. HLTV loans should be targeted at individuals who warrant large unsecured debt, and then only in accordance with outstanding regulatory guidance. The appraisal process takes on increased importance given the greater emphasis on collateral. Prepayment penalties are sometimes used on subprime real estate loans, where allowed by law, given that prepayment rates are generally higher and more volatile for subprime real estate loans. Government Sponsored entities, Fannie Mae and Freddie Mac, have participated in the subprime mortgage market to a limited degree through purchases of subprime loans and guarantees of subprime securitizations.

Servicing and Collections. Collection calls begin early, generally within the first 10 days of delinquency, within the framework of existing laws. Lenders generally send written correspondence of intent to foreclosure or initiate other legal action early, often as early as 31 days delinquent. The foreclosure process is generally initiated as soon as allowed by law. Updated collateral valuations are typically obtained early in the collections process to assist in determining appropriate collection efforts. Frequent collateral inspections are often used by lenders to monitor the condition of the collateral.

Subprime Credit Card Lending

Underwriting. Subprime credit card lenders use risk-based pricing as well as tightly controlled credit limits to mitigate the increased credit risk. In addition, lenders may require full or partial collateral coverage, typically in the form of a deposit account at the institution, for the higher-risk segments of the subprime market. Initial credit lines are set at low levels, such as $300 to $1,000, and subsequent line increases are typically smaller than for prime credit card accounts. Increases in credit lines should be subject to stringent underwriting criteria similar to that required at origination.

Underwriting for subprime credit cards is typically based upon credit scores generated by sophisticated scoring models. These scoring models use a substantial number of attributes, including the frequency, severity, and recency of previous delinquencies and major, derogatory items, to determine the probability of loss for a potential borrower. Subprime lenders typically target particular subprime populations through prescreening models, such as individuals who have recently emerged from bankruptcy. Review of the attributes in these models often reveals the nature of the institution's target population.

Servicing and Collections. Lenders continually monitor customer behavior and credit quality and take proactive measures to avert potential problems, such as decreasing or freezing credit lines or providing consumer counseling, before the problems become severe or in some instances before the loans become delinquent. Lenders often use sophisticated scoring systems to assist in monitoring credit quality and frequently re-score customers. Collection calls on delinquent loans begin early, generally within the first 10 days delinquent, and sometimes as early as 1-day delinquent, within the framework of existing laws. Lenders generally send written correspondence within the first 30 days in addition to calling. Account suspensions occur early, generally within the first 45 days of delinquency or immediately upon a negative event such as refusal to pay. Accounts over 90 days past due are generally subject to account closure and charge-off. In addition, account closures based upon a borrower's action, such as repeated refusal to pay or broken promises to bring the account current within a specified time frame, may occur at any time in the collection process. Account closure practices are generally more aggressive for relatively new credit card accounts, such as those originated in the last six months.

Payday Lending

Payday lending is a subset of subprime lending. Payday loans are usually priced at a fixed dollar fee per $100 borrowed, which represents the finance charge. Because these loans have such short terms to maturity, usually ranging from 14 to 45 days, the cost of borrowing, expressed as an annual percentage rate may be high.

In return for the loan, the borrower usually provides the lender with a debit authorization for the amount of the loan plus the fee. Repayment is often provided through an electronic payment of the fee and the advance with the next direct deposit. In addition, lenders allow payment by mail or other means rather than electronic transfer, and may charge a lower fee/finance charge for consumers that choose to pay electronically. If the borrower informs the lender that he or she does not have the funds to repay the loan, the loan is often refinanced through payment of another fee.

General

The examination instructions described in this section apply to banks with payday lending programs that the bank administers directly or through a third party that partners with the bank to offer payday loans to consumers. These instructions **do not** apply to situations where a bank makes occasional small-dollar loans as an accommodation to borrowers that do not fall within the definition of payday loans above nor do they apply to banks offering products and services, such as deposit accounts and extensions of credit, to non-bank payday lenders. These instructions apply regardless of whether an institution is a subprime lender, as described in the section above.

Due to the heightened safety and soundness risks posed by payday lending, concurrent risk management and consumer protection examinations should be conducted absent overriding resource or scheduling problems. In all cases, a review of each discipline's examinations and workpapers should be part of the examination planning process. Relevant state examinations also should be reviewed. The subprime lending loan reference module of the ED Modules provides procedures to assist examiners in evaluating a payday lending program.

Examiners may conduct targeted examinations of a third party bank partner where appropriate. Authority to conduct examinations of third parties may be established under several circumstances, including through the bank's written agreement with the third party, section 7 of the Bank Service Company Act, or through powers granted under section 10 of the Federal Deposit Insurance Act. Third party examination activities would typically include, but not be limited to, a review of compensation and staffing practices; marketing and pricing policies; management information systems; and compliance with bank policy as well as applicable laws and regulations. Third party reviews should also include testing of individual loans for compliance with underwriting and loan administration guidelines, and appropriate treatment under delinquency, and re-aging and cure programs.

Underwriting

Institutions making payday loans may use a variety of underwriting techniques, such as scoring systems, review of current pay stub or proof of a regular income source and evidence that the customer has a checking account, consultation of nationwide databases that track bounced checks and persons with outstanding payday loans, among others. As described above, the *Interagency Guidelines Establishing Standards for Safety and Soundness (Guidelines)* set out the safety and soundness standards that the agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The Loan Documentation prong of the Guidelines addresses assessing the ability of the borrower to repay the indebtedness in a timely manner and ensuring that any claim against a borrower is legally enforceable. The Credit Underwriting prong addresses providing for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed. Institutions that choose to offer payday loans with strong risk management frameworks might adopt the following controls, among others, to demonstrate their conformance with these prongs of the Guidelines:

- Consideration of the consumer's overall short-term debt obligations relative to resources;
- Consideration of the total length of time a consumer has had payday loan debt outstanding as an indication of the customer's ability to repay the payday loan according to its term without reborrowing; and
- Consideration of any applicable laws and regulations.

Payday Lending Through Third Parties

Insured depository institutions may have payday lending programs that they administer directly, using their own employees, or they may enter into arrangements with third parties. In the latter arrangements, the institution typically enters into an agreement in which the institution funds payday loans originated through the third party. These arrangements also may involve the sale to the third party of the loans or servicing rights to the loans. Institutions also may rely on the third party to provide additional services that the institution might otherwise provide, including collections, advertising and soliciting applications. The existence of third party arrangements when not properly managed, can increase institutions' transaction and legal risks.

The use of third parties in no way diminishes the responsibility of the board of directors and management to ensure that the activity performed on behalf of the bank is conducted in a safe and sound manner that complies with applicable consumer protection laws. Appropriate corrective actions, including enforcement actions, may be pursued for deficiencies related to a third-party relationship that poses safety and soundness issues or compliance with consumer protection laws.

The FDIC's principal concern relating to third parties is whether effective risk controls are implemented. Examiners should assess the institution's risk management program for third-party payday lending relationships. An assessment of third-party relationships should include an evaluation of the bank's risk assessment and strategic planning, as well as the bank's due diligence process for selecting a competent and qualified third party provider. Examiners should determine whether arrangements with third parties are guided by a written contract and approved by the institution’s board. Appropriate arrangements typically:

- Describe the duties and responsibilities of each party, including the scope of the arrangement;
- Specify that the third party will comply with all applicable laws and regulations;
- Specify which party will provide consumer compliance related disclosures;
- Authorize the institution to monitor the third party and periodically review and verify that the third party and its representatives are complying with its agreement with the institution;
- Authorize the institution and the appropriate banking agency to have access to such records of the third party and conduct onsite transaction testing and operational reviews at the third party locations as necessary or appropriate to evaluate such compliance;
- Require the third party to indemnify the institution for potential liability resulting from action of the third party with regard to the payday lending program; and
- Address customer complaints, including any responsibility for third-party forwarding and responding to such complaints.

Effective bank management sufficiently monitors the third party with respect to its activities and performance. This includes dedicating sufficient staff with the necessary expertise to oversee the third party. An appropriate oversight program also includes monitoring the third party’s financial condition, internal controls, and the quality of its service and support, including the resolution of consumer complaints if handled by the third party. Oversight programs that are documented sufficiently facilitate the monitoring and management of the risks associated with third-party relationships.

Concentrations

Given the potential risk of payday lending, concentrations of credit in this line of business pose a significant safety and soundness concern. In the context of payday lending, a concentration would be defined as a volume of payday loans totaling 25 percent or more of an institution’s common equity tier 1 capital plus the ALLL or the ACL for loans and leases, as applicable. Appropriate supervisory action may be necessary to address concentrations, including directing the institution to reduce its loans to an appropriate level, or raising additional capital.

Capital Adequacy

The minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles and that are subject to more stringent underwriting procedures than exist in payday lending programs. Therefore, minimum capital requirements may not be sufficient to offset the risks associated with payday lending. Institutions that underwrite payday loans may need to maintain capital levels as high as one hundred percent of the loans outstanding (i.e. dollar-for-dollar capital), depending on the level and volatility of risk. Risks to consider when determining the appropriate amount of capital include the unsecured nature of the credit, the relative levels of risk of default, loss in the event of default, and the level of classified assets. The degree of legal risk associated with payday lending should also be considered, especially as it relates to third party agreements.

Allowance for Loan and Lease Losses

As with other loan types, institutions should maintain an ALLL or an ACL for loans and leases as applicable, that is appropriate to absorb estimated credit losses with the payday portfolio. Although the contractual term of each payday loan may be short, institutions’ methodologies for estimating credit losses on these loans should take into account if payday loans remain outstanding for longer periods because of renewals and rollovers. In addition, examiners should evaluate the institution’s assessment of the collectibility of accrued fees and finance charges on payday loans and whether the institution employs appropriate methods to ensure that income is accurately measured.

Examiners should determine that institutions engaged in payday lending have methodologies and analyses in place that demonstrate and document that the level of the ALLL or the ACL for payday loans is appropriate. The application of historical loss rates to the payday loan portfolio, adjusted for the current environmental factors, including reasonable and supportable forecast for institutions that have adopted CECL, is one way to determine the ALLL or ACL needed for these loans. Environmental factors include levels of and trends in delinquencies and charge-offs, trends in loan volume, effects of changes in risk selection and underwriting standards and in account management practices, and current economic conditions. Examiners should be mindful that for institutions that do not have loss experience of their own, it may be appropriate to reference the payday loan loss experience of other institutions with payday loan portfolios with similar attributes. Other methods, such as loss estimation models, are acceptable if they estimate losses in accordance with generally accepted accounting principles. Examiners should review documentation to determine that institutions' loss estimates and allowance methodologies reflect consideration of the principles discussed in the 2001 and 2006 Interagency policy statements on ALLL, or if the institution has adopted CECL, the 2020 Interagency Policy Statement on Allowances for Credit Losses.

Classifications

The Retail Classification Policy addresses general classification thresholds for consumer loans based on delinquency, but also discusses examiners' discretion to classify individual retail loans that exhibit signs of credit weakness regardless of delinquency status. Examiners also may classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account management practices that are deficient.

Payday loans may have well-defined weaknesses that may jeopardize the liquidation of the debt. Weaknesses include limited or no analysis of repayment capacity and the unsecured nature of the credit. In addition, payday loan portfolios can be characterized by a marked proportion of obligors whose paying capacity is questionable, and such Payday loans are typically classified as Substandard. Payday loans for which the institution has documented adequate paying capacity of the obligors and/or sufficient collateral protection or credit enhancement are not classified.

Payday loans that have been outstanding for extended periods of time evidence a high risk of loss. While such loans may have some recovery value, it is not practical or desirable to defer writing off these essentially worthless assets. Short-term Payday loans that are outstanding for greater than 60 days from origination generally meet the definition of Loss. In certain circumstances, earlier charge-off may be appropriate (e.g., the institution does not renew beyond the first payday and the borrower is unable to pay, the institution closes an account). The institution's policies regarding consecutive advances also should be considered when determining Loss classifications. Where the economic substance of consecutive advances is substantially similar to "rollovers" – without intervening "cooling off" or waiting periods – examiners should treat these loans as continuous advances and classify accordingly.

Renewals/Rewrites

The Retail Classification Policy provides guidelines for extensions, deferrals, renewals, or rewrites of closed-end accounts. Despite the short-term nature of payday loans, borrowers that request an extension, deferral, renewal, or rewrite are typically expected by institutions to exhibit a renewed willingness and ability to repay the loan. Institutions can refer to the Retail Classification Policy principles that address the use of extensions, deferrals, renewals, or rewrites of payday loans. In consideration of the Retail Classification Policy, institutions typically:

- Limit the number and frequency of extensions, deferrals, renewals, and rewrites;
- Prohibit additional advances to finance unpaid interest and fees and simultaneous loans to the same customer; and
- Ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained.

Accrued Fees and Finance Charges

Examiners should determine whether institutions evaluate the collectibility of accrued fees and finance charges on payday loans because a portion of accrued interest and fees is generally not collectible. (For more guidance on accounting for delinquency fees, refer to ASC Section 310-10-25, Receivables – Overall - Recognition.) Although regulatory reporting instructions do not require payday loans to be placed on nonaccrual based on delinquency status, examiners should assess whether the institution employs appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status. After a loan is placed on nonaccrual status, subsequent fees and finance charges imposed on the borrower would not be recognized in income and accrued, but unpaid fees and finance charges normally would be reversed from income.

Recovery Practices

After a loan is charged off, institutions must properly report any subsequent collections on the loan (refer to ASC Section 310-10-25, Receivables – Overall - Recognition.) Typically, some or all of such collections are reported as recoveries to the ALLL or ACL for loans and leases. In some instances, the total amount credited to the ALLL or ACL for loans and leases as recoveries on an individual loan (which may have included principal, finance charges, and fees) may exceed the amount previously charged off against the ALLL or ACL on that loan (which may have been limited to principal). Such a practice understates an institution's net charge-off experience, which is an important indicator of the credit quality and performance of an institution's portfolio.

Consistent with regulatory reporting instructions, recoveries represent collections on amounts that were previously charged off against the ALLL or ACL for loans and leases. Accordingly, institutions must ensure that the total amount credited to the ALLL or ACL as recoveries on a loan is limited to the amount previously charged off on that loan. Any amounts collected in excess of this limit should be recognized as income.

SECURITIES

INTRODUCTION

Investment securities can provide financial institutions with earnings, liquidity, and capital appreciation. However, investments can also involve significant risks. Therefore, comprehensive risk management programs and appropriate board oversight are used by institutions to identify, measure, monitor, and control investment risks. This section describes various risks and common risk management practices associated with investment activities. The section also describes common investment types, trading activities, accounting and reporting standards, and safety and soundness principles.[1]

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RISK MANAGEMENT PROGRAMS

Consistent with the Interagency Guidelines Establishing Standards for Safety and Soundness,[2] effective risk management programs include internal controls that are commensurate with the size of the institution and the nature, scope, and risk of its activities. Effective programs address organizational structures and lines of authority, risk assessments, reporting requirements, and compliance with applicable laws and regulations. Institutions establish policies that typically include internal controls, risk limits, and guidance designed to provide for the identification, measurement, management, and reporting of risk exposures. The *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (Policy Statement)*, issued via Financial Institution Letter-45-98, provides information on sound practices for institutions to consider in managing investment risks.

Policy Statement

The Policy Statement describes elements of sound risk management programs for held-to-maturity and available-for-sale securities, certificates of deposit held for investment purposes, and end-user derivative contracts not held in trading accounts.[3] Fundamental program components discussed within the Policy Statement include:

- Board oversight and management supervision;
- Policies, procedures, and risk limits;
- Risk identification, measurement, and reporting;
- Internal controls and independent reviews; and
- Accounting systems and procedures.

Board Oversight

Board oversight is an integral part of effective risk management programs. Oversight activities involve approving investment policies and ensuring management has the expertise to manage the investment function and to establish and enforce approved policies and procedures. To effectively perform its oversight responsibilities, a prudent board regularly reviews management reports about investment activities and risk levels and requires management to demonstrate compliance with approved policy guidelines and risk limits. A competent board understands investment activities. Common oversight activities include:

- Establishing clear investment objectives;
- Maintaining appropriate investment, diversification, and risk management standards;
- Establishing appropriate risk limits and investment authorities for individual officers;
- Reviewing and understanding investment activities and acting as needed in response to management reports;
- Assessing investment performance;
- Monitoring management's compliance with the board's investment goals, policies, and risk limits;
- Assessing the adequacy of risk management programs; and
- Authorizing independent reviews of investment activities and appraising the review's findings. .

Management Supervision

Senior management is responsible for the daily supervision of investment activities. To effectively perform its responsibilities, management needs to understand the nature and level of risks involved in the institution's investments and how such risks may impact the institution's overall business strategies and risk profile. Common management activities include:

- Developing investment strategies that meet board objectives, standards, and risk appetite;
- Implementing policies and procedures that promote strong internal controls;
- Selecting investments consistent with board objectives and risk limits;
- Understanding the institution's investment risks;

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[1] Section 39 of the Federal Deposit Insurance Act as implemented by Appendix A of Part 364 *Interagency Guidelines Establishing Standards for Safety and Soundness* establishes various safety and soundness standards.

[2] ibid.

[3] An example of an end-user derivative contract is a swap contract entered into when the depository institution makes a fixed rate loan but wants to change the income stream from a fixed to floating rate.

- Identifying, measuring, monitoring, and controlling investment risks;
- Reporting investment activities and risks to the board;
- Ensuring investment account reconciliations are conducted by personnel independent of those initiating investments;
- Employing and training competent staff; and
- Evaluating and updating investment programs.

Effective management personnel identify and measure the risks associated with individual investments prior to purchase and periodically thereafter. Ongoing analysis may be performed at the institutional, portfolio, or individual instrument level. Prudent management of investment activities involves assessing the risk profile of particular investments in light of the effect on the institution's overall risk profile. Often, management measures risk exposures for each type of investment and then aggregates those exposures with the exposures arising from other business activities to determine the institution's overall risk profile.

Institutions with complex or extensive investment activities may benefit from using the portfolio approach for managing investment risks. Under this approach, management evaluates an investment's effect on overall portfolio risk and return levels. The process generally requires management to establish board-approved portfolio risk limits and a system for measuring overall portfolio risks and returns. The results of complex portfolio measurements are often incorporated into overall interest rate risk or asset/liability management programs.

Prudent risk management programs preclude management from investing in complex investments or investment strategies if institution staff lacks the expertise to properly understand and manage the risks. Even when adequate staff expertise exists within an organization to manage the risks, effective risk management programs include policies, controls, and limits that govern complex investment activities.

Although management may use external consultants and investment advisors for assistance and advice, it cannot delegate its risk management responsibilities to a third party. Management is ultimately responsible for understanding and managing investment risks and documenting its review and acceptance of a third party's due diligence, portfolio recommendations, and analytical methodologies. When management uses third-party analysis, such as investment-level and portfolio-level risk measurement, prudent risk management includes ensuring independence of the analysis from sellers or counterparties.

Policies

The board is responsible for adopting comprehensive, written investment policies that reflect its investment goals and risk tolerances. Effective policies are tailored to the institution's size, complexity, risk profile, and business model and typically address:

- Investment objectives and performance goals,
- Lines of responsibility and authority for all investment activities,
- Authorized activities and instruments,
- Risk limits,
- Broker/dealer selection criteria,
- Risk and performance measurements,
- Internal controls and independent reviews,
- Reporting requirements, and
- Accounting and taxation considerations.

Effective policies generally include guidelines for the acquisition and ongoing management of securities and derivative instruments. The policies may divide authorized investments into segments based on their similar risk characteristics and describe appropriate pre-purchase analysis for each identified segment.

Effective investment policies define criteria for identifying and measuring the risks associated with individual transactions prior to acquisition and periodically thereafter. Accordingly, institutions often have policies that define the characteristics of authorized instruments and include sufficient detail to identify authorized instruments. For example, a policy that merely authorizes management to purchase federal agency securities ("agency") may not be sufficiently detailed. The risk and return characteristics of agency pass-through securities, step-up structured notes, and callable debt instruments are very different. Therefore, effective policies delineate the specific types of agency securities that may be purchased.

Generally, policies also specify the level of risk analysis to be conducted prior to purchase of a security. The goal of pre-purchase analysis is to identify and quantify material risks and returns. However, not all investments require complex pre-purchase analysis. Relatively low-risk or standardized instruments generally require less in-depth analysis than more complex or volatile instruments. Effective policies delineate the type, depth, and documentation requirements for analyzing each type of investment.

When a prudent management team wishes to purchase an investment not specifically authorized by the board, it analyzes the risks and potential returns of the instrument and obtains the board's permission to add the instrument to the list of authorized investments. Comprehensive policies include such exception-to-policy procedures for requesting and reporting expedited investment purchases. Such policies typically establish a scope for internal audits or independent reviews that is sufficient relative to the extent, complexity, and risk profile of the investment activities.

Risk Limits

The board is responsible for establishing investment risk limits and ensuring management demonstrates compliance with approved limits. Senior management is responsible for establishing and enforcing policies and procedures, including risk limits, consistent with the board's goals, objectives, and risk appetite. Risk limits may be expressed in relation to the institution's overall risk profile or total portfolio risks, portfolio-segment risks, or individual investment risks.

Boards often set concentration limits for investments that share common risk characteristics or have heightened sensitivity to similar economic, financial, or other risk factors. For example, boards may establish concentration limits for:

- Investments with historically volatile market values or cash flows;
- Structured investments with underlying collateral consisting of higher risk assets or assets that may have limited liquidity in a stress environment;
- Investments that do not have readily determinable market values; and
- Investments that rely on a common risk mitigant, such as bond insurance, and
- Investment maturities and portfolio duration.

Effective boards establish risk limits that are consistent with the institution's strategic plans and overall asset/liability management objectives. Risk limits are often expressed relative to asset, capital, or income levels. General risk limit considerations include:

- Market risk,
- Credit risk,
- Liquidity risk,
- Asset limits, and
- Maturity limits.

Market risk reflects threats to an institution's financial condition resulting from adverse changes in the value of its investment holdings due to external market factors such as interest rates, equity prices, foreign exchange rates, or commodity prices. The three principal types of market risk are price risk, interest rate risk, and basis risk.

Price risk is the possibility that an instrument's price volatility will unfavorably affect income, capital, or risk reduction strategies. Price risk is usually influenced by other risks. For example, a bond's price risk could be a function of rising interest rates, while a currency-linked note's price risk could be a function of devaluation in the linked currency.

Interest rate risk is the possibility that an instrument's value will fluctuate in response to current or expected market interest rate changes. The value of fixed rate investment securities generally decline when interest rates rise, potentially impacting liquidity and capital.

Yield curve risk is the possibility that an instrument's value will fluctuate in response to a nonparallel yield curve shift. Yield curve risk is a form of interest rate risk.

Basis risk is the possibility that an instrument's value will fluctuate at a rate that differs from the change in value of a related instrument. For example, three-month Eurodollar funding is not perfectly correlated with Treasury bill yields. This imperfect correlation between funding cost and asset yield creates basis risk.

Market risk limits often quantify maximum permissible portfolio and individual-instrument price sensitivity as a percentage of capital or earnings. Capital-based risk limits illustrate the threat to the institution's viability, while earnings-based limits reflect potential profitability effects. In addition to capital- or earnings-based limits, the board may choose to establish limits relative to total assets, total investment securities, or other criteria. Such limits may be based on regulatory capital or equity capital pursuant to Generally Accepted Accounting Principles.

Credit risk reflects the possibility that an issuer or counterparty will fail to meet its financial obligations. Prudent institutions assess the creditworthiness of the issuer or counterparty before purchasing investments or entering into derivative contracts. The board may establish minimum acceptable creditworthiness requirements for individual investments or credit risk limits for securities with similar credit risk profiles. Boards often establish credit risk limits that restrict management to acquiring instruments that meet investment grade standards. The board may also restrict credit risk exposure by establishing issuer and counterparty concentration limits.

A security is investment grade if the issuer of the security has adequate capacity to meet the financial commitments under the security for the projected life of the asset or exposure. The definition of investment grade is included in 12 CFR 1 (Title 12, Part 1 of the Code of Federal Regulations). The rules codified in 12 CFR 1 prescribe standards under which national banks may purchase securities but are also applicable to FDIC-supervised institutions because state chartered banks and savings associations are generally prohibited from engaging in activities and investments that are not permissible for national banks. To meet the standard, management must determine that the risk of default by the obligor is low, and that full and timely repayment of principal and interest is expected. For structured securities (securities that rely on the cash flows and performance of underlying collateral, not the credit of the issuer), the determination that full and timely repayment of principal and interest is expected may be less influenced by the condition of the issuing entity, and influenced more by the quality of the underlying collateral, the structure of the security and the cash flows set out in the governing documents.

Liquidity risk reflects the possibility that an institution cannot immediately convert into cash an investment or offset a particular position at little or no loss of value. Assets that have high market or credit risk or are deeply subordinated will tend to be less liquid. High volatility and lengthy duration, along with difficulty and uncertainty of valuation are all characteristics that may reduce a security's marketability for liquidity purposes. For example, a security whose value is model dependent and conditional on the assumptions applied, will generally be less liquid, especially during times of stress. Less-marketable instruments also include securities such as obscure or thinly traded issues, complex instruments, defaulted securities, and instruments that have large unrealized holding losses.

Asset limits address concentration risk in assets that share similar characteristics, such as specific issuers, market sectors, and instrument types. When appropriately diversified, investment portfolios may have lower risk for a given yield or earn higher yields for a given risk level. Boards generally establish limits commensurate with the institution's individual circumstances, such as limiting total investments in a particular security type (e.g., municipal securities, corporate bonds, and private label mortgage backed securities) to a specific percentage of assets or capital.

Maturity limits balance an investment's maximum stated maturity, weighted average maturity, or duration (at an individual security or portfolio-wide level) with the individual circumstances of the institution. Considerations include items such as the board's risk appetite, current and anticipated loan demand, the stability and mix of deposits and other funding sources, and the risk of higher market interest rates. Prudent maturity limits complement market-risk and liquidity-risk limits and the board's overall investment goals.

Standardized risk-measurement systems and methodologies enhance management's ability to capture material risks and accurately calculate risk exposures. Comprehensive systems provide the board with consistent, accurate risk measurements in a format that directly illustrates compliance with established risk limits.

Internal Control Programs

Internal controls are critical components of effective investment programs and should be carefully evaluated by examiners. Effective internal controls include official lines of authority, appropriate separation of duties, prudent compensation that does not encourage inappropriate risk-taking, and independent reviews of investment activities.

Sound internal control programs are commensurate with the volume and complexity of investment activities, and independent from related operations. Examiners should review the separation of duties between individuals who execute, settle, and account for transactions, as well as those who generate and maintain board and management reports. Effective controls promote efficiency, reliable internal and regulatory reporting, and compliance with laws, regulations, and internal institution policies.

The board is responsible for establishing general internal control guidelines that management translates into clear procedures that govern daily operations. Effective internal control programs are commensurate with the volume and complexity of the institution's investment activity, and generally include procedures for the following:

- Portfolio valuation and monitoring,
- Personnel,
- Compensation,
- Settlement,
- Physical controls and documentation,
- Conflicts of interest,
- Accounting,
- Reporting, and
- Independent review.

A more detailed description of these elements of an effective internal control program follows:

Portfolio valuation and monitoring typically includes independent portfolio pricing. Independent pricing not only helps ensure accurate portfolio accounting and reporting but allows management to assess the liquidity and marketability of specific issues. For thinly traded instruments and other illiquid or complex instruments, independent pricing may be difficult to obtain. In such cases, estimated or modeled values may be used. Prudent management understands and verifies the methods and assumptions used to estimate values. Pricing provided solely by the broker who sold the security is not considered independent pricing.

Portfolio monitoring helps to inform senior management and the board of investment performance and potential risks on an ongoing basis. Monitoring efforts can focus on updating securities issuer credit risk information and the potential impact of market risk exposure from higher interest rates or other stress. This can help inform management's assessment of liquidity and capital sufficiency.

Personnel guidelines can ensure that sufficient staffing resources and expertise exist for the institution's approved investment activities.

Compensation guidelines concern individuals that can expose the institution to investment risks and are typically designed to ensure that compensation, especially incentive compensation, is balanced and adheres to compensation plans that don't encourage unsafe and unsound risk taking.

Settlement guidelines are designed to limit default and timing risk and provide clear requirements for confirmation, clearance, and settlement practices for specific asset types. As an example of a prudent internal control over settlement activity, supporting documents, such as broker's confirmations and account statements are reviewed by persons who do not also have sole custody of securities or have authorization to execute trades.

Physical controls and documentation guidelines describe requirements regarding the acquisition, recordation, and retention of purchased and sold instruments, and the retention and safeguarding of important documents.

Comprehensive invoice reviews cover all investments sold or purchased. Purchase invoices or confirmations can be compared to delivered securities or safekeeping receipts to determine whether the securities delivered are the securities purchased. Invoices and confirmations display each instrument's original purchase price, which provides a basis to establish book value and identify reporting errors. Invoice reviews can also be helpful to determine whether the institution is involved in any of the following inappropriate activities:

- Engaging one securities dealer or representative for virtually all transactions,
- Purchasing from or selling to the institution's trading department,
- Unsuitable investment practices, or
- Inaccurate reporting.

Conflict of interest guidelines list all applicable employees who are authorized to purchase and sell securities. Effective guidelines are typically designed to ensure that all directors, officers, and employees act in the institution's best interest. Boards often adopt policies prohibiting institution personnel from engaging in personal security transactions with the institution's approved securities broker/dealers without prior board approval. Comprehensive policies also include guidelines that address when directors, officers, and employees may accept gifts, gratuities, travel expenses, or other benefits, from securities broker/dealers and their representatives.

Accounting practices are designed to follow established accounting standards, opinions, and interpretations such as those listed in the Accounting section below.

Reporting procedures are designed to follow established internal guidelines discussed in the Risk Reporting section.

Independent reviews of the risk management program are generally conducted at regular intervals to ensure the integrity, accuracy, and reasonableness of the program. Independent reviews may encompass internal and external audits. The scope and formality of independent reviews correspond to the size and complexity of the institution's investment activities and are at least commensurate with the independent reviews of other primary institution activities. Effective reviews typically assess:

- Adherence to board policies and risk limits;
- Compliance with laws and regulations;
- The adequacy of internal controls and documentation standards;
- The adequacy and accuracy of risk measurement and monitoring systems;
- The timeliness, accuracy, and usefulness of reporting systems;
- Personnel resources, competencies, and compensation;
- Accounting practices; and
- Conflicts of interest.

For institutions with significant investment activities, internal and external audits are integral to controlling risks. Such institutions generally conduct periodic, independent reviews to ensure the integrity, accuracy, and reasonableness of their risk management program. The reviews consider items such as:

- Compliance with and the appropriateness of investment policies, procedures, and limits;
- The appropriateness of the institution's risk measurement and monitoring system given the nature, scope, and complexity of its activities; and
- The timeliness, integrity, and usefulness of reports to the board of directors and senior management.

Prudent management practices often include the independent testing and validation of sophisticated risk measurement systems, particularly those developed internally. The findings of such reviews are reported directly to the board at least annually. Effective boards review all independent review reports and ensure any reported issues or policy exceptions are appropriately addressed.

Examiners should evaluate the scope and adequacy of all independent reviews and may, when appropriate, place reliance on review findings during examinations. However, if the scope or adequacy of a review appears deficient, examiners should perform independent procedures. When warranted, examiners should conduct a detailed review of all material investment activities and note those items, as appropriate, in the Report of Examination.

Accounting

Accurate accounting is essential to the evaluation of an institution's risk profile and the assessment of its financial condition and capital adequacy. Reporting treatment for securities activities should be consistent with the institution's business objectives, U.S. Generally Accepted Accounting Principles (U.S. GAAP), and regulatory reporting standards. When necessary, examiners should consult regional accounting specialists for additional guidance.

ASC Topic 320, *Investments - Debt Securities*, requires all institutions to categorize debt securities as held-to-maturity (HTM), available-for-sale (AFS), or trading. Different accounting treatment applies to each category. Only debt securities that management has the positive intent and ability to hold to maturity may be designated as HTM and carried at amortized cost.

If a debt security can be contractually prepaid, or otherwise settled in such a way that the institution would not recover substantially all of its recorded investment, the security may not be designated as HTM. Therefore, debt securities with a risk of substantial investment loss in the event of early prepayment, such as interest-only, stripped mortgage-backed securities, should be categorized as either trading or AFS and reported at fair value on the balance sheet.

AFS debt securities are those that management has not designated for trading or as HTM. AFS debt securities are reported at fair value, with unrealized holding gains and losses generally excluded from net income and reported in accumulated other comprehensive income (AOCI), a separate component of equity capital.

Prior credit loss accounting related to other-than-temporary impairment (OTTI) is superseded upon implementation of ASC Topic 326, *Financial Instruments - Credit Losses*. See the section on *Decline in Fair Value, Accounting for Credit Losses on HTM and AFS Debt Securities under ASC Topic 326* for further information.

Debt securities held principally for selling in the near term must be reported as trading and carried at fair value, with unrealized gains and losses promptly recognized in current earnings and regulatory capital. Refer to the Call Report instructions for additional information.

The substance of management's securities activities determines whether securities reported as HTM or AFS should instead be reported as held for trading. Changes in the fair value of trading assets are reported in current earnings, which differs from the accounting for HTM and AFS securities. Therefore, reporting trading securities as HTM or AFS could be considered an unsafe or unsound banking practice, because the different accounting treatment could misrepresent the institution's financial statements.

ASC Topic 321, *Investments - Equity Securities*, requires all institutions with investments in equity securities with readily determinable fair values (except those accounted for under the equity method and those that result in consolidation) to measure the investments at fair value with the changes in fair value recognized in net income. Institutions with equity securities that do not have readily determinable fair values may elect to measure these securities at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in an orderly transaction for identical or similar investments of the same issuer.

Equity securities (which include investments in mutual funds) may be reported as either held for trading or not held for trading for regulatory reporting purposes. Equity securities not held for trading <u>with</u> readily determinable fair values are reported as such on the balance sheet. But equity securities not held for trading <u>without</u> readily determinable fair values are reported as Other Assets. Federal Home Loan Bank and Federal Reserve Bank stock are not within the scope of ASC Topic 321 and continue to be accounted for at cost and reported in Other Assets.

Premiums and discounts should be accounted for according to the Call Report Instructions. ASC Subtopic 310-20, *Receivables - Nonrefundable Fees and Other Costs*, as amended, requires premiums to be amortized to the earliest call date, with limited exceptions. If the call option is not exercised at its earliest call date, management resets the effective yield using the payment terms of the debt security in accordance with ASC Subtopic 310-20. Inadequately amortized premium amounts should be adversely classified as Loss. The amended accounting guidance does not change the accounting for debt securities held at a discount (i.e., amortized to maturity). For additional information, refer to the Call Report glossary on *Premiums and Discounts*.

Trade date accounting is preferred to settlement date accounting for Call Report purposes (i.e., regulatory reporting purposes) to report HTM securities, AFS securities, and trading assets (other than derivatives). However, if the reported amounts under settlement date accounting do not materially differ from those under trade date accounting, settlement date accounting is acceptable.

For information on derivatives and hedge accounting, refer to the Call Report Instructions and ASC Topic 815, *Derivatives and Hedging.*

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COMMON INVESTMENTS

U.S. Treasury Obligations (Treasuries) are backed by the full faith and credit of the U.S. government and are generally viewed as possessing little or no credit risk. Treasuries are issued with semi-annual coupon payments or sold at a discount with interest paid at maturity. Maturities for Treasuries range from a few days to 30 years. The most common types are Treasury bills, notes, bonds, and Treasury Inflation Protected Securities.

U.S. Government Agencies are wholly owned or controlled operations of the federal government that may raise funds through the Federal Financing Bank, which is backed by the full faith and credit of the U.S. Government.

Government-Sponsored Enterprises (GSEs) are entities created by acts of Congress to support specific public purposes. The GSEs are separately chartered or incorporated by the federal government and privately owned. Securities issued by the GSEs are not backed by the full faith and credit of the U.S. Government. However, market participants often perceive that there is an implied government guarantee supporting these obligations. For example, in 2008, the U.S. Department of Treasury provided $190 billion in financial support to the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Additionally, both enterprises were placed into conservatorship by the Federal Housing Finance Agency. The market's perception of a GSE's credit standing may affect the price of such securities.

Municipal obligations are debt instruments issued by states, counties, cities, or their political subdivisions that allow them to borrow money to build, repair, or improve infrastructure such as schools, streets, and bridges. In general, municipal obligations may be a general obligation backed by the full faith, credit, and taxing authority of the government issuer, or a revenue bond where income generated by a public facility such as a sewer, electrical, or power system is first used to repay the debt. Bank Qualified bonds (BQ bonds) are a type of municipal obligation issued by entities with not more than $10 million in annual bond issuances. BQ bonds provide institutions that purchase them with certain favorable tax treatment.

Corporate Bonds are debt securities issued by companies to raise funds and can be secured or unsecured. Collateral used in secured issues commonly includes real property, machinery, equipment, accounts receivable, stocks, bonds, or notes. Corporate bonds have a wide range of ratings and yields because of corporations' varying financial strength.

Mortgage-Backed Securities (MBS) are instruments secured by pools of mortgages and issued in the secondary mortgage market. An MBS can be issued by a government agency, GSE, or non-government entity (private-label). The instruments may be *pass-through* securities in which investors own an undivided interest in a pool of mortgages and receive pro-rata shares of cash flows from the underlying mortgage pools. Pass-through mortgage securities are sometimes called single class securities. Conversely, mortgage derivative securities, such as collateralized mortgage obligations (CMOs), are multi-class securities where the cash flows of the assets in the collateral pool are divided among the different classes to create securities with distinctive risk characteristics and different cash flow priority claims.

Asset-Backed Securities (ABS) are secured debt instruments (usually with multi-classes) with underlying collateral consisting of a wide array of assets such as home equity loans, credit card receivables, automobile loans and leases, and trade receivables.

Structured Credit Products is a general term used to describe financial instruments where repayment is derived from the performance of the underlying assets, other reference assets, or third parties that support the instrument. Such products include, but are not limited to, asset-backed commercial paper programs (ABCP); CMOs; ABSs; collateralized loan obligations (CLOs); and collateralized debt obligations (CDOs), including securities backed by trust-preferred securities.

Permissible Activities

Part 362 of the FDIC Rules and Regulations, *Activities and Investments of Insured State Banks,* implements Section 24 of the Federal Deposit Insurance Act. Part 362 generally prohibits, with certain exceptions, insured state banks and their subsidiaries from engaging in activities and investments that are not permissible for national banks. National bank investment activities are governed by the National Bank Act (12 USC, §21) and Office of the

Comptroller of the Currency regulations (12 CFR, Part 1). 12 CFR, Part 1 outlines five general types of investments that are permissible for national banks. The five investment types are as follows.

Type I: Obligations of the United States; general obligations of state or political subdivisions; unsecured debt and pass-through obligations of Federal Home Loan Banks, Government National Mortgage Association, FNMA and FHLMC. Preferred stock issued by FNMA, FHLMC and the Student Loan Marketing Association. Municipal revenue bonds are also considered Type I securities if held by well-capitalized institutions. Type I securities are considered permissible investments regardless of whether they meet the investment grade standard.

Type II: State obligations for housing, university and dormitory purposes, as well as obligations of development banks, the Tennessee Valley Authority, and the U. S. Postal Service.

Type III: An investment security that does not qualify as a Type I, II, IV, or V security, such as corporate bonds and municipal revenue bonds. This category includes most trust-preferred securities.

Type IV: Certain residential and commercial mortgage-related securities, and small business related securities backed by a pool of obligors.

Type V: An investment grade, marketable security that is not a Type IV security and is fully secured by interests in a pool of loans to numerous obligors and in which a national bank could invest directly such as asset-backed securities and certain mortgage-backed securities.

Management's analyses of the type II, III, IV, or V securities will demonstrate that the investments meet the definition of investment grade as required under 12 CFR Part 1 of the Code of Federal Regulations. While investment grade is no longer presumed when a security is rated in the four highest ratings bands by a nationally recognized statistical rating organization (NRSRO), NRSRO ratings can be used as one component in the process management uses to satisfy the investment grade standard. If used, examiners should determine whether management has a basic understanding of the methodologies the rating agencies use, as well as the limitations associated with these methodologies.

In limited circumstances, the FDIC may grant an exception to Part 362, on a case-by-case basis, if the FDIC determines that:

- The activity presents no significant risk to the deposit insurance fund, and
- The institution complies with the FDIC's capital regulations.

While Part 362 contains investment type restrictions, it does not include the investment amount restrictions that apply to national banks. For example, a national bank may invest in Type II securities issued by any one obligor not to exceed 10 percent of the bank's capital and surplus. A state chartered institution, however, is not bound to the percentage restrictions found in 12 CFR Part 1. Note, though, that the state where the bank is chartered may have its own exposure restrictions with which the bank must comply.

Trading activity within the HTM or AFS portfolio is an unsuitable investment activity and deemed an unsafe or unsound banking practice. The following activities are unsuitable and speculative within the HTM or AFS portfolio, and any related security acquisitions should be reported as trading assets in the institution's Call Report. Examiners should scrutinize institutions that show a pattern of trading-like activity within their HTM or AFS portfolios to determine whether some or all of the securities should be redesignated as trading assets. Examiners may consult with their regional accountant for guidance on redesignation. Comprehensive internal control programs are typically designed to prevent such unsuitable investment activities involving:

- Gains trading,
- When-issued securities,
- Pair-offs,
- Extended settlements,
- Repositioning repurchase agreements,
- Short sales, and
- Adjusted trading.

Gains trading is the purchase and subsequent sale of a security at a profit after a short holding period. Securities acquired for this purpose that cannot be sold at a profit are typically retained in the AFS or HTM portfolio. Gains trading might be used to defer loss recognition, as unrealized losses on debt securities in such categories do not directly affect regulatory capital and generally are not reported in income until the security is sold for non-advanced approach banking organizations that made the AOCI opt out election.

When-issued securities trading is the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities. A purchaser of a when-issued security acquires the risks and rewards of owning a security and may sell the when-issued security at a profit before having to take delivery and pay for it.

Pair-offs are security purchase transactions that are closed-out or sold at or before the settlement date. In a pair-off, an institution commits to purchase a security. Then, before the predetermined settlement date, management pairs off the purchase with a sale of the same security. Pair-offs involve net settlements when one party to the transaction remits the difference between the purchase and sale price to the counterparty. Pair-offs may also involve the same sequence of events using swaps, options on swaps, forward commitments, options on forward commitments, or other derivative contracts.

Extended settlement involves a securities trade that settles on a date later than the regular-way settlement period. Regular-way settlement is one business day after the trade date for U.S. Government and federal agency securities (except MBSs and derivative contracts). Regular-way settlement for corporate and municipal securities is two business days after the trade date, and for MBSs it can be up to 60 days or more after the trade date. The use of a settlement period in excess of the regular-way settlement period to facilitate speculation is considered a trading activity.

Repositioning repurchase agreements allow an investor to hold a speculative trading position until a security can be sold at a gain. For example, a dealer might allow an institution that entered into a when-issued trade (or a pair-off) that cannot be closed out at a profit on the payment or settlement date, to hold the position until a later date. The institution purchasing the security pays the dealer a small margin that approximates the actual loss in the security. The dealer then agrees to fund the purchase by buying the security back from the purchaser under a resale agreement. Any security acquired through a dealer financing technique such as a repositioning repurchase agreement that is used to fund the speculative purchase of securities should be reported as a trading asset.

Short sales involve the sale of a security that is borrowed, not owned. Generally, the purpose of a short sale is to speculate on a decline in the price of the security or to hedge a long position in the same or similar security. All short sales should be conducted in the trading portfolio. A short sale that involves the delivery of a security sold short by borrowing it from the institution's AFS or HTM portfolio should not be reported as a short sale. It should be reported as a sale of the underlying security with any gain or loss recognized in current earnings.

Adjusted trading involves the sale of a security to a broker or dealer at a price above the prevailing market value and the simultaneous purchase and booking of a different security (frequently with a lower rate, less quality, or a longer maturity) at a price above its market value. Thus, the dealer is reimbursed for losses on the purchase from the institution and ensured a profit. Such transactions inappropriately defer the recognition of losses on the security sold and establish an excessive cost basis for the newly acquired security. Consequently, such transactions are prohibited and may be in violation of 18 USC, Section 1001 *False Statements or Entries* and Section 1005 *False Entries*.

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RISK ANALYSIS

Investment risk is characterized by the possibility and severity of financial loss, and all investments involve some degree of risk. The level of risk involved depends on the type and extent of an institution's investment activities. This section summarizes methods to identify, measure, and analyze major risk exposures.

Risk Measurement

Financial institutions periodically assess investment risk levels to manage investment activities. Accurate risk measurements help management determine the success of its investment strategies and help the board to determine whether management achieved the board's goals and complied with its policies.

Effective risk measurements are tailored to match the characteristics of each type of investment. For example, mortgage derivative products are generally analyzed more closely than lower risk Treasuries. The analysis considers risks such as exposure levels and price volatility, historical and expected returns, liquidity and tax implications, and compliance with internal investment limits.

Generally, management segregates investments into groups with similar risk characteristics for analytical purposes. Most institutions have groups of relatively simple or standardized instruments, the risks of which are well known to management and require limited pre-purchase analysis. All other authorized instruments generally require more extensive pre-purchase analysis.

Well-defined investment segments facilitate pre-purchase analysis and help management understand the risks of each investment type. For example, it would be ineffective to group complex structured notes with straightforward, pass-through agency products. The characteristics of these instruments are distinct and require different pre-purchase analyses.

In addition to pre-purchase analysis, prudent management conducts on-going monitoring for investment risks. As with pre-purchase analysis, on-going post-purchase analysis identifies and measures risk characteristics on an individual-investment or total-portfolio basis.

Effective risk measurement systems used to conduct pre-purchase analysis and on-going monitoring procedures are commensurate with the size and nature of the investment portfolio. For detailed comments regarding the types of market risk measurement systems, refer to Manual Section 7.1, *Sensitivity to Market Risk*. Comprehensive risk measurement systems identify and measure all material risks and allow management to compare the results with the board's risk limits. For example, risk measurement systems often:

- Identify and measure the price sensitivity of embedded options (modified and Macaulay duration measures do not capture option risk);[4]
- Use interest rate shocks large enough (such as ±100 to 400 basis points) to measure realistic, potential market movements on the institution's financial condition including from a liquidity, capital, and earnings perspective;
- Include adjustments (e.g., convexity) to accurately estimate price changes when interest rate movements exceed 100 basis points;[5]
- Subject instruments to nonparallel interest rate shocks when those instruments are exposed to risk from changes in the yield curve's shape;
- Stress test credit sensitive instruments (e.g., non-agency MBS) to identify and measure the level of stress that would give rise to principal loss; and
- Evaluate the liquidity of the investment portfolio, including under possible adverse market conditions.

While management may measure investment risk and performance on an individual instrument basis, broader risk measurements are often beneficial. Management may aggregate individual instrument risk and return measurements to produce risk and return results for the entire investment portfolio. Portfolio results may then be incorporated into the institution's overall interest rate and liquidity risk measurement systems. Aggregation does not necessarily require complex systems. Management may simply combine individual instrument results to conduct portfolio analysis, or use portfolio results to compile whole institution analysis. Examiners should coordinate reviews of risk-aggregation measurements with the liquidity and contingency funding plan reviews and the sensitivity to market risk review.

Credit Risk Analysis

Management assesses the credit risk of individual investments prior to purchase and on an ongoing basis. The frequency and depth of the analysis correlates to the size, risk, and complexity of the investments and portfolio.

When assessing management's pre-purchase and on-going credit risk analysis, examiners should review the offering documents that provide investors details about a security. Offering documents are often referred to as a prospectus, but may also be called an official statement, offering circular, or offering memorandum depending on the specific investment involved. Some key examination considerations regarding various investments are described below.

Corporate Bonds

- Confirm that the spread to Treasuries is consistent with bonds of similar credit quality.
- Confirm that the risk of default is low and consistent with bonds of similar credit quality.
- Assess the issuer's financial and operating performance and capacity to pay through level trend and credit analysis (e.g., debt service coverage ratio analysis), or third-party analytics appropriate for the particular security.

Municipal General Obligation Bonds

- Confirm that the spread to Treasuries is consistent with bonds of similar credit quality.
- Confirm that the risk of default is low and consistent with bonds of similar credit quality.
- Assess the issuer's financial and operating performance and capacity to pay through level, trend, and credit analysis, or third-party analytics appropriate for the particular security.
- Evaluate the soundness of the municipal entity's budgetary position and the stability of its tax revenues.
- Consider the municipal entity's debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority, and management experience.
- Review local demographics and economic factors such as unemployment data, local employers, income indices, and home values.

Municipal Revenue Bonds

- Confirm that the spread to Treasuries is consistent with bonds of similar credit quality.

[4] Macaulay duration is the weighted average term to maturity of a security's cash flows. Modified duration is a measurement of the change in the value of an instrument in response to a change in interest rates.

[5] Convexity is a measure of the way duration changes when interest rates change.

- Confirm that the risk of default is low and consistent with bonds of similar credit quality.
- Assess the issuer's financial and operating performance and capacity to pay through level, trend, and credit analysis, or third-party analytics appropriate for the particular security.
- Review local demographics and economic factors such as unemployment data, local employers, income indices, and home values.
- Assess the source and strength of revenue structure for municipal authorities. Consider obligor's financial condition and reserve levels, annual debt service and debt coverage ratio, credit enhancements, legal covenants, and the nature of the related project.

Structured Securities

- Confirm that the spread to Treasuries is consistent with bonds of similar credit quality.
- Confirm that the risk of default is low and consistent with bonds of similar credit quality.
- Assess the performance of the underlying collateral, the quality of the underwriting of the collateral pool, and any risk concentrations.
- Consider the class or tranche and its relative position in the securitization structure.
- Assess the position in the cash flow waterfall and potential changes in the structure of payments under stressed scenarios.
- Consider loss allocation rules, the specific definition of default, and the potential impact of performance and market value triggers.
- Assess the support provided by credit and liquidity enhancements, such as over collateralization, structural subordination, reserves, and insurance wraps.
- Analyze the impact of collateral deterioration on tranche performance and potential credit losses under adverse general economic or sector conditions.
- Determine whether management restricted or set concentration limits on investments in securities backed by collateral with higher risk characteristics such as low credit scores, high loan-to-value ratios, or high delinquency rates.
- When concentrations in structured credit products exist, determine whether management tracks credit risk at the deal level, across securitization exposures, within and across business lines, and whether related risks are aggregated and monitored.
- When credit ratings or other third party credit analytics are used as one factor in assessing credit risk, determine whether management has a basic understanding of the methodology used, associated limitations, and the independence of the analysis.

Risk Reporting

Boards regularly review investment activities and require management to provide comprehensive investment activity reports. The frequency and substance of the reports are commensurate with a portfolio's complexity and risk profile. Comprehensive management reports to the board normally:

- Summarize all investment activity,
- Clearly illustrate portfolio risks and returns,
- Document management's compliance with investment policy standards and risk limits, and
- List exceptions to internal policies and statutory requirements.

Internal institution policies require management to present policy exceptions to the board or a designated board committee for approval before engaging in an unauthorized activity, and the board usually reviews and documents its decisions regarding each policy exception. Recurring exceptions prompt scrutiny from examiners as well as the board. Additionally, boards might take strong action if management fails to obtain prior approval for an unauthorized activity.

Investment Strategies

Investment strategies involve the plans that management uses to direct daily portfolio operations. To develop sound strategies, management needs to understand the board's goals, risk limits, and related investments and markets. Comprehensive investment strategies are consistent with the institution's:

- Risk appetite,
- Overall strategic goals,
- Capital position,
- Profitability levels,
- Asset/liability structure,
- Earnings composition, and
- Competitive market position.

Investment strategies vary among institutions, ranging from simple to complex. However, all operational strategies need to be documented, reasonable, and supportable. Examiners should evaluate strategies to determine their effect on the institution's risk levels, earnings, capital, liquidity, market sensitivity, asset quality, and overall financial condition.

Delegation of Investment Authority

Investment authority may be delegated to a third party if specifically approved by the board. However, the board and senior management are responsible for identifying and controlling risks arising from third-party relationships to the same extent as if the third-party activities were managed within the institution.

Regardless of whether the board's policies permit management to delegate investment authority to a third party, effective management teams understand each investment's risk, return, and cash flow characteristics. To conduct its independent analysis, management may rely on information and analysis provided by the broker/dealer if the analysis uses sound calculation methods and realistic assumptions and management comprehends the analysis and assumptions.

Institution policies typically preclude investment in instruments or strategies that management does not fully understand. Failure to adequately understand and manage investment risks may constitute an unsafe or unsound banking practice.

Before delegating investment authority to a third party, management evaluates the third party's reputation, performance, and creditworthiness, and completes regulatory, legal, and criminal background checks. Most third party investment arrangements are governed by a formal written agreement that specifies:

- Compensation,
- Approved broker/dealers,
- Investment goals,
- Approved activities and investments,
- Investment discretion,
- Risk limits,
- Risk and performance measurements,
- Reporting requirements,
- Settlement practices, and
- Independent review requirements.

In addition, written agreements normally require all trade invoices, safekeeping receipts, and investment analyses to be readily available to the institution.

Program Evaluation

Periodic evaluations of an institution's risk management program by its board and management help ensure that investment activities meet the board's goals and strategy. The scope and depth of the evaluation correspond to the institution's size, complexity, business model, and investment activities. At many institutions, annual evaluations may be sufficient. In larger or more complex institutions, quarterly (or more frequent) evaluation may be necessary.

Boards review management reports, including summaries of investment activity, portfolio risk, return, and performance measures, and independent review findings to identify weaknesses and determine whether:

- Stated goals accurately represent the board's objectives,
- Management is appropriately pursuing the board's objectives,
- Risk limits properly reflect the board's risk tolerance,
- Risk limits reasonably protect the institution's financial condition,
- Internal controls are adequate,
- New activities are approved, monitored, and appropriately reported,
- Policies provide sufficient guidance for management, and
- Concentrated credit or market risk exposures present undue risk to the investment portfolio's marketability or valuation.

After review of the institution's strategy, current and expected financial condition, competitive environment, and the general economic outlook, a board may reassess its portfolio goals and strategy to ensure that they align with the overall institutional strategy, and adjust the portfolio's goals if necessary.

After evaluating its goals, the board may then affirm that the existing risk limits accurately reflect its risk tolerance. When warranted, the board may consider relaxing or tightening the risk limits placed on management. Before altering its risk limits, the board considers the potential risk/return tradeoff of accepting increased or reduced risk.

When evaluating risk management programs, boards assess management success at achieving board goals, adherence to policies and risk limits, and maintenance of an effective control environment. Boards consider the cause of any material deficiencies and obtain management commitment to rectify the deficiencies.

Finally, boards determine whether any changes to policies are warranted. For example, management may request authority to engage in new investment activities. Boards carefully consider such requests and determine whether the proposed activity is consistent with its investment goals and risk tolerance.

Management also periodically reviews the portfolio management program in detail to identify any general or specific weaknesses. Management responsibilities generally include:

- Measuring portfolio risks and performance;

- Validating the accuracy and adequacy of risk measurement systems;
- Ensuring investment strategies achieve board goals;
- Reporting portfolio activity and performance, policy exceptions, and strategy changes to the board; and
- Correcting policy exceptions and addressing supervisory recommendations.

At many institutions, especially those with non-complex or successful investment programs, the periodic evaluations result in few program alterations. Examiners should assess the periodic evaluations to determine whether the board and management effectively review the portfolio management program.

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EXAMINATION CONSIDERATIONS

Special Mention

Examiners may list securities as Special Mention in the Report of Examination. Special Mention investment securities, similar to other types of assets, are typically based on emerging weaknesses related to the financial condition of the issuer/obligor or value/performance of the underlying collateral that are not well defined at the time of the supervisory evaluation. If the negative trends continue, the issuer of the security may eventually not have the capacity to meet the security's financial commitments. Reasons to list investment securities as Special Mention also rest, in part, on the type of security under review. For example, a corporate bond might be listed Special Mention given the obligor's negative operating trends or use of excess leverage that if not checked could eventually result in the deterioration of repayment capacity. For general obligation municipal bonds, negative operating trends, loss of a significant commercial taxpayer, or deteriorating local economic conditions may support a Special Mention listing. For structured instruments, like private-label mortgage back securities, a Special Mention listing may be supported by emergent negative trends that could eventually jeopardize repayment capacity as signaled by the structure's performance triggers (e.g., trends in overcollateralization tests), in the performance of the underlying collateral (e.g., declining LTVs, increasing delinquencies and defaults), or in the credit support levels backing the bank's tranched position (e.g., initial write-downs of subordinate bonds). Further, failure of bank management to identify and assess weaknesses through its due diligence and ongoing monitoring procedures could be a key factor in assigning an investment security or securities as Special Mention.

Classifying Investment Securities

Examiners should adversely classify subinvestment quality securities in the Report of Examination referencing the October 29, 2013 *Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions* (Uniform Agreement). The Uniform Agreement addresses the examination treatment for adversely classified assets and:

- Characterizes investment quality versus subinvestment quality securities;
- Defines Substandard, Doubtful, and Loss categories used for classifying assets;
- Presents various scenarios to guide examiners in how to classify securities with credit deterioration;
- Describes securities eligible or ineligible for purchase;
- Provides examiners the discretion to assess credit risk and assign a classification based on current information and circumstances independent of any assigned credit rating; and
- Provides information on upgrading previously classified assets.

Examiners should reference the definitions for classified assets as delineated in the Uniform Agreement when contemplating whether to adversely classify an investment security.

A <u>Substandard</u> 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 liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

An asset classified <u>Doubtful</u> 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 <u>Loss</u> are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified Loss should be promptly charged off.

The Uniform Agreement defines an investment grade security when the issuer has adequate capacity to meet its financial commitments for the life of the asset. An issuer has adequate capacity to meet its financial commitments if the risk of default is low and the full and timely repayment of principal and interest is expected. Note, however, this is the definition established in 12 CFR Part 1 for national banks. This definition will usually apply to state-chartered banks, but in some states investment grade may be defined differently across its laws and regulations and therefore a state bank may be subject to restrictions on investments that are more stringent than those in 12 CFR Part 1.

Institutions perform initial due diligence commensurate with an instrument's complexity to determine whether securities meet the investment grade standard. Potential investments that do not meet the definition of investment grade are ineligible for purchase. Management conducts ongoing due diligence and monitoring to determine whether securities continue to meet the standard.

A pass rating may be supported by appropriate credit analysis that documents the quality of an investment grade security, as well as an ongoing analysis that demonstrates the obligor's continued repayment capacity. Investment grade securities are generally not subject to adverse classification. Examiners may classify a security when justified by available credit risk information independent of any assigned credit rating.

Any subsequent upgrade in classification should follow a sustained period of performance and be based on improvement in credit conditions and analysis that indicates all future contractual payments will be received. Generally, the performance period should cover multiple payments as determined by the security's payment structure (i.e., monthly, quarterly, annually).

Regardless of a determination of adverse classification, examiners should consider an investment portfolio's depreciation (and the quality and support for its pricing) in their assessment of capital, asset quality, earnings, and liquidity. Significant rising market interest rates can cause significant unrealized losses at institutions with long-duration bond portfolios. Unrealized losses increase financial and liquidity risks and necessitate more robust examination coverage and ongoing monitoring. Among the potential risks facing affected institutions are a reduced stock of unencumbered liquid assets that can be sold or pledged with no or minimal losses incurred or discounts required; potential access limitations from wholesale funds providers such as the Federal Home Loan Bank, municipalities, deposit brokers, and other counterparties; challenges in executing contingency funding plans; and the possibility that depositors, particularly uninsured depositors, develop doubts about an institution's resilience and solvency, prompting withdrawals. In a rising rate stress scenario, examiners will need to look beyond the HTM and AFS accounting categorizations to the portfolio's economic substance to adequately assess its impact on liquidity, capital, and earnings.

Failure to provide adequate pricing and impairment analysis may also negatively influence the management rating.

Declines in Fair Value

Accounting for credit losses on HTM and AFS debt securities under ASC Topic 326

ASC Topic 326, *Financial Instruments - Credit Losses* supersedes previous OTTI guidance. Institutions that have adopted ASC Topic 326 are required to follow its guidance for the measurement of credit losses for HTM and AFS debt securities.

The measurement of credit losses for HTM debt securities falls within the scope of ASC Subtopic 326-20, *Financial Instruments - Credit Losses – Measured at Amortized Cost*, commonly referred to as the current expected credit losses (CECL) methodology. In accordance with ASC Subtopic 326-20, management will report a provision expense for the amount necessary to adjust the allowance for credit losses (ACL) for the current estimate of expected credit losses. Management may measure expected credit losses on a collective pool basis when similar risk characteristics exist. Otherwise, an ACL on a HTM debt security will be measured on an individual basis.

The measurement of AFS debt securities falls within the scope of ASC Subtopic 326-30, *Financial Instruments - Credit Losses – Available-for-Sale Debt Securities*. Impairment for all AFS debt securities is measured at the individual security level.

The impairment of an AFS debt security occurs when the fair value of that security is below its amortized cost basis. When this occurs, management must determine whether the decline in fair value below the amortized cost basis has resulted from a credit loss or other non-credit factors, such as changes in interest rates or the market liquidity of the instrument. In assessing whether a credit loss exists, management will compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. Impairment relating to credit losses is recognized through an ACL, with the credit loss limited by a fair value floor (i.e., the ACL is limited by the amount that the fair value is less than the amortized cost basis). Changes in the ACL are recorded in the period of change as a provision expense or the reversal of a provision expense. The amount of impairment not recorded through an ACL (i.e., impairment related to non-credit factors) is required to be recorded through other comprehensive income net of tax.

If management intends to sell an AFS debt security, or it is likely that it will be required to sell the debt security before recovery of its amortized cost basis, any ACL should be written off and the amortized cost basis written down to the debt security's fair value at the reporting date, with any incremental impairment (i.e., any decline in fair value since the last reporting date) reported through earnings. Once an individual AFS debt security has been written down, the previous amortized cost basis less write-offs, including non-credit related impairment reported in earnings, becomes the new amortized cost basis of the debt security. The new amortized cost basis is not adjusted for subsequent recoveries of cash flows, but is reflected as a yield adjustment.

Subinvestment Debt Securities

Consistent with ASC Topic 320, AFS debt securities are marked-to-market and carried at their fair value on the balance sheet. The U.S. implementation of Basel III capital measures developed by the Basel Committee on Banking Supervision, reflected in Part 324 of the FDIC Rules and Regulations, gave most banking organizations with total assets below $250 billion a one-time election to opt out of the requirement to include AOCI components in the calculation of regulatory capital (AOCI opt-out). Therefore, the net unrealized holding gains (losses) on AFS debt securities, net of tax effects, are generally excluded from earnings. For institutions that have adopted ASC Topic 326, an exception to this rule occurs when credit impairment has occurred on an AFS debt security. In this case, only the non-credit impairment (i.e., the depreciation related to other factors) on the individual security is not recognized in earnings. The non-credit portion, net of applicable taxes, is reported in AOCI provided the AFS debt security will not be sold before recovery of the amortized cost basis.

For purposes of determining an institution's regulatory capital under Part 324 when there is an AOCI opt-out election, any net unrealized holding gains (losses) on AFS debt securities, including the non-credit portion of a fair value decline to an AFS debt security in the circumstances described above, that are included in AOCI, are ignored. As a result, the amount reported in AOCI normally is not deducted, but is neutralized (i.e., added back in the case of net unrealized losses) in determining regulatory capital.

To appropriately reflect regulatory capital, the amount of the credit impairment or write-downs recognized in earnings based on U.S. GAAP is classified Loss, with the remaining balance classified Substandard. Therefore, only the credit loss portion on a subinvestment debt security should be deducted in determining tier 1 capital.

For subinvestment AFS debt securities with fair values below its amortized cost, the amortized cost (rather than the lower amount at which these securities are carried on the balance sheet, i.e., fair value) is classified Substandard. This classification is consistent with the regulatory capital treatment of AFS debt securities when there is an AOCI opt-out election. As mentioned above, under U.S. GAAP, net unrealized holding gains (losses) on AFS debt securities are excluded from earnings, unless a credit loss is recognized, and reported in a separate component of equity capital. In contrast, these net unrealized holding gains (losses) are excluded from regulatory capital. Accordingly, the amount classified Substandard on these subinvestment quality AFS debt securities (i.e., amortized cost) also excludes the balance sheet adjustment for unrealized holding losses.

Determining Fair Value

As currently defined under U.S. GAAP, the fair value of an asset is defined as the price that would be received to sell an asset or the amount paid to transfer a liability in an orderly transaction between willing market participants (i.e., other than in a forced or liquidation sale). Quoted market prices are the best evidence of fair value and must be used, if available, as the basis for measuring fair value. If quoted market prices are not available, the estimate of fair value must be based on the best information available in the circumstances. The estimate of fair value must consider prices for similar assets and the results of valuation techniques, to the extent available in the circumstances.

Examiners must ascertain a security's fair value to properly classify or make needed regulatory capital adjustments. Hence, examiners should review management's fair value measurements for all adversely classified securities. When management's valuation is reasonable, examiners will use that value to classify the security. If unreasonable or unsupported, examiners should discuss their concerns with management and request that management provide a reasonable and supportable valuation. When management cannot provide a reasonable valuation during the examination, examiners should use the information and pricing services provided by RMS Capital Markets to estimate values for examination purposes.

Qualitative Capital Adequacy Considerations

Net unrealized holding gains (losses) on AFS debt securities are not normally recognized in calculating an institution's regulatory capital ratios as discussed. However, examiners should consider the extent of the net unrealized gains or losses, as well as the appreciation and depreciation on HTM debt securities in the overall assessment of the institution's capital adequacy, liquidity position, and risk management system.

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OTHER ISSUES

Investment Trading Account Risk Management

Trading activities involve strategies or transactions designed to profit from short-term price changes. Trading activities usually employ active strategies, which assume that management can consistently outperform the market. Trading programs can generate earnings, but can expose institutions to different and increased risks.

The FDIC Rules and Regulations (Parts 351 and 324) discuss trading-related requirements and restrictions. Regardless of capital requirements contained in Part 324 and prohibitions contained in Part 351 (Part 351 does not apply to most community and regional institutions), there are risk management considerations for any institution with an investment trading account.

The board and management have the responsibility to identify, measure, monitor, and control trading activity risks. Failure to adequately understand and manage trading activity risks may constitute an unsafe or unsound banking practice. Financial institutions' risk management programs governing trading activities typically address:

- Board oversight, approval, and periodic review requirements;
- Management qualifications;
- Management oversight procedures;
- Policy standards, operational procedures, and risk limits;
- Segregated accounting and reporting requirements;
- Conflict of interest and code of ethics guidelines;
- Compensation practices;
- Internal controls; and
- Risk measurement systems and requirements for reporting material risks such as potential trading losses and performance relative to established benchmarks.

Effective risk measurement systems identify and measure all material risks, including potential trading losses, for defined periods. For example, the system might measure potential one-day trading loss for a given set of statistical assumptions.

The reliability of a risk measurement system is enhanced when management uses reasonable, supportable, and consistent assumptions and translates system results into terms that evidence compliance with the board's trading risk limits.

When measuring the performance of the institution's trading activities, trading desks, or individual traders, management compares actual results to performance benchmarks that provide realistic comparative values. For example, management may compare actual results against the returns that could have been obtained by adopting a passive investment strategy in a similar class of investments. Additional performance benchmarks may include market indexes such as the Standard & Poor's 500 Index, the Russell 2000 Index, the Barclays Capital Aggregate Bond Index, or the Bloomberg U.S. Treasury Index.

CASH AND DUE FROM BANKS

OVERVIEW

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

Cash

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

Clearings

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

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

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

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

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

Cash Items

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

In normal daily operations, all banks have items which are charged to demand deposits but which cannot be charged to individual accounts because of insufficient funds, a lack of information, unknown accounts, etc. Such items include return items, rejects, or unposted debits and may consist of checks, loan payments, or other debit memos. In some banks, such items are separated and an entry is made reclassifying them to a separate asset account. Other banks include the items in a subsidiary control account in the individual demand deposit ledgers. In that case, the account would have a debit balance that would be credited when the bank returns the checks to their sources.

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

Due From Banks

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

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

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

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

DEPOSIT NOTES

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

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

Structured CDs

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

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

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

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

EXAMINATION OBJECTIVES

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

Primary Reserves

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

Interbank Liabilities

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

Policy standards should include exposure limits when a correspondent's financial condition, or the general level of exposure to a correspondent, creates a significant risk to a bank. Exposure limits may be fixed by amount or flexible, but should be based on the financial condition of the correspondent and the type and level of identified exposure. Regulation F provides that when exposure limits are required, banks should limit interday credit exposure to a correspondent to 25 percent of a bank's capital, unless the bank can demonstrate that its correspondent is at least adequately capitalized. When a correspondent is not at least adequately capitalized, banks should reduce their credit exposure to the 25 percent level within 120 days after the date when the current Call Report or other relevant report would be available.

Compensating Balances

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

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

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

Correspondent Concentration Risks

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

A financial institution’s relationship with a correspondent can result in credit (asset) and funding (liability) concentrations. Asset concentrations may be present when an institution maintains significant due from balances; or advances, or commits to advancing, significant funds to a correspondent or their related entities. Liability concentrations may exist when an institution maintains significant due to balances; or depends on a correspondent or their related entities for a disproportionate share of its total funding.

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

Due Diligence

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

Identifying Credit Concentrations

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

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

Identifying Funding Concentrations

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

Calculating Credit and Funding Concentrations

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

Monitoring Correspondent Relationships

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

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

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

Managing Correspondent Concentrations

Institutions should establish prudent internal concentration limits for each correspondent, as well as ranges or tolerances for each factor being monitored. Institutions should also develop contingency plans for managing risks when internal limits, ranges, or tolerances are met, either on an individual or collective basis. However, contingency plans should not rely on temporary deposit insurance programs for mitigating concentration risks.

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

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

EXAMINATION PROCEDURES

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

PREMISES AND EQUIPMENT

INTRODUCTION

Institutions have historically relied on a reasonable investment in premises and equipment to successfully conduct business. A financial institution's physical presence in a community can bolster its public image and competitive position, and enhance convenience for customers. Institution offices can provide a platform for gathering deposits, originating credit, and serving the financial needs of its community. However, overinvestment in facilities may tie up capital and hinder earnings. Therefore, similar to other balance sheet assets, premises and equipment can pose risks to the institution and present a range of accounting issues that require appropriate oversight.

Premises include the cost, less accumulated depreciation, of land and buildings actually owned and occupied (or to be occupied) by the institution, its branches, and consolidated subsidiaries. This includes vaults, *fixed* machinery and equipment, parking lots, and real estate acquired for future expansion. Interest costs associated with the construction of a building are capitalized as part of the cost of the building. Institution premises also include leasehold improvements. Leasehold improvements comprise two types of accounts:

- Buildings constructed on leased property, and
- Capitalized disbursements directly related to leased properties, such as vault, renovation, and fixed machinery and equipment expenses.

Non-fixed equipment includes all *movable* furniture, fixtures, and equipment of the bank, its branches, and consolidated subsidiaries, including automobiles and other vehicles used in the conduct of business.

Premises and equipment are reported in the Call Report schedule RC-Balance Sheet, Item 6, *Premises and Fixed Assets*. The institution's ownership interest in premises and equipment of non-majority-owned corporations is also included in schedule RC, Item 6.

FIXED ASSETS ACCOUNTING

Fixed Assets - Owned

Fixed assets are reported at original cost and are depreciated over their estimated useful life, except for land which is not a depreciable asset.

Interest may be capitalized as part of the historical cost of acquiring assets that need time to be brought to the condition and location necessary for their intended use. The FASB Accounting Standards Codification (ASC) 835-20, *Capitalization of Interest*, calls for capitalization of interest costs associated with the construction of a building, if material. Such interest costs include both the actual interest incurred when the construction funds are borrowed and the interest costs imputed to internal financing of a construction project. The rate used to capitalize interest on internally financed projects in a reporting period shall be the rate(s) applicable to the bank's borrowings outstanding during the period. For this purpose, a bank's borrowings include interest-bearing deposits and other interest-bearing liabilities. The interest capitalized shall not exceed the total amount of interest cost incurred by the bank during the reporting period.

Fixed Assets - Leased

Institutions often lease premises and equipment. Lease obligations, which essentially reflect an extension of credit between the lessee and lessor may reflect material investments and can significantly, affect a bank's earnings.

ASC 840, *Leases*, is the current lease accounting standard for non-public entities and entities that have not adopted ASC 842, *Leases*. ASC 842 is effective for public business entities (as defined in U.S. GAAP) and will become effective for banks that are not public business entities, for fiscal years beginning after December 15, 2020, and interim reporting periods within fiscal years beginning after December 15, 2021. As such, a calendar year end non-public entity's first reporting period will be December 31, 2021. Early adoption is permitted.

In general, under ASC 840, a *capital lease* is recorded on the balance sheet (with interest and depreciation expensed on the income statement). An *operating lease*, on the other hand, is not reported on the balance sheet (it is disclosed in the footnotes of financial statements). Under ASC 840, operating leases are expensed using the straight-lined method on the income statement.

Under ASC 842, lessees are required to classify a lease as either a *finance lease* or an operating lease and, in most cases, identify and report them on the balance sheet. Although the term finance lease replaced the term capital lease that was previously used in ASC 840, the substance of recording and reporting the transactions remains the same.

Lease Accounting – ASC 840

In accordance with ASC 840, any lease entered into by a lessee institution, which at its inception meets <u>one or more</u> of the following four criteria must be accounted for as a property acquisition financed with a debt obligation, i.e., a capitalized lease. The criteria are:

- Ownership of the property is transferred to the lessee at the end of the lease term;
- The lease contains a bargain purchase option;
- The lease term represents at least 75 percent of the estimated economic life of the leased property; and
- The present value of the minimum lease payments at the beginning of the lease term is 90 percent or more of the fair value of the leased property to the lessor at the inception of the lease, less any related investment tax credit retained by or expected to be realized by the lessor.

If none of the criteria listed above is met, the lease should be accounted for as an operating lease. Normally, rental payments should be charged to expense as they become payable over the term of the operating lease.

Capitalized leases are to be reported in the Premises and Fixed Assets category of the Call Report. The amount capitalized equals the present value of the minimum required payments over the non-cancellable term as defined by the lease (plus the present value of payments required under a bargain purchase option, if any) less any portion of payments representing administrative expenses (such as insurance, maintenance, and taxes to be paid by the lessor). The property should be amortized according to the institution's normal depreciation policy (except, if appropriate, the amortization period should be the lease term) unless the lease involves land only, which is not a depreciable asset.

Lease Accounting – ASC 842

The core principle of ASC 842 is that a lessee should recognize the assets and liabilities that arise from leases. Under ASC 842, institutions are required to report a right-of-use (ROU) asset and a lease liability for most finance and operating leases. The ROU asset reflects the lessee's control over the leased item's economic benefits during the lease term. The measurement of the ROU asset includes the initial present value of lease payments plus certain third party, initial direct costs minus any lease incentives. The lessee records a related lease liability equal to the present value of the unpaid future lease payments.

The discount rate used to estimate the present value should be the rate implicit in the lease, or if that rate cannot be readily determined, the lessee's incremental borrowing rate (IBR). Many times a lessee may not have the necessary information, (such as the residual value estimate of the lessor or the initial direct cost incurred by the lessor) to determine the rate implicit in the lease. In such cases, the lessee may use its IBR.

While most leases will be reported on the balance sheet, ASC 842 permits a lessee to make an accounting-policy election to exempt leases with a term of one year or less (at the commencement date) from on-balance sheet recognition. The lease term generally includes the non-cancellable period of a lease as well as purchase options and renewal options that are reasonably certain to be exercised by the lessee, renewal options controlled by the lessor, and any other economic incentive for the lessee to extend the lease, which may include a related-party commitment.

Classification of Leases by the Lessee

ASC 842 requires a lessee to classify a lease (at the commencement date) as either a finance lease or an operating lease. When lease terms effectively transfer control of the underlying asset, the substance of the transaction is reflective of a sale, and the lease is classified as a finance lease by the lessee. Leases between related parties, such as a holding company and its financial institution are classified in the same manner as a lease with unrelated parties, i.e., the classification is based on the terms of the contract without considering the related party relationship. ASC 842 has five criteria for determining if a lease is a finance lease or an operating lease for the lessee.

A lessee is required to classify a lease as a finance lease when <u>one or more</u> of five criteria are met:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term;
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise;
- The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion is not used for purposes of classifying the lease;
- The present value of the sum of the lease payments and any residual guarantee by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset; or
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

If none of the five criteria are met and the lease is not a short-term lease in which the institution has elected the short-term lease policy election, the lessee is to classify the lease as an operating lease.

While the initial reporting of the ROU asset and lease liability will be the same regardless how the lease is classified (i.e., finance or operating lease), the reporting in the income statement differs. For a finance lease, a lessee is required to report interest expense on the lease liability using the effective interest method separately from the amortization expense on the ROU asset, typically on a straight-line basis. For an operating lease, a lessee is required to report a single lease cost. The lease expense is recorded on a straight-line basis over the lease term by adding the interest expense on the lease liability to the amortization of the ROU asset.

If a lease is not being correctly reported, appropriate comments should be included in the Report of Examination. The comments should remind management of the responsibility for accurate reporting and include the recommendation that competent outside assistance be obtained if the bank lacks satisfactory accounting expertise. In addition, if the amount incorrectly reported is significant, amended Call Reports may be necessary. Examiners are to verify whether bank decisions on how to report a lease are be fully supported and documented.

Sale-Leaseback Transactions

Sale-leaseback transactions occur when the owner of a property sells the property and subsequently leases it back from the buyer. The seller-leasee transfers legal ownership of the property to the buyer-lessor in exchange for consideration and then makes periodic rental payments to the buyer-lessor to retain use of the property.

Sale-Leaseback Accounting - ASC 840-40

If an institution sells premises or fixed assets and leases back the property, the lease shall be treated as a capital lease if it meets any one of the four capitalization criteria in ASC 840. Otherwise, the lease shall be accounted for as an operating lease. ASC 840-40, *Leases – Sale-Leaseback Transactions* provides guidance on the treatment of any gain or loss. A loss must be recognized immediately for any excess of net book value over fair value at the time of sale. In the event a bank sells a property for an amount less than its fair value, (for example, in order to obtain more favorable lease terms), the difference between the sale proceeds and fair value represents an additional loss that must be deferred and amortized over the life of the lease. Any gain resulting from a sale-leaseback transaction is generally deferred and amortized over the life of the lease. Accordingly, the general rule on deferral does not permit the recognition of all or part of the gain in income at the time of sale. Exceptions to the general rule do permit full or partial recognition of a gain at the time of the sale if the leaseback covers less than substantially all of the property that was sold or if the total gain exceeds the minimum lease payments.

Sale-Leaseback Accounting – ASC 842-40

For a sale-leaseback transaction to qualify for sales treatment under ASC 842, the transfer of the asset must meet the requirements for a sale in ASC 606, *Revenue from Contracts with Customers*. If the transaction qualifies as a sale in accordance with ASC 606 and the transaction would not be considered a failed sales-leaseback (as described below), any gain or loss on the sale is recognized immediately. However, an option for the seller-lessee to repurchase the asset would preclude accounting for the transfer of the asset as a sale unless both of the following criteria are met:

- The exercise price of the option is the fair value of the asset at the time the option is exercised, and
- There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

The classification of a lease can affect whether a sale has occurred. In the event a leaseback is classified as a finance lease by the seller-lessee, or a sales-type lease by the buyer-lessor, then a sale has not occurred since a finance lease is essentially the purchase of an asset and a sales-type lease is essentially a sale of an asset. As such, the transaction would be considered a failed sales-leaseback.

If the transaction would not meet the conditions for a sale under ASC 606, or when the leaseback would not be classified as an operating lease (i.e., a failed sales-leaseback), the transaction would be accounted for as a financing arrangement. The transferor would not derecognize the asset and will continue to depreciate the asset as the legal owner. Any sales proceeds received would be reported as a liability.

For sale and leaseback transactions accounted for under ASC 840, the transition guidance does not require an entity to reassess whether the transaction would have qualified as a sale and a leaseback under ASC 842.

The accounting requirements for leases and sales of real estate are complex; and examiners who have questions on lease accounting or sale-leaseback transactions should refer to appropriate accounting resources or contact their regional accounting specialist.

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ANALYSIS OF FIXED ASSETS

From an accounting standpoint, an investment in fixed assets is an essential cost of doing business. Attention should be focused on the adequacy of depreciation, the reasonableness of the overall commitment, and the current and prospective utilization of fixed assets in serving the present and future anticipated banking needs. Only under exceptional circumstances, such as the contemplated abandonment of institution premises, gross under-utilization due to obsolescence, closed bank situations, or other extreme circumstances, do market value considerations assume any significance in the analysis of fixed assets.

Depreciation Costs

Depreciation is an overhead cost of doing business as the item being depreciated will have to be replaced when it ceases to have utility. An acceptable depreciation program allocates the original cost of the fixed asset over its estimated useful life. Failure to follow a realistic schedule of fixed asset depreciation distorts both the balance sheet and income statement.

Institutions carry premises and equipment at cost less accumulated depreciation, and adjust the carrying amount for permanent impairments of value. Any method of depreciation or amortization conforming to accounting principles that are generally acceptable for financial reporting purposes may be used. However, depreciation for premises and fixed assets may be based on a method used for federal income tax purposes if the results would not be materially different from depreciation based on the asset's estimated useful life. Under normal circumstances, examiners should not need to prepare detailed depreciation schedules in accordance with the generally accepted accounting principles. In instances where tax depreciation and book depreciation are the same, and depreciation is accelerated for tax purposes only, detailed analysis of book values may be necessary to determine whether fixed assets are being appropriately depreciated.

Depreciation can result in a taxable, temporary difference if an institution uses the straight-line method to determine the amount of depreciation expense to be reported for book purposes but uses an accelerated method for tax purposes. In the early years, tax depreciation under the accelerated method will typically be larger than book depreciation under the straight-line method. During this period, a taxable, temporary difference originates. Tax depreciation will be less than book depreciation in the later years when the temporary difference reverses. Therefore, in any given year, the depreciation reported on the books will differ from that reported in the bank's tax returns. However, total depreciation taken over the useful life of the asset will be the same under either method.

Overinvestment

An over commitment in equipment and facilities can adversely affect earnings. A review of pertinent Uniform Bank Performance Report schedules will reveal how an institution compares to its peers in terms of total assets invested in premises and equipment, and the percent of operating income absorbed by occupancy expense. This information, though not in itself conclusive, can be a useful starting point in the analysis. Other considerations include the bank's business model and strategy. However, as long as commitments conform to state banking regulations and aggregate direct and indirect investments, including lease obligations, appear reasonable in relation to the institution's earnings performance and capacity, the decision as to what constitutes an appropriate fixed asset commitment should generally be left to management's discretion.

Fixed Asset Investments

A reasonable investment in premises and equipment is essential to conducting institution business. However, overinvestment in facilities or equipment may encumber capital and burden earnings. Consequently, many states impose limits on fixed asset investments. In order to keep their investments within statutory limits, some institutions have engaged in a variety of alternative arrangements, such as the organization of subsidiary or affiliate realty corporations, sale-leaseback transactions, and lease-purchase contracts. These arrangements are most common in connection with institution buildings, but in some instances are also used in connection with equipment.

The realty corporation arrangement typically calls for investment in a subsidiary corporation and capitalization by the bank of an amount within state limitations, with the subsidiary corporation financing the additional cost of banking facilities in the mortgage market. The facilities are then leased to the bank by the subsidiary corporation at a rent rate that usually coincides with the mortgage payments. In one type of affiliate setup, a group of the bank's directors may form a corporation to hold title to the property and lease it to the bank.

Examiners should determine whether any arrangements or transactions concerning fixed assets involve insiders and, if so, that such transactions are on substantially the same terms as those prevailing at the time for comparable transactions with non-insiders and do not involve more than normal risk or present other unfavorable features to the institution. In addition, examiners should consider whether insiders' use of institution owned/leased facilities and equipment (including vehicles) is prudent and in accordance with banking laws and employment agreements.

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FIXED ASSET INSURANCE

Basic insurance policies and extended coverage endorsements typically provide coverage of risks caused by fire, lightning, explosion, windstorm, hail, civil unrest, aircraft or vehicle damage, etc. Broad form property insurance includes coverage for the risks identified in basic policies and adds additional coverage for falling objects, weight of ice, sleet, or snow, and accidental water damage.

The most common form of property insurance is special coverage, or *all risk* insurance. Special coverage policies may provide the best overall risk protection; however, the number and type of items excluded from coverage can be numerous. Typical exclusions include damage caused by government action, nuclear hazard, wars, floods, fungus, and pollution.

Regardless of the type of property insurance policies a bank carries, examiners should assess whether management thoroughly understands, periodically reviews, and documents their analysis of the adequacy of their institution's insurance coverage.

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EXAMINATION PROCEDURES

The Other Assets and Liabilities Examination Documentation Module includes examination procedures regarding the evaluation of the reasonableness of investment in premises and equipment.

OTHER REAL ESTATE

OTHER REAL ESTATE

Other real estate (ORE), also referred to as Other Real Estate Owned (OREO), consists of real property held for reasons other than to conduct the s business of the bank or savings association (referred to as "institutions"). Institutions usually acquire ORE through foreclosure after a borrower defaults on a loan secured by real estate. Most states have laws governing the acquisition and retention of such assets.

Examiners should determine whether management establishes appropriate policies and procedures for acquiring, holding, and disposing of ORE. Prudent management establishes policies and procedures that generally:

- Protect the institution's interests in ORE while mitigating the impact on surrounding property values,
- Ensure ORE is accounted for in conformance with U.S. generally accepted accounting principles (GAAP) and Call Report Instructions, and
- Assure the institution's compliance with federal and state laws pertaining to holding ORE.

For regulatory reporting purposes, ORE includes:

- All real estate, other than institution premises, actually owned or controlled by the institution and its consolidated subsidiaries, including real estate acquired through foreclosure or deed in lieu of foreclosure, even if the institution has not yet received title to the property;
- Real estate collateral in an institution's possession, regardless of whether formal foreclosure proceedings have been initiated;
- Property originally acquired for future expansion but no longer intended for that purpose; and
- Foreclosed real estate transferred, but not meeting the requirements for sales accounting under the revenue recognition standard.[1]

Maintaining Other Real Estate

Section 39 of the Federal Deposit Insurance Act, *Standards for Safety and Soundness*, requires each federal banking agency to establish safety and soundness standards for all insured depository institutions. Appendix A to Part 364 of the FDIC Rules and Regulations, *Interagency Guidelines Establishing Standards for Safety and Soundness*, sets out the safety and soundness standards that the agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Operational and managerial safety and soundness standards pertaining to asset quality require institutions to identify problem assets and prevent deterioration in those assets. Institutions should maintain and protect ORE from deterioration to maximize recovery values. Typical expenses incurred during the ORE holding period relate to maintenance, tax, insurance, and miscellaneous costs.

Examiners should assess whether management maintains ORE in a manner that complies with local property ordinances and fire codes. Other requirements, such as homeowner association covenants, may also require careful attention. Efforts to ensure an ORE property is maintained in a marketable condition not only improve an institution's ability to obtain the best price for the property, but also minimize liability and reputation risks.

Real estate taxes on ORE should be paid in a timely manner to avoid unnecessary penalties and interest.

Maintenance of adequate hazard and liability insurance helps mitigate the risk of loss due to unforeseen events during the holding period. Prudent management periodically reviews general insurance policies to determine the adequacy of hazard and liability coverage for ORE. Where adequate general coverage is not in place, management may obtain policies on each parcel of ORE. If an institution decides to self-insure, the decision is generally board approved and appropriately documented.

Examiners should also assess whether management implements reasonable procedures for managing other miscellaneous expenses the institution may incur during the ORE holding period. These expenses could include, but are not limited to, sewer and water fees, utility charges, property management fees, and interest on prior liens.

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OTHER REAL ESTATE ACCOUNTING

The accounting and reporting standards for the receipt and holding of foreclosed real estate are set forth in ASC Subtopic 310-20, *Receivables – Nonrefundable Fees and Other Costs*, and ASC Topic 360, *Property, Plant, and Equipment*. Subsequent to the issuance of ASC Topic 360, AICPA Statement of Position (SOP) No. 92-3, *"Accounting for Foreclosed Assets,"* was rescinded. However, certain provisions of SOP 92-3 were retained for regulatory reporting because the application of these provisions represents prevalent practice in the banking industry and is consistent with safe and sound banking practices and the

[1] Reference is to the "revenue recognition standard" in ASC Topic 606, *Revenue from Contracts with Customers* and ASC Subtopic 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*.

accounting objectives set forth in Section 37(a) of the Federal Deposit Insurance Act. These specific provisions are included in the glossary entry “Foreclosed Assets” in the Call Report Instructions.

ASC Subtopic 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets* is the standard for transfers of most nonfinancial assets, including ORE. ASC Subtopic 610-20 requires the application of specified portions of ASC Topic 606, *Revenue from Contracts with Customers* to an institution’s sale of foreclosed real estate.

Carrying Value

Call Report Instructions provide that foreclosed real estate received in full or partial satisfaction of a loan be recorded at the fair value less cost to sell the property. This fair value (less cost to sell) becomes the "cost" of the foreclosed real estate. If the amortized cost of the loan exceeds the "cost" of the property, the difference is a loss which must be charged to the Allowance for Credit Losses (ACL) for loans and leases at the time of foreclosure or repossession. However, if an asset is sold shortly after it is received in a foreclosure or repossession, it may be appropriate to substitute the value received in the sale (net of the cost to sell the property) for the fair value, with any adjustments made to losses previously charged against the ACL for loans and leases.

The amortized cost of a loan is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount and net deferred fees or costs, collection of cash, charge-offs, foreign exchange, and fair hedge accounting adjustments. An asset received in full or partial satisfaction of a loan should be accounted for at its fair value less cost to sell, and the loan’s amortized cost should be reduced by the fair value (less cost to sell) of the asset at the time of receipt. Legal fees and other direct costs incurred by the institution in a foreclosure should be expensed as incurred.

After foreclosure, each foreclosed real estate parcel must be carried at the lower of (1) the fair value of the real estate minus the estimated costs to sell the real estate or (2) the “cost” of the real estate. If the real estate’s fair value minus the estimated costs to sell the real estate is less than its “cost,” the deficiency must be recognized as a valuation allowance against the real estate which is created through a charge to expense. The valuation allowance should thereafter be increased or decreased (but not below zero) for changes in the real estate’s fair value or estimated selling costs.

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FINANCED SALES OF ORE

ASC Subtopic 610-20 requires the application of specified portions of ASC Topic 606, to an institution’s sale of ORE.

In determining the appropriate accounting for a transfer of ORE under ASC Topic 606, the institution assesses whether the buyer is a legal entity and if so, whether the selling institution has a controlling financial interest in the legal entity. If an institution determines that it has a controlling financial interest in the buying legal entity, it should not derecognize the ORE and should apply the guidance in ASC Topic 810, *Consolidation*. If a controlling financial interest in the buyer does not exist or the buyer is not a legal entity, which is typically the case for most sales of ORE, the entire gain or loss, if any, along with the derecognition of the ORE are recorded if certain requirements in ASC Topic 606 and ASC Subtopic 610-20 are met.

In determining whether gain or loss recognition is appropriate and, accordingly, whether the ORE should be derecognized, examiners will need to determine whether:

- A contract (within the meaning of the revenue recognition standard) exists for the transfer of ORE,
- The institution meets its performance obligations identified within the contract, and
- The institution uses the appropriate transaction price for calculating the gain or loss on the sales date.

These standards apply to all transfers of ORE, but greater judgement will generally be required when the transfer is seller-financed.

Evaluating the Existence of a Contract

In the context of an ORE sale or transfer, the transaction with the buyer must meet all the following criteria:

(a) The parties to the contract have approved the contract and are committed to perform their respective obligations;
(b) The institution can identify each party’s rights regarding the ORE to be transferred;
(c) The institution can identify the payment terms for the ORE to be transferred;
(d) The contract has commercial substance (that is, the risk, timing, or amount of the institution’s future cash flows is expected to change as a result of the contract); and
(e) It is probable that the institution will collect substantially all of the consideration to which it will be entitled in exchange for ORE that will be transferred to the buyer, i.e., the transaction price. In

evaluating whether collectability of an amount of consideration is probable, an institution shall consider only the buyer's ability and intention to pay that amount of consideration when it is due.

Although all five criteria require careful analysis for seller-financed sales of ORE, two criteria in particular could require significant judgment. These criteria are (a) the commitment of the parties to the contract to perform their respective obligations and (e) the probability of collecting the transaction price. When determining whether the buyer is committed to perform its obligations under criterion (a) and collectability under criterion (e), all facts and circumstances related to the buyer's ability and intent to pay the transaction price is generally evaluated, which may include:

- Amount of cash paid as a down payment;
- Existence of recourse provisions;
- Credit standing of the buyer;
- Age and location of the property;
- Cash flow from the property;
- Payments by the buyer to third parties;
- Other amounts paid to the selling institution, including current or future contingent payments;
- Transfer of non-customary consideration (i.e., consideration other than cash and a note receivable);
- Other types of financing involved with the property or transaction;
- Financing terms of the loan (reasonable and customary terms, amortization, any graduated payments, any balloon payment);
- Underwriting inconsistent with the institution's underwriting policies for loans not involving ORE sales; and
- Future subordination of the selling institution's receivable.

While there are no longer prescriptive minimum down payment requirements, the amount and character of a buyer's equity (typically the down payment) and recourse provisions remain important factors when evaluating seller-financed ORE. Specifically, the buyer's initial equity in the property immediately after the sale is an important consideration in determining whether a buyer is committed to perform its obligations.

All relevant information is generally weighed collectively in evaluating whether the five contract criteria have been met when determining the appropriate accounting for a seller-financed ORE. As such, a transaction with an insignificant down payment and nonrecourse financing generally would not meet the definition of a contract unless there is considerable support from other factors, such as very low risk of default and the buyer's expertise in operating the business or property.

If the five contract criteria have not been met, the institution generally may not derecognize the ORE, or recognize revenue (gain or loss) as an accounting sale has not occurred. Assessment of the transaction should continue to determine whether the contract criteria have been met in a later period. Until all criteria are met, any consideration received from the buyer should be recorded as a deposit liability.[2] In circumstances where a sale is not recognized and the transaction price is less than the carrying amount of the ORE, examiners should consider whether the decline in fair value of the ORE should be recognized as a valuation allowance, or an increase in an existing valuation allowance.

Evaluating the Performance Obligations

If the five contract criteria have been met, the institution determines whether it has satisfied its performance obligations as identified in the contract by transferring control of the ORE to the buyer. Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from the asset (e.g., ORE). Indicators of the transfer of control include the following:

(a) The institution has a present right to payment for the asset,
(b) The buyer has legal title to the asset,
(c) The institution has transferred physical possession of the asset,
(d) The buyer has the significant risks and rewards of ownership of the asset, and
(e) The buyer has accepted the asset.

For seller-financed sales of ORE, the transfer of control generally occurs on the closing date of the sale when the institution obtains the right to receive payment for the ORE and transfers legal title to the buyer. However, all relevant facts and circumstances must be considered in determining whether control of the ORE has transferred, which may also include the selling institution's:

- Involvement with the property following the transaction,
- Obligation to repurchase the property in the future,
- Obligation to provide support for the property following the sale transaction, and
- Retention of an equity interest in the property.

[2] Although ASC Topic 606 describes the consideration received (including any cash payments) using such terms as "liability," "deposit," and "deposit liability," for regulatory reporting purposes these amounts should be reported as an other liability, and not as a deposit.

In particular, if an institution has an obligation or right to repurchase the ORE, the buyer does not obtain control of the property because the buyer is limited in its ability to direct the use of, and obtain, substantially all of the remaining benefits from the asset even though the buyer may have physical possession. In this situation, an institution should account for the contract as a lease in accordance with ASC Topic 842, Leases, or as a financing in accordance with the revenue recognition standard.

Situations may exist where the selling institution has legal title to the ORE, while the borrower whose property was foreclosed upon under the original loan still has redemption rights to reclaim the property in the future. If such redemption rights exist, the selling institution may not be able to transfer control to the buyer of the ORE and recognize revenue until the redemption period expires.

Only when a contract exists and an institution has transferred control of the property, can the institution derecognize the ORE and recognize a gain or loss on the transaction.

Transaction Price

The transaction price in a sale of ORE is generally the contract amount in the purchase/sale agreement if the seller-financed agreement is at market terms. However, the transaction price may differ from the amount stated in the contract due to the existence of a significant financing component. Under the revenue recognition standard, a significant financing component exists if the timing of the buyer's payments explicitly or implicitly provides the selling institution or the buyer with a significant benefit of financing the transfer of the ORE (e.g., a below market rate). A seller-financed transaction of ORE at off-market terms generally indicates the existence of a significant financing component. If a significant financing component exists, the contract amount in the purchase/sale agreement should be adjusted for the time value of money to reflect what the cash selling price of the ORE would have been at the time of its transfer to the buyer. The discount rate used in adjusting for the time value of money should be a market rate of interest considering the credit characteristics of the buyer and the terms of the financing. The transaction price or the adjusted transaction price, when appropriate, is used for determining the gain or loss, if any, on the transfer of ORE.

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VALUATIONS AND CLASSIFICATION

Many states require institutions to obtain appraisals or evaluations when acquiring, holding, and disposing of real estate. Management should obtain appraisals or evaluations as required to ensure assets are reported at appropriate values and that any material change in market conditions or physical property aspects is periodically recognized. If an institution is selling and financing the sale of an ORE parcel, Part 323 of the FDIC Rules and Regulations, governing appraisals, and some state laws require updated appraisals or evaluations.

Examiners can test the general validity of appraised values by comparing the sale prices and appraised values of properties previously held. The fact of foreclosure is presumptive, but not conclusive, evidence that takeover value exceeds market or appraised value. Therefore, each parcel of ORE is reviewed and classified on its own merits.

Often a reliable appraisal may not be available or the appraisal on file may be suspect for various reasons. Nevertheless, a careful evaluation of all the relevant factors should enable the examiner to make an accurate and reliable judgment about a property's fair value less cost to sell with regard to classification. Any portion of the carrying value in excess of fair value less cost to sell should be classified Loss. However, any amount classified Loss in the report of examination should not be charged-off by the institution, rather the Loss should be recognized as a valuation allowance, or an increase in an existing valuation allowance. The remaining carrying value should then be evaluated and adversely classified, as appropriate. Regulatory definitions of Substandard, Doubtful, and Loss (as discussed in this manual's Section 3.2 - Loans) should be used in the analysis of ORE holdings.

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ORE VALUATION ALLOWANCE

As previously mentioned, a valuation allowance is established for each parcel of ORE during the holding period when the real estate's fair value minus the estimated costs to sell the real estate is less than the real estate's "cost." Call Report Instructions clarify that valuation allowances must be determined on an asset-by-asset basis. As a result, the individual valuation allowance should be subtracted from the related asset's "cost" to determine the property's carrying value, which is the amount subject to classification.

Valuation allowances on foreclosed properties being held for sale are not recognized as a component of regulatory capital. The risk-based capital standards that apply to non-Community Bank Leverage Ratio institutions permit only the "adjusted allowance for credit losses" to be included in Tier 2 capital up to a maximum of 1.25% of risk-weighted assets. Advanced approaches institutions must also comply with Part 324 of the FDIC Rules and Regulations, section 324.10(d)(3)(ii)(B).

OTHER ASSETS AND LIABILITIES

INTRODUCTION

Assets and liabilities that are not reported in major balance sheet categories are generally reported in other asset or other liability categories. Although these items are listed in "other" categories, it does not mean the accounts are of less significance than items detailed in major categories. Intangible assets lack physical substance and are also reported separately on the balance sheet. The following pages include descriptions of common other assets, intangible assets, and other liabilities. Additional guidance and information is included in the Call Report Instructions and the Examination Documentation (ED) Module - Other Assets and Liabilities.

OTHER ASSETS

Accrued Income

All banks, regardless of size, shall prepare the Call Report on an accrual basis. Accrued income represents the amount of interest earned or accrued on earning assets and applicable to current or prior periods that has not yet been collected. Examples include accrued interest receivable on loans and investments. When income is accrued but not yet collected, a bank debits a receivable account and credits an applicable income account. When funds are collected, cash or an equivalent is debited, and the receivable account is credited.

The degree to which accrual accounts and practices are reviewed during an examination should be governed by the examination scope. When scoping examination procedures, examiners should consider the adequacy of a bank's internal control structure and the extent to which accrual accounting procedures are analyzed during audits.

When reviewing accrual accounts and practices, examiners should assess the general accuracy of the accrual accounting system and determine if accruals relate to items in default or to items where collection is doubtful. If accrued income accounts are materially overstated, examiners should consider the impact to overall profitability levels, classify overstated amounts as Loss, and recommend management amend Call Reports.

Tax Assets

Banks must estimate the amount of the current income tax liability (or receivable) to be reported on its tax returns. Estimating this liability (or receivable) may involve consultation with the bank's tax advisers, a review of the previous year's tax returns, the identification of significant expected differences between items of income and expense reflected on the Call Report and on the tax returns, and the identification of expected tax credits.

Deferred tax assets and liabilities represent the amount by which taxes receivable (or payable) are expected to increase or decrease in the future as a result of temporary differences and net operating losses or tax credit carryforwards that exist at the reporting date. When determining the current and deferred income tax assets and liabilities to be reported in any period, a bank's income tax calculation will contain an inherent degree of uncertainty surrounding the realizability of the tax positions included in the calculation.

A net deferred tax asset is reported if a debit balance results after offsetting deferred tax assets (net of valuation allowance) and deferred tax liabilities measured at the report date for a particular tax jurisdiction. If the result for a particular tax jurisdiction is a net credit balance, then a net deferred tax liability is reported. A bank may report a net deferred tax debit, or asset, for one tax jurisdiction, such as for federal income tax purposes, and also report at the same time a net deferred tax credit, or liability, for another tax jurisdiction, such as for state or local income tax purposes.

Temporary differences arise when an institution recognizes income or expense items on the books during one period, but records them for tax purposes in another period. For example a deductible temporary difference is created when a provision for loan and lease losses is expensed in one period for financial reporting purposes, but deferred for tax purposes until the loans are charged off in a subsequent period.

A bank sustains an operating loss when deductions exceed income for federal income tax purposes. An operating loss in a year following periods when the bank had taxable income may be carried back to recover income taxes previously paid. Banks may carry back operating losses for two years. Generally, an operating loss that occurs when loss carrybacks are not available (e.g., when losses occur in a year following periods of losses) becomes an operating loss carryforward. Banks may carry operating losses forward 20 years.

Tax credit carryforwards are tax credits that cannot be used for tax purposes in the current year, but which can be carried forward to reduce taxes payable in a future period.

Deferred tax assets are recognized for operating loss and tax credit carryforwards just as they are for deductable temporary differences. However, a bank can only recognize the benefit of a net operating loss, or a tax credit carryforward, to the extent the bank determines that a valuation allowance is not necessary. A valuation allowance must be recorded, if needed, to reduce the amount of deferred tax assets to an amount that is more likely than not to be realized. Examiners should obtain management's analysis and support for any deferred tax asset and valuation allowance reported for financial reporting purposes. Examiners should refer to the Call Report Glossary for guidance on income taxes and may contact the regional accounting specialist for further guidance in cases involving significant amounts of net deferred tax assets.

Part 325 of the FDIC Rules and Regulations, Capital Maintenance (Part 325), establishes limitations on the amount of deferred tax assets that can be included in Tier 1 capital. The maximum allowable amount is limited to the lesser of: the amount of deferred tax assets dependent upon future taxable income expected to be realized within one year of the calendar quarter-end date, based on projected future taxable income for that year; or ten percent of the amount of Tier 1 capital that exists before certain deductions. Refer to Part 325 for more details.

Interest-Only Strips

Accounting standards for interest-only strips receivable are set forth in ASC 860, Transfers and Servicing (formerly FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as amended by FAS 156, Accounting for Servicing of Financial Assets, FAS 166, Accounting for Transfers of Financial Assets, and certain other standards). ASC 860 defines interest-only strips receivable as the contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset.

Financial assets such as interest-only strips receivable, that can contractually be prepaid or otherwise settled in such a way that the holder of the financial asset would not recover substantially all of its recorded investment do not qualify to be accounted for at amortized cost. Interest-only strips subsequently measured at fair value like available-for-sale securities are reported as other assets. Alternatively, interest-only strips may be reported as trading securities. Refer to the Call Report Instructions for additional details.

Equities without Readily Determinable Fair Values

An equity security does not have a readily determinable fair value if sales or bid-and-asked quotations are not currently available on a securities exchange registered with the Securities and Exchange Commission and are not publicly reported by the National Association of Securities Dealers Automated Quotations or the National Quotation Bureau. Equity securities that do not have readily determinable fair values may have been purchased by a bank or acquired for debts previously contracted, and may include items such as paid-in stock of a Federal Reserve Bank, stock of a Federal Home Loan Bank, and stock of a bankers' bank. Refer to the Call Report Instructions for additional details.

Bank-Owned Life Insurance Policies

The purchase of bank-owned life insurance (BOLI) can be an effective way for institutions to manage exposures arising from commitments to provide employee compensation and pre- and post-retirement benefits, and to protect against the loss of key persons.

Consistent with safe and sound banking practices, institutions must understand the risks associated with BOLI and implement a risk management process that provides for the identification and control of such risks. A sound pre-purchase analysis, meaningful ongoing monitoring program, reliable accounting process and accurate assessment of risk-based capital requirements are all components of a comprehensive risk management process.
The ability of state chartered banks to purchase life insurance is governed by state law. The safe and sound use of BOLI depends on effective senior management and board oversight. An institution's board of directors must understand the complex risk characteristics of the institution's insurance holdings and the role this asset plays in the institution's overall business strategy.

Each institution should establish internal policies and procedures governing its BOLI holdings, including guidelines that limit the aggregate cash surrender value (CSV) of policies from, any one insurance company, as well as the aggregate CSV of policies from all insurance companies. In general, it is not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25 percent of its Tier 1 capital. Therefore, an institution that plans to acquire BOLI in an amount that results in an aggregate CSV in excess of this concentration limit, or any lower internal limit, should gain prior approval from its board of directors or the appropriate board committee. In this situation, management is expected to justify that any increase in BOLI resulting in an aggregate CSV above 25 percent of Tier 1 capital does not constitute an imprudent capital concentration.

Management should conduct a thorough pre-purchase analysis to help ensure that the institution understands the risks, rewards, and unique characteristics of BOLI. The nature and extent of this analysis should be commensurate with the size and complexity of the potential BOLI purchases and should take into account existing BOLI holdings.

A comprehensive assessment of BOLI risks on an ongoing basis is especially important for an institution whose aggregate BOLI holdings represent a capital concentration. Management should analyze the financial condition of BOLI insurance carriers, review the performance of BOLI products, and report their findings to the board at least annually. More frequent reviews may be necessary if management anticipates additional BOLI purchases, a decline in an insurance carrier's financial condition, policy surrenders, or changes in tax laws that could affect BOLI products or performance.

Examiners should review the Interagency Statement on the Purchase and Risk Management of Life Insurance (Interagency Statement) when assessing an institution's BOLI program. Examiners should closely scrutinize risk management policies and controls associated with BOLI assets when an institution holds BOLI in an amount that approaches or exceeds 25 percent of Tier 1 capital. An institution holding life insurance in a manner inconsistent with safe and sound banking practices is subject to supervisory action. Where ineffective controls over BOLI risks exist, or the exposure poses a safety and soundness concern, supervisory action against the institution, may include requiring the institution to divest affected policies, irrespective of potential tax consequences.

ASC 325-30, Investments-Other – Investments in Insurance Contracts (formerly FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance, and Emerging Issues Task Force Issue No. 06-5, Accounting for Purchases of Life Insurance – Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4) addresses the accounting for BOLI. Only the amount that could be realized under an insurance contract as of the balance sheet date (that is, the CSV reported by the carrier, less any applicable surrender charges not reflected in the CSV) is reported as an asset. If a bank records amounts in excess of the net CSV of the policy, then the excess should be classified Loss.

For risk-based capital purposes, an institution that owns general account permanent insurance should apply a 100 percent risk weight to its claim on the insurance company. If an institution owns a separate account policy and can demonstrate that it meets certain requirements, it may choose to apply a look-through approach to the underlying assets to determine the risk weight. Refer to Call Report Instructions, the ED Module - Bank-Owned Life Insurance (BOLI), and the Interagency Statement for further details.

MISCELLANEOUS ASSETS

Miscellaneous assets that are not reported in major Balance Sheet or Other Asset categories should be reported separately under all other assets in the Call Report. Examples include derivative instruments held for purposes other than trading that have a positive fair value, computer software, and bullion. Some of the more common miscellaneous assets are described below.

Prepaid Expenses

Prepaid expenses are the costs that are paid for goods and services prior to the periods in which the goods or services are consumed or received. When the cost is prepaid, the payment is recorded as an asset because it represents a future benefit to the bank. In subsequent periods the asset is reduced (expensed) as the goods or services are used or rendered. At the end of each accounting period, the bank makes adjusting entries to reflect the portion of the cost that has expired during that period. The prepayment is often for a service for which the benefit is spread evenly throughout the year. As the service is provided, the prepaid expense is amortized to match the cost to the period it benefits. Examples of prepaid expenses include premiums paid for insurance, advance payments for leases or asset rentals, payments for stationery or other supplies that will be used over several months, and retainer fees paid for legal services to be provided over a specified period.

Examiners should ensure management accurately adjusts prepaid expenses to reflect exhausted purchased goods or services. Prepaid expenses that are recorded and amortized in accordance with generally accepted accounting principles should not be adversely classified. However, any prepaid expense that is overstated should be classified Loss.

Repossessed Personal Property

Repossessed personal property such as automobiles, boats, equipment, and appliances, represents assets acquired for debts previously contracted. A bank that receives assets from a borrower in full satisfaction of a loan, such as a receivable from a third party, an equity interest in the borrower, or another type of asset (except a long-lived asset that will be sold), will account for the asset at its fair value. An asset received in partial satisfaction of a loan should be accounted for as described above and the recorded amount of the loan should be reduced by the asset's fair value less the cost to sell. .Examiners should assess repossessed assets individually for possible adverse classification.

Suspense Accounts

Suspense accounts, also known as interoffice or clearing accounts, are temporary holding accounts in which items are carried until they can be identified and their disposition to the proper account is made. For example, items are included in suspense accounts when a transaction is coded incorrectly and cannot be processed immediately, when an account number is missing on a loan or deposit transaction, or when a check drawn on a deposit account at the bank is not properly endorsed. Most suspense items are researched and cleared the following day. The balances of suspense accounts as of the report date should not automatically be reported as Other Assets or Other Liabilities. Rather, the items included in these accounts should be reviewed and material amounts should be reported appropriately in the Call Report. Moreover, banks should regularly reconcile suspense accounts. Stale suspense items should be charged off when it is determined that they are uncollectible and should be classified Loss in the report of examination.

Cash Items Not In Process Of Collection

In contrast to those cash items that are in process of collection, cash items that are not paid when presented are referred to as cash items that are not in the process of collection. In general, cash items that are not in the process of collection occur when the paying bank has refused payment after being presented with the cash item. Once payment has been refused, the cash item immediately becomes not in process of collection and is reclassified as an Other Asset. Cash items not in the process of collection are frequently kept in a suspense account. Although collection efforts will continue, when it becomes clear that the cash item will not be paid, the bank should promptly charge off the cash item. It is common for the payee bank to refuse payment if the customer's deposit account had insufficient funds, the check was improperly endorsed, the checking account on which the check is drawn has been closed, or for some other acceptable reason.

Other Accrued Interest Receivables

Accrued interest on securities purchased (if accounted for separately from accrued interest receivable in the bank's records) and retained interests in accrued interest receivable related to securitized credit cards is reported in all other assets in the Call Report. Accrued interest receivable amounts that are overstated should be classified Loss.

In a typical credit card securitization, an institution transfers a pool of receivables and the right to receive the future collections of principal (credit card purchases and cash advances), finance charges, and fees on the receivables to a trust. If a securitization transaction qualifies as a sale, then the selling institution removes the receivables that were sold from its reported assets and continues to carry any retained interests in the transferred receivables on its balance sheet. An institution should treat this accrued interest receivable asset as a retained (subordinated) beneficial interest. Accordingly, it should be reported in all other assets in the Call Report and not as a loan receivable.

For further guidance refer to the Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations and the Call Report Instructions.

Indemnification Assets

Indemnification assets represent the carrying amount of the right to receive payments from the FDIC for losses incurred on specified assets acquired from failed insured depository institutions or otherwise purchased from the FDIC that are covered by loss-sharing agreements. Despite the linkage between them, the acquired covered assets and the indemnification asset, are treated as separate units of account. Each covered asset is reported in the appropriate category on the balance sheet. The indemnification asset is recorded at its acquisition-date fair value and is reported in all other assets in the Call Report.

Examiners should ensure the acquiring institution's financial and regulatory reporting is appropriate for the covered assets and the indemnification asset. Refer to the Call Report Instructions for further details.

INTANGIBLE ASSETS

Goodwill and Other Intangible Assets

Goodwill is an intangible asset that is commonly recognized as a result of a business combination. .Other intangible assets resulting from a business combination, such as core deposit intangibles, purchased credit card relationships, servicing assets, favorable leasehold rights, trademarks, trade names, internet domain names, and non-compete agreements, should be recognized as an asset separately from goodwill. This discussion will focus on intangible assets acquired through business combinations.

Goodwill represents the excess of the cost of a company over the sum of the fair values of the tangible and identifiable intangible assets acquired less the fair value of liabilities assumed in a business combination accounted for in accordance with ASC 805, Business Combinations (formerly FAS 141 (revised 2007), Business Combinations).

Push down accounting is the establishment of a new accounting basis for a bank in its separate financial statements as a result of it becoming substantially wholly owned via a purchase transaction or a series of purchase transactions. When push down accounting is applied, any goodwill is reflected in the separate financial statements of the acquired bank as well as in any consolidated financial statements of the bank's parent.

When measuring Tier 1 capital for regulatory capital purposes, institutions generally must deduct goodwill and other intangible assets (other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital). Refer to Part 325 for further information on the regulatory capital treatment of goodwill and intangible assets.

Accounting for Goodwill

After initial recognition, goodwill must be accounted for in accordance with ASC 350, Intangibles-Goodwill and Other (formerly FAS 142, Goodwill and Other Intangible Assets), which requires that goodwill be tested for impairment at least annually.

Goodwill is considered impaired when the amount of goodwill exceeds its implied fair value at the reporting unit level. An impairment loss must be recognized in earnings. After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill shall be its new accounting basis. Subsequent reversal of a previously recognized goodwill impairment loss is prohibited once the measurement of that loss is completed. Goodwill of a reporting unit must be tested for impairment annually and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Examples of such events or circumstances include a significant adverse change in the business climate, unanticipated competition, a loss of key personnel, and an expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed. In addition, goodwill must be tested for impairment after a portion of goodwill has been allocated to a business to be disposed.

A bank may not remove goodwill from its balance sheet, for example, by selling or upstreaming this asset to its parent holding company or another affiliate.

Other intangible assets that have indefinite useful lives should not be amortized but must be tested at least annually for impairment. Intangible assets that have finite useful lives must be amortized over their useful lives and must be reviewed for impairment.

Refer to the Call Report Instructions for further details.

Servicing Assets

The right to service assets is represented by the contractual obligations undertaken by one party to provide servicing for mortgage loans, credit card receivables, or other financial assets for another. Servicing includes, but is not limited to, processing principal and interest payments, maintaining escrow accounts for the payment of taxes and insurance, monitoring delinquencies, and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicers typically receive certain benefits from the servicing contract and incur the costs of servicing the assets.

Servicing is inherent in all financial assets; however, it becomes a distinct asset or liability only when contractually separated from the underlying financial assets by sale or securitization with servicing retained or by a separate purchase or assumption of the servicing rights and responsibilities. Whenever an institution undertakes an obligation to service financial assets, a servicing asset or liability must be recognized unless the institution securitizes the assets, retains all of the resulting securities, and classifies the securities as held-to-maturity.

Accounting

Accounting and reporting standards for asset and liability servicing rights are set forth in ASC 860-50, Transfers and Servicing – Servicing Assets and Liabilities (formerly FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as amended by FAS 156, Accounting for Servicing of Financial Assets, and FAS 166, Accounting for Transfers of Financial Assets), and ASC 948, Financial Services-Mortgage Banking (formerly FAS 65, Accounting for Certain Mortgage Banking Activities, as amended by FAS 140).. Servicing assets result from contracts to service financial assets for which the servicing benefits (revenues from contractually specified servicing fees, late charges, and other ancillary sources) are expected to more than adequately compensate the servicer. Contractually specified servicing fees are all amounts that, per contract, are due to a servicer in exchange for servicing the financial assets and which would no longer be received by a servicer if the contract for servicing were shifted to another servicer.

A bank must recognize and initially measure at fair value a servicing asset or a servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in either of the following situations:

- The bank's transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset that meets the requirements for sale accounting; or
- An acquisition or assumption of a servicing obligation that does not relate to financial assets of the bank or its consolidated affiliates included in the Call Report.

If a bank sells a participating interest in an entire financial asset, it only recognizes a servicing asset or servicing liability related to the participating interest sold.

A bank should subsequently measure each class of servicing assets and servicing liabilities using either the amortization method or the fair value measurement method. Once a bank elects the fair value measurement method for a class of servicing, that election must not be reversed.

Under the amortization method, all servicing assets or servicing liabilities in the class should be amortized in proportion to, and over the period of, estimated net servicing income for assets (servicing revenues in excess of servicing costs) or net servicing loss for liabilities (servicing costs in excess of servicing revenues). The servicing assets or servicing liabilities should be assessed for impairment or increased obligation based on fair value at each quarter-end Call Report date. The servicing assets within a class should be stratified into groups based on one or more of the predominant risk characteristics of the underlying financial assets. If the carrying amount of a stratum of servicing assets exceeds its fair value, the bank should separately recognize impairment for that stratum by reducing the carrying amount to fair value through a valuation allowance for that stratum. The valuation allowance should be adjusted to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. For the servicing liabilities within a class, if subsequent events have increased the fair value of the liability above the carrying amount of the servicing liabilities, the bank should recognize the increased obligation as a loss in current earnings.

Under the fair value measurement method, all servicing assets or servicing liabilities in a class should be measured at fair value at each quarter-end report date. Changes in the fair value of these servicing assets and servicing liabilities should be reported in earnings in the period in which the changes occur.

Institutions that sell only a limited number of financial assets with servicing retained and do not otherwise actively purchase or sell servicing rights may determine that the servicing activity is immaterial. Typically, these institutions will have a relatively low volume of financial assets serviced for others and the value of any servicing assets and liabilities would likewise be immaterial. Management must provide a reasonable basis for not reporting servicing activity. Refer to the Servicing Liabilities section below and the Call Report Instructions for further details.

Valuation

The fair value of servicing assets and liabilities is determined in accordance with ASC 820, Fair Value Measurements and Disclosures (formerly FAS 157, Fair Value Measurements) that defines fair value and establishes a framework for measuring fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the asset's or liability's principal (or most advantageous) market at the measurement date. This value is often referred to as an exit price. ASC 820 establishes a three level fair value hierarchy that prioritizes inputs used to measure fair value based on observability. The highest priority is given to Level 1 (observable, unadjusted) and the lowest priority to Level 3 (unobservable).

Valuation techniques consistent with the market approach, income approach, and/or cost approach should be used to measure fair value, as follows:

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.

The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multi period excess earnings method.

The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

When the discounted cash flow approach is used to measure the fair value of servicing assets, a number of factors and assumptions are considered when projecting the potential income stream (net of servicing costs) generated by the servicing rights. This income stream is present valued using appropriate market discount rates to determine the estimated fair value of the servicing rights. These factors and assumptions, which should be adequately documented, include:

- Average loan balance and coupon rate,
- Average portfolio age and remaining maturity,
- Contractual servicing fees,
- Estimated income from escrow balances,
- Expected late charges and other possible ancillary income,
- Anticipated loan balance repayment rate (including estimated prepayment speeds),
- Direct servicing costs and appropriate allocations of other costs, as well as the inflation rate effect, and
- Delinquency rate and estimated out-of-pocket foreclosure and collection costs that will not be recovered.

Regulatory Capital

Part 325 provides information on the regulatory capital treatment of mortgage servicing assets and nonmortgage servicing assets.

For purposes of calculating Tier 1 capital, the balance sheet assets for mortgage servicing assets and nonmortgage servicing assets will each be reduced to an amount equal to the lesser of:

- 90 percent of the fair value of these assets; or
- 100 percent of the remaining unamortized book value of these assets (net of any related valuation allowances).

The total amount of mortgage servicing assets, nonmortgage servicing assets, along with purchased credit card relationships recognized for regulatory purposes (i.e., not deducted from assets and capital) is limited to no more than 100 percent of Tier 1 capital. In addition to the aggregate limitation on such assets, the maximum allowable amount of purchased credit card relationships and nonmortgage servicing assets, when combined, is limited to 25 percent of Tier 1 capital. These limitations are calculated before the deduction of any disallowed servicing assets, disallowed purchased credit card relationships, disallowed credit-enhancing interest-only strips, disallowed deferred tax assets, and any nonfinancial equity investments. In addition, banks may elect to deduct disallowed servicing assets on a basis that is net of any associated deferred tax liability.

Servicing Risk

Examiners should be aware of the risks that can affect an institution from the failure to follow the servicing rules related to securitized assets. While credit risk may appear to be of little or no concern, the mishandling of procedures in these transactions can affect a holder's ability to collect. Financial institutions perform roles as sellers, buyers, servicers, trustees, etc., in these types of transactions. Examiners should evaluate the potential risks that might arise from one or more of these roles. In most cases, the government agency that provided the guarantee or insurance against ultimate default will also impose guidelines and regulations for the servicer to follow. If the servicer or others involved in the servicing function fail to follow these rules and guidelines, then the government agency that is providing the guarantee or insurance may refuse to honor its commitment to insure all parties against loss due to default. It is necessary for the financial institution to have adequate policies and procedures in place to control and limit the institution's liability and exposure in this regard.

Examination Procedures

When assessing asset quality during onsite examinations and when reviewing merger applications, examiners and supervisory personnel should review the valuation and accounting treatment of servicing assets. The ED Module - Mortgage Banking contains various examination procedures and references for reviewing mortgage servicing assets.

OTHER LIABILITIES

Other Borrowed Money

Mortgages, liens, and other encumbrances on premises and other real estate owned, and obligations under capitalized leases, which the bank is legally obligated to pay, are reported as other borrowed money in the Call Report. Regardless of the mortgage amount outstanding on bank premises, the asset should be carried on the general ledger at historical cost net of accumulated depreciation. ASC 840 establishes generally accepted accounting principles regarding lease transactions that must be accounted for as a property acquisition financed with a debt obligation

Additional information on premises and leases is included in the Premises and Equipment section of this Manual.

Accrued Expenses

Expenses are also reported in the Call Report on the accrual basis of accounting that records revenues when realized or realizable and earned, and expenses when incurred. This attempt to match expenses incurred during a period to the revenues that they helped generate is known as the matching principle. At the end of each reporting period, but no less frequently than quarterly, bank management needs to make appropriate entries to record accrued expenses. Interest on deposits accrued through charges to expense during the current or prior periods, but not yet paid or credited to a deposit account, are reported as other liabilities in the Call Report. Likewise, the amount of income taxes, interest on nondeposit liabilities, and other expenses accrued through charges to expense during the current or prior periods, but not yet paid, are reported as other liabilities.

Servicing Liabilities

As noted under Servicing Assets, servicers typically receive certain benefits from a servicing contract and incur costs of servicing the assets. The accounting and reporting standards addressing servicing rights (i.e., assets and liabilities) are set forth in ASC 860-50. Servicing liabilities result from contracts to service financial assets for which the benefits of servicing are not expected to adequately compensate the servicer. Banks must initially measure a servicing liability at fair value and subsequently measure each class of servicing liabilities using either the amortization method or the fair value measurement method. The election of the subsequent measurement method should be made separately for each class of servicing liabilities. Refer to the Call Report Instructions for further details.

Deferred Tax Liabilities

As noted under Tax Assets, a net deferred tax liability is reported if a net credit balance results after offsetting deferred tax assets (net of valuation allowance) and deferred tax liabilities measured at the report date for a particular tax jurisdiction. A bank may report a net deferred tax debit, or asset, for one tax jurisdiction, and also report at the same time a net deferred tax credit or liability, for another tax jurisdiction.

Deferred tax liabilities are recognized for taxable temporary differences. For example, depreciation can result in a taxable temporary difference if a bank uses the straight-line method to determine the amount of depreciation expense to be reported in the Call Report but uses an accelerated method for tax purposes. In the early years, tax depreciation under the accelerated method will typically be larger than book depreciation under the straight-line method. During this period, a taxable temporary difference originates. Tax depreciation will be less than book depreciation in the later years when the temporary difference reverses. Other taxable temporary differences include the undistributed earnings of unconsolidated subsidiaries and associated companies and amounts funded to pension plans that exceed the recorded expense.

Allowance for Off-Balance Sheet Exposures

Each bank should maintain, as a separate liability account, an allowance at a level that is appropriate to cover estimated credit losses associated with off-balance sheet credit instruments such as loan commitments, standby letters of credit, and guarantees. This separate allowance should be reported as an other liability, not as part of the allowance for loan and lease losses. The allowance for credit losses on off-balance sheet exposures should meet the criteria for accrual of a loss contingency set forth in generally accepted accounting principles.

All Other Miscellaneous Liabilities

Examiners will encounter other miscellaneous liabilities not reported in major Balance Sheet or Other Liability categories that should be reported separately in all other liabilities in the Call Report. Examples include accounts payable, deferred compensation payable, dividends declared but not yet paid, and derivative instruments held for purposes other than trading that have a negative fair value.

OFF-BALANCE SHEET ACTIVITIES

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 contacts 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).

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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.

MANAGEMENT

INTRODUCTION

The quality of management and the manner in which directors and senior management govern a bank's affairs are critical factors in the successful operation of a bank. For purposes of this section, the term *bank* includes all FDIC-supervised institutions and the *term management* includes the board of directors, which is elected by the shareholders, and executive or senior officers, who are appointed to their positions by the board. In the complex, competitive, and rapidly changing environment of financial institutions, it is extremely important for all members of bank management to be aware of their responsibilities and to discharge those responsibilities in a manner which will ensure stability and soundness of the institution, so that it may continue to provide to the community the financial services for which it was created.

The importance of a bank director's position is emphasized by the fact that bank directors can, in certain instances, be held personally liable for violations of standards of conduct governing a director's responsibility for the operation and management of the bank as enacted by the governing jurisdiction for example, gross negligence or disregard for safety and soundness considerations threatening the financial safety of a bank. Also, Congress has placed great emphasis on the role of bank management by passing legislation which allows regulatory authorities to utilize formal cease and desist actions against institution affiliated parties (IAPs) to assess civil money penalties (CMPs), and/or to remove an officer, director, or other IAP from office or to prohibit any further participation by such party, in any manner, in the conduct of the affairs of any insured depository institution.

The board of directors is the source of all authority and responsibility. In the broadest sense, the board is responsible for formulation of sound policies and objectives of the bank, effective supervision of its affairs, and promotion of its welfare. The primary responsibility of executive management is implementation of the board's policies and objectives in the bank's day-to-day operations. While selection of competent executive management is critical to the successful operation of any bank, the continuing health, viability, and vigor of the bank are dependent upon an interested, informed, and vigilant board of directors. Therefore, the main thrust of this section is devoted to the powers, responsibilities, and duties vested in bank directors.

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MANAGEMENT/DIRECTORS

Selection and Qualifications of Directors

Selection to serve as a bank director is an honor. It often means an individual has a reputation as being successful in business or professional endeavors, is public spirited, and is deserving of public trust and confidence. It is this last attribute and the implied public accountability that distinguishes the office of bank director from directorships in most other corporate enterprises. Bank directors are not only responsible to the shareholders who elected them, but must also be concerned with the safety of depositors' funds, consequences to the Deposit Insurance Fund, and the influence the bank exercises on the community it serves.

Laws governing the election of board members emphasizing the importance of a director's position vary by state. Statutory or regulatory qualifications usually include taking an oath of office, unencumbered ownership of a specific amount of the bank's capital stock, and residential and citizenship requirements. There are federal laws pertaining to directors that have certain restrictions, prohibitions, and penalties relating to: interlocking directorates; purchases of assets from or sales of assets to directors; commissions and gifts for procuring loans; and criminal activities such as embezzlement, abstraction, willful misapplication, and making false entries.

These qualifications and restrictions have no counterpart in general corporate law, and both illustrate and emphasize the quasi-public nature of banking, the unique role of the bank director, and the grave responsibilities of that office. The position of bank director is one, therefore, not to be offered or entered into lightly.

Aside from the legal qualifications, each director should bring to the position particular skills and experience which will contribute to the composite judgment of the group.

The Statement Concerning the Responsibilities of Bank Directors and Officers[1] explains the key duties and character traits of a successful director. The essential attribute that allows a director to fulfill the duties of loyalty and care associated with the office is personal integrity. Personal integrity usually gives assurance that a director capable of assuming the important fiduciary responsibilities of the office will fairly and equitably represent the diverse interests of shareholders, depositors, and the general public. A prudent director will exhibit independent thoughts and have the courage to express them, sufficient time available

[1]See Statement Concerning the Responsibilities of Bank Directors and Officers (Dec. 3, 1992).

to fulfill their responsibilities, and be free of financial difficulties that could negatively reflect on the bank.

Other desirable personal characteristics include:

- Knowledge of the duties and responsibilities of the office;
- Genuine interest in performing those duties and responsibilities to the best of their ability;
- Capability to recognize and avoid potential conflicts of interest, or the appearance of same, which might impair their objectivity;
- Sound business judgment and experience to facilitate understanding of banking and banking problems;
- Familiarity with the community and trade area the bank serves and general economic conditions; and
- Independence in their approach to problem solving and decision making.

Powers, Duties and Responsibilities of Directors

The powers, duties and responsibilities of the board of directors are usually set forth in the applicable banking statutes and the bank's charter and bylaws. Generally speaking, the powers and responsibilities of bank directors include but are not limited to those discussed below.

Governing the Manner in Which All Business of the Bank is Conducted

Directors are responsible for providing a clear framework of risk appetite, strategic focus, objectives and general policies within which executive officers operate and administer the bank's affairs. These objectives and policies at a minimum, include written guidelines for such matters as investments, loans, asset/liability and funds management, profit planning and budgeting, capital planning, internal routine and controls, audit programs, conflicts of interest, code of ethics, and personnel. Policies for specialty areas, such as the Bank Secrecy Act (BSA), Information Technology (IT), Trust Department activities, and consumer compliance will also facilitate appropriate oversight. Objectives and policies that are written and reviewed periodically to determine that they remain applicable also demonstrate effective director oversight. Examiners may encounter situations (often in smaller banks with control vested in one or a few individuals) where written policies have not been developed for these operational functions, and management is reluctant to do so on the grounds that such written guidelines are unnecessary. To a considerable degree, the necessity for written policies may be inferred from the results achieved by management. That is, if the examiner's assessment of the bank reflects that it is sound and healthy in virtually every important respect, it may be difficult to convince management of the need for formalized written policies. However, when deficiencies are noted in one or more aspects of a bank's operations, it is nearly always the case that absence of written and clearly defined objectives, goals, performance standards, and limits of authority is an important contributing factor. Moreover, it is recognized that the depth and detail of written policies may properly vary among banks, depending on the nature, scope and complexity of their operations. Therefore, it remains the FDIC's strongly held belief that all banks should have written policies that are readily understood by all affected parties, kept up-to-date, and relevant to the institution's needs and circumstances. While it is acceptable for a bank to obtain written policies from an outside source, it is the responsibility of management to ensure that the policies are suited to their bank and that the policies accurately describe the bank's practices. The board of directors should give final approval of the substantial content of policies.

The policies and objectives of the directorate should include provisions for adherence to the Interagency Guidelines Establishing Standards for Safety and Soundness set forth in Part 364, Appendix A, of the FDIC Rules and Regulations. These standards set specific guidelines for the safe operation of banks in the following areas: internal controls and information systems; internal audit system; loan documentation; credit underwriting; interest rate exposure; asset growth; asset quality; earnings; and compensation, fees, and benefits. The specific provisions for each area are discussed in further detail within the appropriate sections of this Risk Management Manual of Examination Policies (Manual). Conformance to these standards may help identify emerging problems and correct deficiencies before capital becomes impaired. The standards, which should be viewed as minimum requirements, establish the objectives of proper operations and management, but leave specific methods of achieving these objectives to each institution.

Examiners should review the bank's conformance to the safety and soundness standards at each examination. The nature, scope and risk of the institution's activities should be considered when evaluating the adequacy of controls in each of the respective areas. Material deficiencies should be documented in appropriate sections of the Report of Examination.

Strategic Planning

A vital part of the responsibilities of directors is to set the future direction of the bank. The board and senior management face challenges and opportunities daily related to evolving economic and market conditions, competition, and innovation; along with emerging or unforeseen risks, such as cyber threats or natural disasters. Sound strategic planning is crucial to successful performance in the face of uncertainty and change. The strategic plan is a strategic vision of the board of directors on how the bank should operate. The planning time horizon will not be identical for every bank, but a three- to five-year planning horizon is generally satisfactory for most banks. To be effective, strategic planning decisions must be dynamic and updated as circumstances change.

The strategic planning process is unique to each bank, driven by its culture, mission, business model, risk appetite, resources available (including management talent), risk profile, size, geographic location, communities served, and other considerations. As a result, the formality of the strategic planning process will vary from bank to bank.

The most effective strategic planning process is one that is dynamic, carefully attended to, and well supported. Strategic plan projections are intended to be reviewed and revised periodically as circumstances change and new strategies devised to meet stated objectives. An increasingly competitive marketplace suggests that an inadequate or ill-conceived planning process may be as much the cause of bank failure as poor loans.

Examiners should consider the following when assessing the adequacy of the strategic planning process:

- How formal is the bank's planning process compared to the bank's business model, risk profile, size and complexity?
- Were the right people involved? The board? Middle management?
- Is the plan based on realistic assumptions regarding the bank's present and future financial condition, market area(s), and competitive factors?
- Does the bank monitor actual performance against its plan?
- Does the bank consider alternative plans in response to changing conditions?

In addition to an evaluation of the process, examiners should evaluate the reasonableness of the plan's assumptions. This assessment should take into account the personnel resources, financial resources, operating circumstances, and conditions unique to the bank being examined, including examination findings that would impact the bank's financial condition and ability to meet plan projections. Planning the future direction of the institution is, properly, the responsibility of the board of directors and not examiners. However, when the goals and objectives chosen by directors are likely to result in significant financial harm to the bank, examiners must identify the deficiencies in the plan and attempt to effect necessary changes through supervisory recommendations.

Examiners should consider the adequacy of the planning process and the plan itself when assigning the Management rating.

Selecting and Retaining Competent Management

It is a primary duty of a board of directors to select and appoint executive officers who have the skills, integrity, knowledge, and experience to administer the bank's affairs effectively and soundly. It is also the responsibility of the board to dispense with the services of officers who prove unable to meet reasonable standards of executive ability and efficiency.

An effective pre-employment screening program to appropriately vet candidates will help to ensure that the senior management team possesses a high level of integrity. Section 19 of the FDI Act prohibits any person convicted of certain criminal offenses from participating in the affairs of a bank without the prior written consent of the FDIC. Additionally, Section 32 of the FDI Act requires banks that are not in compliance with minimum capital requirements or are otherwise in a troubled condition to seek the FDIC's approval before hiring or appointing directors or senior executive officers.

Regular evaluation of the management and staffing structure helps the board to ensure that necessary positions and reporting lines are established and appropriate for bank's size, activities, complexity, and risk profile. Having these systems in place ensures there is accountability for key decisions and strategies. If the board is dissatisfied with the performance of senior management, the board should act quickly to find a qualified replacement if hiring senior management is necessary.

Personnel Administration

Recruiting, training, and personnel activities are vital to the development and continuity of a quality staff. Some features of good personnel administration are a designated organization structure, detailed position descriptions, carefully planned recruiting, appropriate training and developmental activities, a performance appraisal system, quality salary administration, and an effective communications network.

Observance of Applicable Laws

It is important for directors to ensure that executive management is cognizant of applicable laws and regulations; develop a system to effect and monitor compliance, which will likely include provisions for training and retraining personnel in these matters; and, when violations do occur, make corrections as quickly as possible. Board members cannot be expected to be personally knowledgeable of all laws and regulations, but they should ensure that compliance with all laws and regulations receives high priority and violations are not knowingly committed by themselves or anyone the bank employs.

Avoiding Self-Serving Practices

Although somewhat independent from the responsibility to provide effective direction and supervision, the need for directors to avoid self-serving practices and conflicts of interest is of no less importance. Bank directors must place performance of their duties above personal concerns. Wherever there is a personal interest of a director that is adverse to that of the bank, the situation clearly calls for the utmost fairness and good faith in guarding the interests of the bank. Accordingly, directors must never abuse their influence with bank management for personal advantage, nor wrongfully employ confidential information concerning the bank's clients. The same principles with respect to self-serving practices and conflicts of interest apply to the executive management of the bank. Refer to the Indebtedness of Directors, Officers and Their Interests and the Conflicts of Interest sections of this Chapter for additional discussion.

Paying Dividends

The board of directors has the responsibility of maintaining an adequately capitalized bank, and once this responsibility has been satisfied, the payment of dividends may receive consideration. Dividends represent the distribution of bank earnings to owners. Establishing the medium, rate, and date of payment must be based on the directors' overall assessment of the bank's financial condition. Refer to Section 2.1- Capital for additional information on payment of dividends.

Appropriate Internal Control System and Adequate Auditing Program

A sound framework of internal controls and a reliable and objective audit function are essential tools for bank directors. The existence of such enables directors to remain well informed of the adequacy, effectiveness, and efficiency of accounting, operating, and administrative controls and provides an assessment of the quality of ongoing operations. Establishment and oversight of such controls are the responsibility of the board of directors. Refer to the Internal Routines and Controls section for a complete discussion of these vital areas.

Management Information System (MIS)

The critical need for and dependence on information involves a concern and responsibility for the integrity of not only the specific information furnished, but the system that supplies it as well. Advances in technology have helped banks improve both information availability and models for analysis and decision making. Regardless of the technology employed, management is responsible for developing and implementing an information system that facilitates managerial activities. Examiners should review reports generated by the MIS to assess the quality and accuracy of the information being provided.

An effective MIS is comprised of information from a number of sources, and the information must serve a number of users, each having various needs. The MIS must selectively update information and coordinate it into meaningful and clear formats. One possible approach would be to combine information from the bank's accounting system with other internal sources, such as personnel records, and include information from external sources regarding economic conditions, characteristics of the marketplace and competition, technology, and regulatory requirements. Quality, quantity, and timeliness are factors that determine the effectiveness of management information systems.

Supervision by Directors

The board of directors is charged with conducting the affairs of the bank. However, this task may be delegated to senior officers, provided there is proper oversight. Supervision by directors does not necessarily indicate a board should be performing management tasks, but rather ensuring that its policies are being implemented and adhered to and its objectives achieved. It is the failure to discharge these supervisory duties that has led to the decline and failure of banks and personal liability of directors for losses incurred.

Directors' supervisory responsibilities can best be discharged by establishing procedures calculated to bring to their attention relevant and accurate information about the bank in a consistent format and at regular intervals and taking appropriate action in response to the information received. From this critical point, the remainder of a director's job unfolds. Directors who keep abreast of basic facts and statistics such as resource growth, capital growth, loan-to-deposit ratios, deposit mix, liquidity position, general portfolio composition, loan limits, loan losses and recoveries, delinquencies, etc., have taken a first, indispensable step in discharging their responsibilities. It is essential, therefore, that directors insist on receiving pertinent information about the bank in concise, meaningful, and written form, and it is one of executive management's most important responsibilities to make certain directors are kept fully informed on all important matters and that the record clearly reflects this.

Directors' meetings that are conducted in a businesslike and orderly manner are a significant aid to fulfillment of the board's supervisory responsibilities. This requires, among other things, regular attendance (whether in person or by remote access). Regular attendance at board and committee meetings demonstrate a director's commitment to stay informed about the bank's risks, business and operational performance, and competitive position in the marketplace. Generally, minutes of the board and committee meetings record the attendance of each director, other attendees, and directors' votes or abstentions. Prudent directors that dissent from the majority, will, for their own protection, insist upon their negative vote being recorded along with reasons for their action.

Careful and consistent preparation of an agenda for each board meeting not only assists in the conduct of such meetings, but also provides board members reasonable assurance that all important matters are brought to their attention. Agenda items will vary from bank to bank depending on asset size, type of business conducted, loan volume, trust activities, and so forth. In general, an appropriate agenda include reports on income and expenses; new, overdue, renewed, insider, charged-off, and recovered loans; investment activity; personnel; and individual committee actions.

To carry out its functions, the board of directors may appoint and authorize committees to perform specific tasks and supervise certain phases of operations. In most instances, the name of the committee, such as loan, investment, audit, and, if applicable, trust, identifies its duties. Of course, utilization of the committee process does not relieve the board of its fundamental responsibilities for actions taken by those groups. Review of the minutes of these committees' meetings is usually a standard part of the board meeting agenda.

Communication of facts to a board of directors is essential to sound and effective supervision. However, with the ever-broadening scope of modern banking and the increased complexity of banking operations, the ability of a board of directors to effectively supervise is becoming more difficult. Because of this, the use of outside personnel to provide management supervision is relatively common. While this practice does not release the board from its responsibilities, it does provide an opportunity for management improvement through the use of these external sources. The bank holding company can play a very large role in the supervision of its individual banks. Bank holding companies that control a number of banks may be able to provide individual banks' boards with lending and investment counseling, audit and internal control programs or services, profit planning and forecasting, personnel efficiency reports, electronic data processing services, marketing strategy and asset appraisal reports. Banks that do not operate within a holding company organization are also able to obtain management assistance from various firms offering the above services. In the interest of quality supervision by a bank's board of directors, the use of outside advisors, while not releasing the board from its responsibilities, can be a valuable management tool.

Legal Liabilities of Directors

In general, directors and other corporate officers of a bank may be held personally liable for: a breach of trust; gross negligence and recklessness which is the proximate cause of loss to the bank; ultra vires acts, or acts in excess of their powers; fraud; and misappropriation or conversion of the bank's assets. From the standpoint of imposing directors' liability where the facts evidence that fraud, misappropriation, conversion, breach of trust or commission of ultra vires acts is clearly shown, a relatively simple situation presents itself. Difficulties usually arise, however, in cases involving negligence (or breach of duty) which fall short of breach of trust or fraud.

Directors' liability for negligent acts is premised on common law for failure to exercise the degree of care prudent individuals would exercise under similar circumstances, and/or noncompliance with applicable statutory law, either or both of which cause loss or injury to the bank. Statutory liability is reasonably well defined and precise. Common law liability is somewhat imprecise because failure to exercise due care on the part of a director depends on the facts and circumstances of the particular case.

A director's duty to exercise due care and diligence extends to the management, administration, and supervision of the affairs of the bank and to the use and preservation of its assets. Perhaps the most common dereliction of duty by bank directors is the failure to maintain reasonable supervision over the activities and affairs of the bank, its officers, and employees. The actions and inactions listed below have been found to constitute negligence on the part of directors.

- An attitude of general indifference to the affairs of the bank, such as failing to hold meetings as required by the bylaws, obtain a statement of the financial condition of the bank, or examine and audit the books and records of the bank to determine its condition.
- Failure to heed warnings of mismanagement or defalcations by officers and employees and take appropriate action.

- Failure to adopt practices and follow procedures generally expected of bank directors.
- Turning over virtually unsupervised control of the bank to officers and employees relying upon their supposed fidelity and skill.
- Failure to acquaint themselves with examination reports showing the financial condition of a company to which excessive loans had been made.
- Assenting to loans in excess of applicable statutory limitations.
- Permitting large overdrafts in violation of the bank's internal policies or permitting overdrafts to insiders in violation of law.
- Representing certain assets as good in a Report of Condition when such assets were called to the directors' attention as Loss by the primary regulator and directions were given for their immediate collection or removal from the bank.

In the final analysis, liability of bank directors for acts of negligence rests upon their betrayal of those who placed trust and confidence in them to perform the duties of their office honestly, diligently, and carefully. While applicable principles involving directors' negligence (or breach of duty) are easy enough to state, their application to factual situations presents difficulties. In essence, the courts have judged the conduct of directors "not by the event, but by the circumstance under which they acted" (Briggs v. Spaulding, 141 U.S. 132, 155 (1890), 35 L.Ed. 662, 672). Courts also have generally followed what may be called the rule of reason in imposing liability on bank directors, "lest they should, by severity in their rulings, make directorships repulsive to the class of men whose services are most needed; or, by laxity in dealing with glaring negligences, render worthless the supervision of directors over...banks, and leave these institutions a prey to dishonest executive officers." (Robinson v. Hall, 63 F. 222, 225-226 (4th Cir. 1894)).

The following quotation represents a brief recapitulation of the law on the subject (Rankin v. Cooper, 149 F. 1010, 1013 (C.C.E.D. Ark. 1907):

> (1) Directors are charged with the duty of reasonable supervision over the affairs of the bank. It is their duty to use ordinary diligence in ascertaining the condition of its business, and to exercise reasonable control and supervision over its affairs. (2) They are not insurers or guarantors of the fidelity and proper conduct of the executive officers of the bank, and they are not responsible for losses resulting from their wrongful acts or omissions, provided they have exercised ordinary care in the discharge of their own duties as directors. (3) Ordinary care, in this matter as in other departments of the law, means that degree of care which ordinarily prudent and diligent men would exercise under similar circumstances. (4) The degree of care required further depends upon the subject to which it is to be applied, and in each case must be determined in view of all of the circumstances. (5) If nothing has come to the knowledge to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, upon the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required, and a want of that care makes them responsible. Directors cannot, in justice to those who deal with the bank, shut their eyes to what is going on around them. (6) Directors are not expected to watch the routine of every day's business, but they ought to have a general knowledge of the manner in which the bank's business is conducted, and upon what securities its larger lines of credit are given, and generally to know of and give direction to the important and general affairs of the bank. (7) It is incumbent upon bank directors in the exercise of ordinary prudence, and as a part of their duty of general supervision, to cause an examination of the condition and resources of the bank to be made with reasonable frequency.

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FEDERAL BANKING LAWS AND REGULATIONS PRIMARILY PERTAINING TO BANK DIRECTORS

Section 18(k) of the Federal Deposit Insurance Act (FDI Act) - Authority to Regulate or Prohibit Certain Forms of Benefits to Institution Affiliated Parties

Part 359 of the FDIC Rules and Regulations - Golden Parachutes and Indemnification Payments

Part 359, pursuant to Section 18(k), permits the FDIC to prohibit or limit, by regulation or order, golden parachute payments or indemnification payments. Refer to "Other Issues" within this section for additional information.

Section 39(c) of the FDI Act - Compensation Standards

This statute requires the FDIC to prohibit excessive compensation to executive officers, employees, directors, and principal shareholders as an unsafe and unsound practice. The definition of excessive compensation, as well as the specific prohibition required by Section 39(c), is found in Section III of Appendix A to Part 364, Standards for Safety and Soundness. Refer to “Other Issues” within this section for further information.

Section 32 of the FDI Act - Agency Disapproval of Directors and Senior Executive Officers of Insured Depository Institutions or Depository Institution Holding Companies

An insured depository institution or depository institution holding company must notify the appropriate Federal banking agency of the proposed addition of any individual to the board of directors or the employment of any individual as a senior executive officer of such institution or holding company at least 30 days (or such other period, as determined by the appropriate Federal banking agency), which period may be extended an additional 60 days for FDIC–supervised institutions, before such addition or employment becomes effective, if (i) the insured depository institution or depository institution holding company is not in compliance with the minimum capital requirements applicable to such institution or is otherwise in a troubled condition; or the agency determines, in connection with the review by the agency of the plan required under Section 38 or otherwise, that such prior notice is appropriate. *See also*, 12 CFR Part 303, Subpart F.

Section 19 of the FDI Act - Penalty for Unauthorized Participation by Convicted Individual

Section 19 of the FDI Act prohibits, without the prior written consent of the FDIC, a person convicted of any criminal offenses involving dishonesty or breach of trust or money laundering, or who has entered into a pretrial diversion or similar program in connection with a prosecution for such offense, from becoming or continuing as an institution-affiliated party (IAP), owning or controlling, directly or indirectly, an insured institution, or otherwise participating, directly or indirectly, in the conduct of the affairs of an insured institution.

The intent of Section 19 is not punitive. Rather, the purpose is to provide the applicant an opportunity to demonstrate that a person is fit to participate in the conduct of the affairs of an institution without posing a risk to its safety and soundness or impairing public confidence in that institution. The FDIC’s policy is to approve applications in which this risk is absent. For additional information, refer to Subpart L of Part 303 of the FDIC Rules and Regulations.

Section 22(g) and 22(h) of the Federal Reserve Act - Loans to Executive Officers of Banks and Extensions of Credit to Executive Officers, Directors and Principal Shareholders of Member Banks

The Federal Reserve Board’s Regulation O – Loans to Executive Officers, Directors and Principal Shareholders of Member Banks

Section 337.3 of the FDIC Rules and Regulations – Limits on Extensions of Credit to Executive Officers, Directors and Principal Shareholders of Insured Nonmember Banks

Sections 22(g) and 22(h) are made applicable to nonmember insured banks via Section 18(j)(2) of the FDI Act and pertain to loans and extensions of credit by both member and nonmember banks to their executive officers, directors, principal shareholders and their related interests. Section 18(j)(2) does not apply to any foreign bank in the United States but does apply to the insured branch itself. It is a very important statute in the examination and supervisory process because it is aimed at prevention and detection of insider abuse, a common characteristic of failed or failing banks. In addition, Section 11(b) of the Home Owners’ Loan Act makes Sections 22(g) and 22 (h) applicable to every savings association in the same manner and to the same extent as if the savings association were a member bank

The Federal Reserve Board’s Regulation O was issued pursuant to Sections 22(g) and 22(h) of the Federal Reserve Act. It requires that extensions of credit to executive officers, directors, principal shareholders or their related interests be made on substantially the same terms and follow credit underwriting procedures that are not less stringent than those prevailing at the time for comparable transactions with persons not covered by the regulation. Aggregate lending limits and prior approval requirements are also imposed by Regulation O. Moreover, payment of overdrafts of directors or executive officers is generally prohibited unless part of a written, preauthorized interest bearing, extension of credit plan or by transfer of funds from another account at the bank. The requirements, prohibitions, and restrictions of Regulation O are important and examiners should be fully familiar with them. The complete text of the regulation is contained in the FDIC Rules and Regulations.

Section 337.3 of the FDIC Rules and Regulations generally makes Regulation O applicable to FDIC-supervised institutions and sets forth requirements for approval of extensions of credit to insiders. Specifically, prior approval of the bank’s board of directors is necessary if an extension of credit or line of credit to any of the bank’s executive officers, directors, principal shareholders, or to any related interest of any such person, exceeds the amount specified in the regulation when aggregated with the amount of all other extensions of credit or lines of credit to that person. This approval must be granted by a majority of the bank's directors and the interested part(y)(ies) must abstain from participating directly or indirectly in the voting.

Any FDIC-supervised institution that violates—or any officer, director, employee, agent or other person participating in the conduct of the affairs of a FDIC-supervised institution— who violates any provision of Section 22(g) or 22(h) of the Federal Reserve Act may be subject to a CMP. In determining the amount of the penalty, the FDIC takes into account the financial resources and good faith of the bank or person charged, gravity of the violation, history if any of previous violations, and such other matters as justice may require. Examiners are reminded violations of Regulation O must be evaluated in accordance with the 13 factors specified in the Interagency Policy Regarding the Assessment of Civil Money Penalties by the Federal Financial Institutions Regulatory Agencies.

Part 348 of the FDIC Rules and Regulations - Management Official Interlocks

The Depository Institution Management Interlocks Act (DIMIA) is codified at 12 U.S.C. 3201 *et seq.* and its general purpose is to foster competition. The DIMIA prohibits a management official of one depository institution or depository holding company from also serving in a similar function in another depository institution or depository holding company if the two organizations are not affiliated and are located in the same area or if the two organizations are not affiliated and are very large, as defined in the regulation.

A number of exceptions allowing interlocking relationships for certain organizations and their affiliates are detailed in Part 348 of the FDIC Rules and Regulations. In addition, Section 303.249 of the FDIC Rules and Regulations provides a procedure to seek the approval of the FDIC to establish a management interlock. Under Section 8(e) of the FDI Act, the FDIC may serve written notice of intention to remove a director or officer from office whenever, in its opinion, such director or officer of an insured bank has violated the management interlock regulation.

Section 7(j) of the FDI Act and the Change in Bank Control Act of 1978

Section 7(j) of the FDI Act prohibits any person, acting directly or indirectly or through or in concert with one or more other persons, from acquiring control of any insured depository institution through a purchase, assignment, transfer, pledge, or other disposition of voting stock of the insured bank unless the appropriate Federal banking agency has been given 60-days prior written notice of the proposed acquisition. An acquisition may be made prior to the expiration of the disapproval period if the agency issues written notice of its intent not to disapprove the action. The term "insured depository institution" includes any bank holding company or any other company which has control of any insured bank. The term "control" is defined as the power, directly or indirectly, to direct the management or policies of an insured bank or to vote 25% or more of any class of voting securities of an insured bank. Willful violations of this statute are subject to civil money penalties of up to $1 million per day. This statute gives the FDIC important supervisory powers to prevent or minimize the adverse consequences that almost invariably occur when incompetent or dishonest individuals obtain positions of authority and influence in banks.

Section 737 of the Gramm-Leach-Bliley Act – Bank Officers and Directors as Officers and Directors of Public Utilities

This section of the Gramm-Leach-Bliley Act amends the Federal Power Act to preclude persons from serving both as an officer or director of a public utility and a bank except in certain circumstances. Dual service is permissible when the individual does not participate in any deliberations involved in choosing a bank to underwrite or market the securities of the utility, when the bank is chosen by competitive procedures, or when the issuance of securities by the public utility have been approved by all appropriate regulatory agencies.

Section 8 of the FDI Act

Among other things, Section 8 of the FDI Act provides the Federal banking agencies with the authority to take action to remove from office or prohibit an IAP from any further participation in the conduct of the affairs of any depository institution. Specifically, Section 8(e) and Section 8(g) are utilized in such proceedings. Actions taken under this authority represent serious charges with significant potential consequences. Therefore, outstanding guidelines should be closely followed during the examination process. For additional guidance, refer to Section 8 the FDI Act and the Formal Administrative Actions section of this Manual.

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OTHER ISSUES

Indebtedness of Directors, Officers and Their Interests

The position of director or officer gives no license to special credit advantages or increased borrowing privileges. Loans to directors, officers and their interests must be made on substantially the same terms as those prevailing at the time for comparable transactions with regular bank customers. Therefore, management loans should be evaluated on their own merits. Their business operations will, in many instances, necessitate bank loans, and these ordinarily will be among a bank's better assets. Since directors usually maintain a deposit relationship with their bank, this carries with it an obligation to meet their reasonable and prudent credit requirements.

On the other hand, there have been many instances where improper loans to officers, directors, and their interests resulted in serious losses. Unfortunately, when the soundness of a management loan becomes questionable, an embarrassing situation usually results. That is, management loans frequently may not be subject to the same frank discussion accorded other loans. Bank directors may assent to such loans, despite knowledge that they are unwarranted, rather than oppose a personal or business friend or associate. Moreover, directors who serve on the board in order to increase their opportunities for obtaining bank credit are reluctant to object to credit extensions to their colleagues. Problems that occur with management loans have received considerable legislative attention and laws have been passed to curb abuses associated with the position of director or officer (*e.g.*, Sections 22(g) and (h) of the Federal Reserve Act). However, while steps have been taken to reduce the potential for problems in this area, a review of the board's policies and actual practices regarding insider loans remains an important part of the examination process.

Conflicts of Interest

Examiners should be especially alert to any insider involvement in real estate projects, loans or other business activities that pose or could pose a conflict of interest with a director's fiduciary duties of care and loyalty to the bank. On occasion, loans are advanced to business associates involved in apparently unrelated projects where an insider nevertheless benefits. The involvement of bank insiders in these projects is sometimes not apparent because ownership is held in the form of "business trusts" or other entities without disclosure of the identity or personal guarantees of the principals. In order to help uncover these types of situations, examiners should routinely inquire of senior management, through incorporation in the "first day" letter or request, whether any of the following situations exist:

- Loans or other transactions existing at the bank in which an officer, director or principal stockholder (or immediate family member of each) of the bank holds a beneficial interest.
- Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) of another depository institution holds a beneficial interest.
- Loans or other transactions at any other depository institution in which a bank officer, director, or principal stockholder (or immediate family member of each) holds a beneficial interest, either direct or indirect.
- Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) has no direct interest but which involve parties with whom an insider has other partnership or business associations.
- Loans extended personally by officers, directors or principal stockholders (or immediate family member of each) to parties who are also borrowers from the bank or loans extended personally by any borrowing customers to an officer, director or principal stockholder of the bank.

If any of this information is not readily available and of reasonably recent compilation, management should be requested to survey their officers, directors and principal stockholders, as necessary, to obtain it.

Examiners are also reminded to inquire into bank policies and procedures designed to bring conflicts of interest to the attention of the board of directors when they are asked to approve loans or other transactions in which an officer, director, or principal stockholder may be involved. Where such policies and procedures are lacking or insufficient to reveal insider involvement before action is taken by the board, examiners should strongly encourage the board to remedy the deficiency. The board should also be encouraged to act specifically on any loan or other transaction in which insiders or their associates may be involved, either directly or indirectly, or because of business associations outside the loan or transaction in question. Moreover, examiners should determine whether the results of board deliberations on any matter involving a potential conflict of interest are noted clearly in the minutes.

Examiners are also reminded to carefully scrutinize any loan or other transaction in which an officer, director or principal stockholder is involved. Such loans or other transactions should be sound in every respect and be in full compliance with applicable laws and regulations and the bank's own policies. Any deficiencies in credit quality or other aspects of the transaction should receive critical comment not only from an asset quality perspective but from a management perspective as well. More specifically, if a director has a personal financial interest in a loan or other transaction subject to adverse classification, the board should be urged to require that director to strengthen the credit sufficiently to remove the adverse classification within a reasonable time frame or resign from the board. In the event a principal stockholder or an officer who is not a director is involved in an adversely classified loan or other transaction, the board should be urged to assume special oversight over the loan or activity, either directly or through a committee of outside directors, with a view towards limiting any further exposure and moving aggressively to secure or collect any exposed balances as the circumstances may permit. These types of situations not only tend to compromise the credit standards of the lending institution and increase the risk of eventual losses, but that they can also lead to violations of civil and criminal laws.

Nonbanking Activities Conducted on Bank Premises

Many banks conduct nonbanking activities on bank premises by selling insurance (*e.g.*, credit, life, accident, and health) in conjunction with loan transactions of the bank. When these nontraditional banking activities take the form of establishment of a new department or subsidiary of the bank, the benefit and profit is directly realized by the bank and its shareholders. However, when these activities are conducted on bank premises for the benefit of others, a bank may be deprived of corporate opportunity and profit. The FDIC has long taken the position that when nonbanking activities are conducted on bank premises either by bank personnel or others and when the benefit and profit do not flow directly to the bank, certain disclosures, approvals, and reimbursements must be made.

In all cases, it is important for the bank's directors and shareholders to be fully informed regarding the nonbanking activity conducted on bank premises. The operation is typically be approved by the bank's shareholders, and expenses incurred by the bank in connection with these operations formally approved by the board of directors annually. A well run bank ensures that it is adequately compensated for any expenses it incurs in furnishing personnel, equipment, space, etc. to this activity. It is recommended that bank management disclose completely to its bonding company any such nonbanking activity conducted on its premises. Management would also be well advised to obtain acknowledgement from the bonding company that such activities do not impair coverage under the fidelity bond. Finally, the conduct of nonbanking activity must be in conformance with applicable State statutes and regulations. For additional discussion, refer to the Interagency Statement on Retail Sales of Nondeposit Investment Products.[2]

Situations where the bank is being deprived of corporate opportunity through the diversion of opportunity or profit, or inadequately compensated for the utilization of its resources should be discussed with bank management and commented upon in the Risk Management Assessment and the Examination Conclusions and Comments pages, if appropriate. Additionally, the absence of disclosure and approval to the bank's directors, shareholders, and bonding company should be discussed with management and covered in the aforementioned schedule(s). Finally, in those instances where the examiner believes, based on known facts, that a violation of applicable statutes or regulations has occurred, or where there is material or substantial evidence that a criminal violation has been committed, the matter should be handled in accordance with guidelines prescribed in other sections of this Manual.

Directors of Banks with Dominant Management Officials

Examiners should carefully consider the risks associated with institutions controlled by an official that has material influence over virtually all decisions involving the bank's policies and operations. A dominant official can be an individual, family, shareholder, or group of persons with close business dealings or otherwise acting together regardless of whether the individual or any other members of the family or group have an executive officer title or receive compensation from the institution.

The definition of dominant official, as provided in this section, is not intended to capture individuals who merely occupy multiple positions, particularly in small institutions, if they do not also exert material influence over virtually all decisions involving the bank's policies and operations. Nevertheless, in such situations additional transaction testing to confirm the adequacy of segregation of duties and internal controls may be necessary.

Examiners should not automatically view the presence of a dominant official negatively or as a supervisory concern. For example, in a small bank with limited staff, a dominant official may emerge because no one else at the bank has the skills or experience to operate the bank. The presence of a dominant official does however present two potential challenges for boards of directors: incapacitation or loss of the dominant official and difficulties in resolving mismanagement, should it occur.

Incapacitation or loss of the dominant official may deprive the bank of competent management presenting key person risk. Key person risk results when an institution is dependent upon a single, yet highly qualified official that is core to the operation of the institution. For example, the loss or incapacitation of the key person may deprive the

[2] See Interagency Statement on Retail Sales of Nondeposit Investment Products (Feb. 15, 1994) and Joint Interpretations of The Interagency Statement on Retail Sales of Nondeposit Investment Products (Sep, 12, 1995).

bank of critical institutional knowledge and competent management. The loss of a key person may also result in short- or long-term business disruptions, productivity losses, or negatively affect profitability. Further, the process to replace a key person can be expensive and lengthy. In these cases, examiners should evaluate the effectiveness of compensating controls that protect the institution from the loss of the key person. Compensating controls include items such as key person life insurance, careful business-continuity and succession planning, and cross-training programs.

Problem situations resulting from mismanagement by a dominant official are more difficult to solve through normal supervisory efforts, therefore, it is extremely important that examiners assess the bank's control environment and, when applicable, recommend necessary changes to the control structure. The presence of a dominant official coupled with other risk factors such as ineffective internal controls, inadequate board oversight, or high-risk business strategies irrespective of established board policies, are a supervisory concern and require enhanced supervision. Red flags associated with institutions operated by a dominant official are discussed in Section 9.1- Bank Fraud and Insider Abuse of this Manual.

Situations involving dominant officials may involve boards that simply put their trust in the dominant officer without providing adequate oversight or effective challenge to management. This lack of effective challenge by boards may arise for various reasons. In particular, when first elected some directors may have a limited understanding of banking operations or of their oversight responsibilities and therefore feel dependent on operating management with more banking experience. Also, directors nominated by dominant officials may believe they owe allegiance to those dominant officials. In some cases, the dominant official may control the flow of information to the board of directors and could limit the board's knowledge of daily management activities, thereby contributing to the lack of adequate oversight or effective challenge to bank management by the board.

Conversely, the dominant official could be an officer or non-officer board chair and/or principal shareholder who dominates the bank's affairs through the threat of dismissal of non-compliant officers and/or control of the board of directors.

Operational risks inherent when a dominant official is present may include the circumvention of internal controls by the dominant official. For example, a dominant official that simultaneously fulfills roles with conflicting responsibilities, such as chief executive officer (CEO) and chief financial officer, or serving as CEO and chair of the audit committee. In another situation, sound risk management practices may be ignored, such as when a dominant CEO does not involve the board with strategic decisions and policy matters in a timely manner.

If examiners identify dominant officials at an institution, they should assess the official's level of influence. Does the official direct the affairs of the institution without challenge from the board of directors? Is the official an officer or non-officer board chair/principal shareholder who dominates the board and management? Does the official determine the policies and/or the strategic direction of the bank? Does the official control the flow of information to the board of directors? These are examples of material influence. Such influence, along with other risk factors and risk management controls designed to mitigate these risks, should be considered during on-site examinations, off-site monitoring, and in the evaluation of management in connection with the regulatory and supervisory processes. In these situations, examiners should review the risk profile and control environment of the bank and assess whether:

- An appropriate segregation of duties and responsibilities is achieved or alternative actions are taken to mitigate the level of control exercised by the dominant individual;
- Director involvement in the oversight of policies and objectives of the bank is at an appropriate level;
- Board composition provides the bank with a range of knowledge and expertise, including, but not limited to, banking, accounting, and the major lending areas of the bank's target markets;
- There are a sufficient number of outside and independent directors;
- Committees of major risk areas exert a proper level of function, responsibility, and influence, and the value of the committees is exhibited in the decision-making process;
- A proper level of independence has been achieved for board committees of major risk areas, including, but not limited to, audit committees;
- An adequate audit committee has been established with only, or at least a majority of, outside directors, if not already required by Section 363.5 of the FDIC's Rules and Regulations;
- A need exists for the performance of annual financial audits by an independent certified public accounting firm if not already required under Part 363;
- A qualified, experienced, and independent internal auditor is in place;
- A proper segregation of the internal audit function is achieved from operational activities;
- An appropriate rationale is established regarding any changes to a bank's external auditors, including, but

not limited to, a review of the audit committee minutes or a review of auditor notifications;[3]

- An adequate written code of conduct, ethics, and conflict of interest policies have been established;
- A need exists for the bank's board to perform and report on an annual conflicts of interest and ethics review;
- A need exists for a bank to engage outside consultants to conduct an external loan review; and
- A proper segregation of the internal loan review process is established.

Report of Examination (ROE) Treatment

If a dominant official is identified during an examination, examiners should describe related risks in the ROE. ROE comments should identify the dominant official, describe the official's material influence and effect on the bank, describe the level of board independence and oversight, and describe the effectiveness of any mitigating controls. If no concerns are identified, the comments should be included in the Confidential-Supervisory Section. If concerns attributed to a dominant official are identified, supervisory recommendations should be scheduled on the Examination Conclusions and Comments or Risk Management Assessment pages, as appropriate, according to ROE instructions. Concerns attributed to a dominant official, including non-compatible duties, pursuit of high-risk business strategies, ineffective board oversight, or lack of other adequate mitigating controls should be raised on the Matters Requiring Board Attention (MRBA) report page. Supervisory recommendations, including those raised on the MRBA page, should specify clear corrective actions that mitigate risk. Additionally, when a dominant official is identified, the Dominant Officer/Policymaker line item of the Summary Analysis of the Examination Report (SAER) should be answered "Yes."

Examiners should consider how identified dominant official related weaknesses might affect the institution when assigning component and composite ratings. Concerns or deficiencies should not be excluded from the ROE or disregarded when assigning ratings simply because the bank's current financial condition is satisfactory or does not reflect deterioration. Forward-looking supervisory practices require that examiners consider how current practices may affect the future condition of the bank. Additionally, the extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority must be considered when assigning the Management rating. And finally, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution.

Enhanced supervision to address supervisory concerns related to dominant management or ownership include recommending director education to assist board members in performing their fiduciary responsibilities and engaging outside directors during the examination and other supervisory processes. Directors' fiduciary duties, include changing management composition, or seeking change in board composition, if a dominant official's influence hinders a director's oversight, independence, or influence.

When warranted, supervisory concerns should be addressed with informal or formal corrective programs. When concerns are particularly elevated or prior supervisory actions do not effect timely corrective actions, consideration should be given, after consultation with the Regional Office, to recommending changes to board composition or management to reduce a dominant official's impact on material decisions. Enforcement action provisions should be tailored to, and specifically address, the risks identified by specifying what actions the institution should take to mitigate the risk. For instance, a provision requiring the board to obtain a management study should also require the study to provide recommendations for specific actions that the institution should take to implement appropriate controls to mitigate the risk associated with the dominant official. Case managers should also record and retain information regarding the basis for key supervisory decisions and actions in a memo to the file, including instances where supervisory actions are considered or recommended but not ultimately taken.

Application review and processing should include an assessment of whether a dominant influence is present, mitigating factors are adequate, and related prior supervisory actions have been effective. If mitigating factors are not adequate or related supervisory actions did not have the intended effect, case managers should reflect that in the Summary of Investigation and consider whether changes to the application or appropriate conditions should be sought prior to approving an application.

Advisory Directors

Some banks establish a position of honorary director (or similar title) for various reasons for persons who do not want to relinquish their position but are no longer able to effectively fulfill the demanding duties of director, such as due to illness. Generally, the honorary director attends board meetings as desired and offers advice on a limited

[3] If the bank recently changed external auditors, examiners should assess the board and audit committee's rationale and review committee minutes and "change-in-auditor" notifications for possible opinion shopping and any other safety and soundness issues.

participation basis, but has no formal voice or vote in proceedings, nor the responsibilities or liabilities of the office, except where there may be a continuing connection with a previous breach of duty as an official director.

Restrictions on Golden Parachute Payments and Indemnification Payments

Golden Parachute Payments

- Part 359[4] of the FDIC Rules and Regulations limits and/or prohibits, in certain circumstances, insured depository institutions, their subsidiaries, and their affiliated depository institution holding companies from agreeing to make or making golden parachute payments when the entity making the payment is "troubled," as defined in Section 303.101 of the FDIC Rules and Regulations.
- The rule does not restrict the payment of golden parachutes by healthy institutions, except that depository institution holding companies (including healthy ones) are prohibited from making golden parachute payments to IAPs of troubled subsidiary banks and savings associations.
- Several exceptions to the prohibition are included in the regulation; some are required by statute, others have been added by the FDIC. These exceptions are as follows:

  - Bona-fide deferred compensation plans;
  - Nondiscriminatory severance payment plans (for personnel reductions in force);
  - Qualified pension or retirement plans;
  - Payments pursuant to employee welfare benefit plans;
  - Payments made by reason of termination caused by death or disability; and
  - Payments required by State statute or foreign law.

  The final three listed exceptions require the approval of both the appropriate Federal banking agency and the FDIC:

  - A troubled institution hiring new management;
  - Severance payment in the event of an unassisted change in control; and
  - Any others on a case-by-case basis with the regulators' approval.

Indemnification Payments

- With regard to indemnification payments, Part 359 limits the circumstances under which an insured depository institution, its subsidiary, or its affiliated depository institution holding company may indemnify IAPs for expenses incurred in administrative or civil enforcement actions brought by bank regulators. The circumstances where indemnification may be permitted are as follows:

  1. The institution's board of directors determines in writing that these four criteria are satisfied:

     - The IAP acted in good faith and in a manner believed to be in the best interests of the institution;
     - The payment will not materially adversely affect the safety and soundness of the institution;
     - The payment is limited to expenses incurred in an administrative proceeding or civil action instituted by a Federal financial institution's regulator; and
     - The IAP agrees to reimburse the institution if he/she is found to have violated a law, regulation, or other fiduciary duty.

  2. An insurance policy or fidelity bond may pay restitution and the reasonable cost of defending an administrative proceeding or civil action. It may not pay a penalty or judgement.

- Under no circumstances may an institution or an insurance policy of the institution indemnify an IAP for any judgment or civil money penalty imposed in an action where the IAP is assessed a civil money penalty, is removed from office or prohibited from participating in the affairs of the institution, or is required to cease and desist from or take any affirmative action pursuant to Section 8(b) of the FDI Act. However, partial indemnification is allowed for charges that are found in the IAP's favor as explained below under "Issues."

Issues

Generally speaking, the essence of Part 359 lies in its definitions of terms such as: golden parachute payment, bona fide deferred compensation plan, and prohibited indemnification payment, as well as certain significant exceptions to the general prohibitions.

[4] Part 359 implements Section 18(k) of the FDI Act, 12 U.S.C. 1828(k).

The following are additional discussions on several issues encompassed in the regulation.

- With regard to indemnification payments, the majority of administrative or civil enforcement cases end in a settlement and no indemnification payment will be permitted unless charges are dropped. The parties concerned will have to factor in this cost of no indemnification in their decisions to settle or not.

  However, there are situations when an individual has been charged with several significant items of misconduct, etc., and then during the process a settlement is reached where only some of the infractions are admitted. The rule permits partial indemnification by reasonable payment of legal or professional expenses in those cases if there has been a formal and final adjudication or finding in connection with a settlement that the IAP has not violated banking laws or regulations or engaged in unsafe or unsound banking practices or breaches of fiduciary duty. There is a special case-by-case exception to allocate costs to the sets of charges with indemnification permitted for those that are dropped.

  Regardless of findings or adjudication conclusions, partial indemnification is not permitted in cases where an IAP is removed from office and/or prohibited from participating in the affairs of the institution.

  It is recognized that in many cases the appropriate amount of any partial indemnification will be difficult to ascertain with certainty. Although no prior regulatory consent is required, the regulators, obviously, are part of the settlement process. The process provides the opportunity for the regulators to give "non-objections" at the time of settlement, prior to the indemnification being made. As part of the settlement process, the bank should be required to provide from the attorney or expert seeking fees a statement containing a description of specifically attributable expenses. Concern should focus on the reasonableness of the allocations.

- If a golden parachute is prohibited to an individual leaving the institution, it is prohibited forever, even if the institution returns to health (after the individual has left the institution). There are ample exceptions and procedures for an individual who is leaving a troubled institution to avoid the prohibition if that individual has not contributed significantly to the demise of the institution. If an individual does not qualify for one of these exceptions, that individual should not benefit due to the institution reversing its course and returning to health after that individual has left the institution.

- Troubled institutions cannot apply for an exception to offer "white knight" parachutes to their current officers to not leave the institution. Rather such provisions are intended to entice new management to join the institution by compensating for the uncertainty of joining a troubled institution. It is considered illogical for the FDIC to provide an exception to permit a troubled institution to offer a buyout to current management to get them to stay. The regulation does not prohibit an institution from offering golden parachutes to their current officers. It only prohibits the payment of a non-permissible golden parachute if the individual leaves while the institution is troubled. On the contrary, it is believed to be of greater incentive that the only way the current officers' golden parachutes will be of value is if they stay and work to return the institution to health.

- Approval is required for a severance payment in the event of an unassisted change in control. A maximum payment of 12 months' salary is permitted under this exception. Any requests for payments in excess of 12 months' salary would have to be considered for approval under the general case-by-case exception.

  The change-in-control exception is provided in recognition of the need for current management to be motivated to seek out acquirers. This exception is believed appropriate for cases where the IAP may not clearly demonstrate that all the factors for the general exception are evident, yet an acquisition of the troubled institution has been arranged and the acquirer is willing to make the otherwise prohibited golden parachute payment. On the other hand, if after consideration of the factors for the general case-by-case exception, the appropriate Federal banking agency and/or the FDIC determines it inappropriate to make the severance payment, an exception should not be approved.

Excessive Compensation

Section III of Part 364, Appendix A, prohibits the payment of excessive compensation, as well as compensation that could lead to material financial loss to an institution, as an unsafe and unsound practice. Furthermore, Section II of Part 364, Appendix A, urges institutions to maintain safeguards that prevent excessive compensation or compensation that could subject the institution to material financial loss. Excessive compensation is defined as when amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder. The following items should be considered when determining whether compensation is excessive:

- The combined value of all cash and noncash benefits provided to an individual;
- The compensation history of the individual and other individuals with comparable expertise;
- The financial condition of the institution;
- Compensation practices at comparable institutions, based on such factors as asset size, location, and the complexity of the loan portfolio or other assets;
- For post-employment benefits, the projected total cost and benefit to the institution;
- Any connection between the individual and any instance of fraud or insider abuse occurring at the institution; and
- Any other factors determined to be relevant.

The FDIC does not seek to dictate specific salary levels or ranges for directors, officers, or employees. In fact, Section 39 of the FDI Act prohibits establishing guidelines that set a specific level or range of compensation for bank insiders. The criteria listed above are designed to be qualitative rather than quantitative in order to grant an institution's directors reasonable discretion when structuring a compensation program.

Examiners should review the information used by the board to establish the compensation structure of the institution. The information should adequately explain the rationale for the system in place and should enable the board to consider the above items that determine whether compensation is excessive.

Gaining Access to Bank Records and Employees

Section 10(b)(6) of the FDI Act provides authority for examiners to make a thorough examination of any insured depository institution and requires them to complete a full and detailed report of the institution's condition. In most instances, the executive officers of insured depository institutions cooperate with the requests of examiners. However, there are rare occasions when executive officers are extremely uncooperative, or refuse to provide access to bank records and employees that are essential to the evaluation of the condition of the institution. In such cases, this pattern of behavior by executive officers may be indicative of serious problems in the bank, including fraud, mismanagement, or insolvency. The Regional Office should be consulted when executive officers restrict access to bank records or employees.

Bank Owned Life Insurance (BOLI)

A number of banks use BOLI as a means of protecting against the loss of key employees or hedging employee compensation and benefit plans. However, the purchase of life insurance is subject to supervisory considerations and life insurance holdings must be consistent with safe and sound banking practices. Examiners are to assess whether bankers complete a thorough analysis before purchasing BOLI. Associated risks, minimum standards for pre-purchase analysis and basic guidelines are detailed in the Other Assets and Liabilities section of this Manual.

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MODEL RISK MANAGMENT

Some banks routinely use models for a broad range of activities, including underwriting credits; valuing exposures, instruments, and positions; measuring risk; managing and safeguarding client assets; determining capital and reserve adequacy; and many others. The use of models can improve business decisions, but can also introduce risk, such as potential adverse consequences (including financial loss) of decisions based on models that are incorrect or misused. To ensure safe and sound operations, it is important that, like any other risk, a bank's board and management identify, measure, monitor, and control model risk.

The Supervisory Guidance on Model Risk Management (MRM Guidance) describes the key aspects of effective model risk management. While this manual section provides an overview of model risk management principles, examiners should refer to the MRM Guidance for a more thorough discussion of model risk management.

Appendix A to Part 364 has long-established standards for safety and soundness for banks in the areas of internal controls and information systems; internal audit systems; loan documentation; credit underwriting; interest rate exposure; asset quality; earnings; and compensation, fees, and benefits. To the extent that models are used in these major operating areas of the bank, whether the model was developed and operated internally or through a third party, examiners are to assess model risk management practices for consistency with safety and soundness standards.

Overview

The term *model* refers to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates. A model also includes quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgement, provided that the output is quantitative in nature.

It is important for model risk management practices to be commensurate with the bank's risk exposures, as well as the complexity and extent of its model use.

An effective model risk management framework includes:

- Disciplined and knowledgeable model development processes that are well documented and conceptually sound, with controls to ensure proper implementation and processes to ensure correct and appropriate use;
- Effective validation processes; and
- Strong governance, policies, and controls.

Tools used for simple mathematical calculations are generally not considered models, but should nonetheless be subject to a reasonable control process.

Model Development, Implementation, and Use

Disciplined and knowledgeable development and implementation processes that are consistent with the model's intended use and with bank policy are critical to appropriately managing model risk. There are many important aspects to model development and implementation, including:

- A clear statement of purpose to ensure development is aligned with intended use;
- Design, theory, and logic that are well documented and supported;
- Rigorous assessment and documentation of data quality and relevance;
- Documented testing during model development to determine whether the model is performing as intended; and
- Controls and testing for model implementation and systems integration.

Model use provides additional opportunity to test whether a model is functioning effectively and to assess its performance over time as conditions and model applications change. Also, an understanding of model uncertainty and inaccuracy and a demonstration that the bank is accounting for them appropriately are important outcomes of effective model development, implementation, and use.

Model Validation

Model validation is the set of processes and activities intended to verify that models are performing as expected, in line with their design objectives and business uses. Effective validation helps ensure that models are sound. It also identifies potential limitations and assumptions, and assesses their possible impact. Independence, competence, knowledge, skills, expertise, incentives, influence, and authorities of staff conducting validation are important elements of model validation.

Key elements of comprehensive validation include: evaluation of conceptual soundness, ongoing monitoring, and outcomes analysis.

- Evaluation of conceptual soundness includes assessing the quality of the model design and construction, a review of documentation supporting the methods used and variables selected for the model, sensitivity analysis (where appropriate), and evaluating qualitative information and judgment.
- Ongoing monitoring includes designing a program of ongoing testing and evaluation of model performance to confirm that the model is appropriately implemented and is being used and is performing as intended, which may include process verification and benchmarking.
- Outcomes analysis, including backtesting, includes a comparison of model outputs to corresponding actual outcomes, with the precise nature of comparisons depending on the objectives of a model.

Governance, Policies, and Controls

Developing and maintaining strong governance, policies, and controls over the model risk management framework is fundamentally important to its effectiveness. Even if model development, implementation, use, and validation are satisfactory, a weak governance function will reduce the effectiveness of overall model risk management. A strong governance framework provides explicit support and structure to risk management functions through policies defining relevant risk management activities, procedures that implement those policies, allocation of resources, and mechanisms for evaluating whether policies and procedures are being carried out as specified. Notably, the extent and sophistication of a bank's governance function is expected to align with the extent and sophistication of model usage.

Examination Review

Examination planning contact with bank management, as well as interim contacts, provides examination staff with opportunities to discuss the extent of model use and determine whether there are any material changes since the prior examination. If management indicates new model use or material changes since the prior examination, examiners should consider asking some additional questions to assist in exam scoping and to appropriately tailor the request list. For example, ask management:

- Where model risk management is addressed in policies and whether there are any procedures, standards or monitoring practices the bank may have that address model risk management practices.
- Whether the bank maintains a model inventory. While banks are not required to maintain a model inventory, identifying models used across the bank can be an important practice to assist in model risk management. For banks with minimal model use, model risk, and model complexity, the inventory may

be an informal list. To the extent a bank maintains an inventory, it will be useful in the exam planning process in developing the scope of the model risk review.
- Whether the bank has model documentation or validation reports for models used.
- Whether model risk management is covered in the audit scope.
- Whether the bank maintains any exception or findings tracking reports.

Based on discussion with management, examiners should consider including relevant documents in the request list. Based on management discussions and the response to the request list, examiners should determine whether a review of the model risk management framework or review of specific models is necessary or warranted. Examiners should tailor the examination review scope based on the bank's risk exposure, activities, complexity and extent of model use. The review should focus on assessing the adequacy of the model risk management framework. To the extent models are used for key operating areas, examiners should consider reviewing the model documentation and validation. This review process can provide examiners with insight not only into the model and its quality but also the adequacy of risk management practices. If examiners determine the risk posed by the bank's model use is not at a level to necessitate a model sample review, examiners should consider reviewing internal risk management standards imbedded in operating policies and discussing vendor model due diligence processes with bank management. Such information can provide examiners with meaningful insight into whether model risk is managed appropriately.

References:
- Appendix A to Part 364 of FDIC Rules and Regulations
- Supervisory Guidance on Model Risk Management (FIL 22-2017)

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EVALUATION OF MANAGEMENT

A bank's performance with respect to asset quality and diversification, capital adequacy, earnings performance and trends, liquidity and funds management, and sensitivity to fluctuations in market interest rates is, to a very significant extent, a result of decisions made by the bank's directors and officers. Consequently, findings and conclusions in regard to the other five elements of the CAMELS rating system are often major determinants of the management rating. More specific considerations are detailed in the Basic Examination Concepts and Guidelines section of this Manual. However, while a bank's overall present condition can be an indicator of management's past effectiveness, it should not be the sole factor relied upon in rating management. This is particularly true when there is new management or when the bank's condition has been or could be significantly affected by external factors versus internal decisions.

When significant problems exist in a bank's overall condition, consideration must be given to management's degree of responsibility. However, appropriate recognition should also be given to the extent to which weaknesses are caused by external problems (such as a severely depressed local economy). A distinction should be made between problems caused by bank management and those largely due to outside influences. Management of a bank whose problems are related to the economy would warrant a higher rating than management believed substantially responsible for a bank's problems, provided that prudent planning and policies are in place and management is pursuing realistic resolution of the problems. Management's ability becomes more critical in problem situations, and it is important to note management's policies and acts of omission or commission in addressing problems.

The extent to which mismanagement has contributed to areas of weakness is particularly relevant to the management evaluation. Similarly, positive economic conditions may serve to enhance a bank's condition despite weak or undocumented policies and practices. At a minimum, the assessment of management should include the following considerations:

- Whether or not insider abuse is in evidence;
- Existing management's past record of performance in guiding the bank;
- Whether loan losses and other weaknesses are recognized in a timely manner;
- Past compliance with supervisory agreements, commitments, orders, etc.; and
- Capability of management to develop and implement acceptable plans for problem resolution.

Assessment of new management, especially in a problem situation, is difficult. Performance by individuals at their former employment, if known to the examiner, may be helpful, but the examiner should assess each situation based on its particular circumstances. The management rating should generally be consistent with any recommended supervisory actions. A narrative statement supporting the management rating and reconciling any apparent discrepancies between the assigned rating and any recommended supervisory actions (or lack of recommended actions) should be included on the confidential pages of the examination report.

Examination procedures regarding the evaluation of management are included in the Examination Documentation Modules.

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RATING THE MANAGEMENT FACTOR

Uniform Financial Institutions Rating System

The Federal Deposit Insurance Corporation and the other Federal Financial Institutions Examination Council (FFIEC) member agencies adopted a uniform interagency system for rating the condition and soundness of the nation's financial institutions. The Uniform Financial Institutions Rating System involves an assessment of six critical aspects of an institution's condition and operations. Management and administration is one of those critical dimensions.

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

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

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

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

Ratings

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

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

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

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

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

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INTRODUCTION

Internal controls include the policies and procedures that financial institutions establish to reduce risks and ensure they meet operating, reporting, and compliance objectives. The board of directors is responsible for ensuring internal control programs operate effectively. Their oversight responsibilities cannot be delegated to others within the institution or to outside parties. The board may delegate operational activities to others; however, the board must ensure effective internal control programs are established and periodically modified in response to changes in laws, regulations, asset size, organizational complexity, etc.

Internal control programs should be designed to ensure organizations operate effectively, safeguard assets, produce reliable financial records, and comply with applicable laws and regulations. Internal control programs should address five key components:

- Control environments,
- Risk assessments,
- Control activities,
- Information and communication, and
- Monitoring.

These components must function effectively for institutions to achieve internal control objectives. This overview of internal control is described further in a report by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) titled *Internal Control-Integrated Framework*. Institutions are encouraged to evaluate their internal control program against this COSO framework.

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INTERNAL CONTROL SYSTEMS

Part 364 of the FDIC Rules and Regulations establishes safety and soundness standards that apply to insured state nonmember banks and state-licensed, insured branches of foreign banks. Appendix A to Part 364 includes, among other things, general standards for internal controls, information systems, and audit programs. The standards require all financial institutions to have controls, systems, and programs appropriate for their size and the nature, scope, and risk of their activities. Internal controls and information systems should ensure:

- An organizational structure that defines clear lines of authority and responsibilities for monitoring adherence to established policies;
- Effective risk assessments;
- Timely and accurate financial, operational, and regulatory reports;
- Adequate procedures to safeguard and manage assets; and
- Compliance with applicable laws and regulations.

Many internal controls are programmed directly into software applications as part of data input, processing, or output routines. Other controls involve procedural activities standardized in an institution's policies. The relative importance of an individual control, or lack thereof, must be viewed in the context of other controls. Every bank is unique, and one set of internal procedures cannot be prescribed for all institutions. However, all internal control programs should include effective control environments, risk assessments, control activities, information systems, and monitoring programs.

If examiners determine internal routines or controls are deficient, they should discuss the deficiencies with the chief executive officer and the board of directors, and include appropriate comments in the report of examination (ROE).

Key Control System Components

Control Environment

The control environment begins with a bank's board of directors and senior management. They are responsible for developing effective internal control systems and ensuring all personnel understand and respect the importance of internal controls. Control systems should be designed to provide reasonable assurance that appropriately implemented internal controls will prevent or detect:

- Materially inaccurate, incomplete, or unauthorized transactions;
- Deficiencies in the safeguarding of assets;
- Unreliable financial and regulatory reporting; and
- Deviations from laws, regulations, and internal policies.

Risk Assessments

Risk assessments require proper identification, measurement, analysis, and documentation of significant business activities, associated risks, and existing controls. Financial risk assessments focus on identifying control weaknesses and material errors in financial statements such as incomplete, inaccurate, or unauthorized transactions. Risk assessments are conducted in order to identify, measure, and prioritize risks so that attention is placed first on areas of greatest importance. Risk assessments should analyze threats to all significant business lines, the sufficiency of mitigating controls, and any residual risk exposures. The results of all assessments should be appropriately reported, and risk assessment methodologies should be updated regularly to reflect changes in business activities, work processes, or internal controls.

Control Activities

Control activities include the policies and procedures institutions establish to manage risks and ensure pre-defined control objectives are met. Preventative controls are designed to deter the occurrence of an undesirable event. Detective controls are designed to identify operational weaknesses and help effect corrective actions. Control activities should cover all key areas of an organization and address items such as organizational structures, committee compositions and authority levels, officer approval levels, access controls (physical and electronic), audit programs, monitoring procedures, remedial actions, and reporting mechanisms.

Information and Communication

Reliable information and effective communication are essential for maintaining control over an organization's activities. Information about organizational risks, controls, and performance must be quickly communicated to those who need it. Technology systems and organizational procedures should facilitate the effective distribution of reliable operational, financial, and compliance-related reports. Clearly defined procedures should be developed that make it easy for individuals to report risks, errors, or fraud through formal and informal means. The procedures should include appropriate mechanisms for communicating, as needed, with external parties such as customers, regulators, shareholders, and investors.

Monitoring

Internal control systems must be monitored to ensure they operate effectively. Monitoring may consist of periodic control reviews specifically designed to ensure the sufficiency of key program components, such as risk assessments, control activities, and reporting mechanisms. Monitoring the effectiveness of a control system may also involve ongoing reviews of routine activities. The effectiveness of a periodic review program is enhanced when people with appropriate skills and authority are placed in key monitoring roles.

Control Standards

The control environment begins with the board of directors, which must establish appropriate control standards. The board of directors or an audit committee, preferably consisting entirely of outside directors (directors independent of operational duties), must monitor adherence to established directives.

Boards should establish policy standards that address issue such as decision-making authorities, segregation of duties, employee qualifications, and operating and recording functions. Key internal controls are described below.

Director Approvals

The board of directors should establish limits for all significant matters (such as lending and investment authorities) delegated to relevant committees and officers. Management should regularly provide financial and operational reports to the board, including standardized reports that detail policy exceptions, new loans, past due credits, concentrations, overdrafts, security transactions, etc. The board or a designated board committee should periodically review all authority levels and material actions. The key control objective is that the board is regularly informed of all significant matters.

Sound Personnel Policies

Sound personnel policies are critical components of effective control programs. The policies should require boards and officers to check employment references, hire qualified officers and competent employees, use ongoing training programs, and conduct periodic performance reviews.

Management should check the credit and previous employment references of prospective employees. The FBI is available to check the fingerprints of current and prospective employees and to supply institutions with criminal records, if any, of those whose fingerprints are submitted. Some insurance companies that write bankers' blanket bonds also offer assistance in screening officers and employees.

Pursuant to Section 19 of the Federal Deposit Insurance Act (FDI Act), the FDIC's written consent is needed in order for individuals to serve in an insured bank as a director, officer, or employee if they have been convicted of a criminal offense involving dishonesty, breach of trust, or money laundering.

Segregation of Duties

The possibility of fraud diminishes significantly when two or more people are involved in processing a transaction. A segregation of duties occurs when two or more individuals are required to complete a transaction. The segregation of duties allows one person's work to verify that transactions initiated by another employee are properly authorized, recorded, and settled. When establishing segregation-of-duty standards, management should assign responsibilities so that one person cannot dominate a transaction from inception to completion. For example, a loan officer should not perform more than one of the following tasks: make a loan, disburse loan proceeds, or accept loan payments. Individuals having authority to sign official checks should not reconcile official check ledgers or correspondent accounts, and personnel that originate transactions should not reconcile the entries to the general ledger. Additionally, information technology (IT) personnel should not initiate and process transactions, or correct data errors unless corrections are required to complete timely processing. In this situation, corrections should be pre-authorized, when possible, and authorized personnel should review and approve all corrections as soon as practical after the corrections are processed, regardless of any pre-authorizations.

Automated controls that act similar to manual segregation-of-duty controls can be written into software programs. For example, automated holds can be placed on customer accounts requiring special attention, such as dormant accounts or accounts with large uncollected funds. An automated hold allows tellers or customer service representatives to access an account for a customer, but requires the approval of a second person to authorize a transaction. In addition, certain modifications of data, such as master file changes, should require action from two authorized people before data is altered. When a hold on an account is added or removed, or when an action requiring supervisory approval occurs, exception reports should be automatically printed and reviewed by a designated person who is not involved with the activity. When properly designed, automated control methods are generally considered superior to manual procedures.

Joint Custody

Joint custody (a.k.a. *dual control*) refers to a procedure where two or more persons are equally accountable for the physical protection of items or records. For example, two keys or split combinations or passwords, under the separate control of different individuals, must be used in order to obtain access to vaults, files, or other storage devices. These custodial responsibilities should be clearly assigned and communicated to all affected employees. For the system to be effective, persons exercising control must guard their key, combination, or password carefully. If this is done, only collusion can bypass this control feature. Examples of items that should be under joint custody include reserve cash, negotiable collateral, certificated securities, trust assets, safekeeping items, reserve supplies of official checks, unissued electronic debit or credit cards, and unissued traveler's checks. Other examples include spare locks, keys, or combinations to night depositories, automated teller machines, safe deposit boxes, and tellers' cash drawers.

Vacation Policies

Banks should have a policy that requires all officers and employees to be absent from their duties for an uninterrupted period of not less than two consecutive weeks. Absence can be in the form of vacation, rotation of duties, or a combination of both activities. Such policies are highly effective in preventing embezzlements, which usually require a perpetrator's ongoing presence to manipulate records, respond to inquiries, and otherwise prevent detection. The benefits of such policies are substantially, if not totally, eroded if the duties normally performed by an individual are not assumed by someone else.

Where a bank's policies do not conform to the two-week recommended absence, examiners should discuss the benefits of this control with senior management and the board of directors and encourage them to annually review and approve the bank's actual policy and any exceptions. In cases where a two-week absent-from-duty policy is not in place, the institution should establish appropriate compensating controls that are strictly enforced. Any significant deficiencies in an institution's vacation policy or compensating controls should be discussed in the ROE and reflected in the Management component of the Uniform Financial Institutions Rating System (UFIRS).

Note: Management should consider suspending or restricting an individual's normal IT access rights during periods of prolonged absence, especially for employees with remote or high-level access rights. At a minimum, management should consider monitoring and reporting remote access during periods of prolonged absence.

Rotation of Personnel

Personnel rotations can provide effective internal controls and be a valuable part of overall training and business-continuity programs. The rotations should be planned by auditors and senior officers to ensure maximum effectiveness, but should not be announced ahead of time to the involved personnel. The rotations should be of sufficient duration to permit disclosure of irregularities due to error or fraud.

Pre-numbered Documents

Financial institutions should use sequentially numbered instruments wherever possible for items such as official checks and unissued stock certificates. In addition, institutions should maintain board meeting minutes on pre-numbered pages. Pre-numbered documents aid in proving, reconciling, and controlling used and unused items. Number controls should be monitored by a person who is detached from the particular operation; and unissued, pre-numbered instruments should be maintained under joint custody.

Cash Controls

Institutions should provide tellers with a separate cash drawer to which they have sole access. Common cash funds should not be used. An inability to fix responsibility in the event of a discrepancy could unnecessarily embarrass an employee or result in improper termination. Random cash drawer audits are also a fundamental control process.

Reporting Irregularities and Shortages

Management should develop procedures for the prompt reporting and investigation of irregularities and identified shortages. The results of investigations should be regularly reported to management and internal auditors, and when appropriate to fidelity insurers, regulators, and law enforcement agencies.

Business Continuity Plans

Business continuity planning requires banks to consider the impact of disruptions from natural disasters, technical problems, malicious activities (such as cyber attacks), pandemic incidents, etc. Directors and senior managers must develop business continuity plans to protect physical assets, safeguard financial records, and minimize operational interruptions.

Management should develop continuity plans for all significant operational areas based on the potential impact and probable occurrence of business disruptions. Disruptions include those with a high probability of occurrence and low impact to an institution, such as brief power interruptions, and to disruptions with a lower probability of occurrence but higher impact to an institution, such as tornadoes.

Business continuity plans should define key roles, responsibilities, and succession plans for various operational areas. Independent internal or external auditors should review the adequacy of the plans at least annually. Management should establish adequate training programs, periodically test the continuity plans, and report the test results and any recommendations for improvements to the board.

For additional details, refer to the FFIEC IT Examination Handbook titled Business Continuity Planning.

Accounting Systems

Efficient banking operations cannot be conducted without recordkeeping systems that generate accurate and reliable information and reports. Such systems are necessary to keep directors well informed and help officers manage effectively. Properly documented records are also necessary for meeting the needs of customers, shareholders, supervisory agencies, tax authorities, and courts of law.

Accounting systems should be designed to facilitate the preparation of internal reports that correspond with the responsibilities of individual supervisors and key employees. Records should be updated daily and reflect each day's activities separately from other days. Subsidiary records, such as those pertaining to deposits, loans, and securities, should balance with general ledger accounts.

While it is expected that records and systems will differ between banks, the books of every institution should be kept in accordance with well-established accounting and banking principles. In each instance, a bank's records and accounts should accurately reflect financial conditions and operating results. The following characteristics should be present in all accounting systems.

Audit Trail

Recordkeeping systems should be designed to enable the tracing of any transaction as it passes through accounts. Some of the more common recordkeeping deficiencies encountered during examinations include:

- General ledger entries are outdated or fail to contain adequate transaction descriptions;
- Customer loan records are incorrect, incomplete, or nonexistent;
- Cash item, overdraft, and suspense account records are deficient;
- Teller cash records are inadequately detailed;
- Security registers (electronic or manual) do not include all necessary information;
- Correspondent bank account reconcilements are outdated, lack complete descriptions, or fail to reflect the status of outstanding items;
- Account overage or shortage descriptions lack sufficient details;
- Letters of credit or other contingent liability records are inadequate; and
- Inter-office or intra-branch accounts are not properly controlled or monitored.

Accounting Manual

The uniform handling of monetary transactions is essential to the production of reliable financial reports. Management should establish accounting manuals and data processing guides that help employees consistently process and record transactions. Data processing guides are often provided by a servicer and supplemented by procedures written by bank personnel. The guides normally include instructions for compiling and reconciling source documents (such as checks and transaction tickets), instructions for processing the documents internally or transmitting them to a servicer for processing, and instructions for distributing output reports. Many systems allow employees to image source documents and transmit electronic files to a servicer for final posting. Regardless of the method used to process financial transactions, banks should have clear instructions for recording transactions and controlling the movement of documents and data between customers, the bank, and data processors.

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AUDIT

Internal control and internal audit are related, but separate concepts. Internal control involves the systems, policies, and procedures that institutions design to control risks, safeguard assets, and achieve objectives. Internal audits help directors and officers evaluate the adequacy of internal control systems by providing independent assessments of internal controls, bank activities, and information systems.

Appropriately structured and monitored audit programs substantially lessen financial and operational risks, and all banks should adopt adequate audit programs. Ideally, such programs include ongoing internal audits and periodic external audits.

Internal Audit

The board of directors and senior management are responsible for ensuring internal control systems operate effectively. Internal audits provide a systematic way for institutions to assess the effectiveness of risk-management and internal-control processes. When properly structured and conducted, internal audits provide vital information about risks and controls so management can promptly address any identified weaknesses.

When examiners identify weaknesses in internal auditing programs, they should discuss their concerns with management and the board and include appropriate recommendations in the ROE.

General Standards

As noted previously, Appendix A to Part 364 of the FDIC Rules and Regulations includes general standards for internal controls, information systems, and audit programs. Internal audit programs should be appropriate for the size of an institution and the nature and scope of its activities, and provide for:

- Adequate monitoring of the internal control system;
- Independence and objectivity;
- Qualified personnel;
- Adequate testing and review of information systems;
- Adequate documentation of tests, findings, and corrective actions;
- Verification and review of management's actions to address material weaknesses; and
- Review by the audit committee or board of directors of the effectiveness of the internal audit function.

The 2003 Interagency Policy Statement on the Internal Audit Function and its Outsourcing discusses:

- Board and management responsibilities,
- Key characteristics of the internal audit function,
- Considerations at small institutions,
- Outsourcing arrangements,
- Independence considerations when external auditors also provide internal audit services,
- Independence requirements relating to public and non-public companies,
- Annual audit and reporting requirements based on an institution's size, and
- Examiner reviews of internal audit functions and related matters.

As previously noted, directors and senior management should have reasonable assurance that the internal control system prevents or detects inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial reporting; and deviations from laws, regulations, and internal policies.

To ensure the internal audit program is appropriate for the institution's current and planned activities, directors should consider whether their institution's internal audit activities are conducted in accordance with professional standards, such as the Institute of Internal Auditors' (IIA), *Standards for the Professional Practice of Internal Auditing*. These standards provide criteria to address independence, professional proficiency, scope of work, performance of audit work, management of internal audits, and quality assurance reviews. Furthermore, directors and senior management should ensure the internal audit program adequately reflects key functional characteristics regarding organizational structure; management, staffing, and audit quality; scope; communication; and contingency planning.

Organizational Structure - The internal audit function should be positioned so the board has confidence that internal auditors will act impartially and not be unduly influenced by senior officers or operation managers. The audit committee should oversee the internal audit function, evaluate performance, and assign responsibility for the internal audit function to an internal audit manager or a member of management. If the responsibility is assigned to a member of management, the individual should not be involved in daily operations to avoid potential conflicts of interest. The internal audit manager should understand the internal audit function and have no responsibility for operating the system of internal control. Ideally, the internal audit manager should report directly and solely to the audit committee regarding audit issues and administrative matters such as resources, budget, appraisals, and compensation. If the internal audit manager is placed under a dual reporting structure (reports to a senior officer and the audit committee), the board should weigh the risk of diminished independence against the benefit of reduced administrative burden. Additionally, the audit committee should document its consideration of the risk and any mitigating controls the institution has in place to maintain audit independence.

Management, Staffing, and Audit Quality - The internal audit manager is responsible for control risk assessments, audit plans, audit programs, and audit reports. Control risk assessments document the internal auditor's understanding of significant business activities and associated risks. These assessments typically analyze the risks inherent in each significant business activity, mitigating control processes, and any residual risks to the institution. Internal audit plans should be based on the findings of the control risk assessments. The plans should include a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and the resource budget. Internal audit programs should describe audit objectives and list the procedures to be performed during each internal audit review. Audit reports should generally present the purpose, scope, and results of the audit including findings, conclusions, and recommendations. Workpapers that document the work performed and support the audit report should be maintained.

Ideally, the internal audit function's only role should be to independently and objectively evaluate and report on the effectiveness of an institution's risk management, control, and governance processes. The role should not include business-line oversight of control activities, such as approving or implementing operating policies or procedures. The audit committee should ensure that any consulting type work performed (e.g., providing advice on mergers, acquisitions, new products, services, internal controls, etc.) by the internal auditor(s) does not interfere or conflict with the objectivity of monitoring the internal control system.

The internal audit function should be staffed and supervised by people with sufficient expertise to identify operational risks and assess the effectiveness of internal controls. Internal audit policies, procedures, and work programs should be commensurate with the size and complexity of the internal audit department and institution.

Scope - The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's balance sheet and off-balance sheet activities. At least annually, the audit committee should evaluate and approve internal audit's control risk assessment(s), the scope of audit plans, and how much the audit manager relies on the work of outside vendors. The audit committee should also periodically review internal audit's adherence to approved audit plans and should consider expanding internal audit work if significant issues arise or material changes occur in the institution's structure, activities, or risk exposures.

The audit committee and management are responsible for determining the extent of auditing required to effectively monitor the internal control system. The expense of having a full-time audit manager or auditing staff is likely justified at institutions with complex structures or high-risk operations. However, the cost of having a full-time audit manager or staff may be prohibitive for institutions with less complexity and risks. Nevertheless, institutions without an internal audit staff can maintain an objective internal audit function by implementing comprehensive, independent reviews of significant internal controls. To be effective, competent individuals should design review procedures, and the individuals directing or performing the reviews must not be responsible for managing or operating the controls under review. The person completing the control reviews should report findings directly to the audit committee. The audit committee should evaluate the findings and ensure senior management takes appropriate action to correct any identified deficiencies.

Communication - Directors and senior management should encourage open discussions and critical evaluations of identified control weaknesses and any proposed solutions. Internal auditors should immediately discuss internal control weaknesses or deficiencies with the appropriate level of management. Significant matters should be promptly reported directly to the board of directors or its audit committee with a copy of the written report provided to senior management. Moreover, the board or audit committee should provide internal auditors the opportunity to discuss their findings without management being present, and institutions should establish procedures for employees to submit concerns (confidentially and anonymously) about questionable accounting, control, or auditing matters.

Contingency Planning - Whether using an in-house audit staff or an outsourced arrangement, the institution should have a contingency plan to mitigate any significant discontinuity in internal audit coverage, particularly for high-risk areas.

Outsourcing Internal Audits

Outsourcing arrangements involve contracts between an institution and a vendor that provides internal audit services. The arrangements may involve vendors providing limited or extensive audit assistance. Regardless of the level of outsourced services, an institution's directors are responsible for establishing and maintaining effective internal controls and internal audit programs.

Financial institutions should consider current and anticipated business risks when establishing each party's internal audit responsibilities. Institutions should have a written contract/engagement letter that clearly distinguishes its duties and those of the outsourcing vendor. Such contracts typically include provisions that:

- Define the expectations and responsibilities of both parties;
- Set the scope, frequency, and fees of a vendor's work;
- Describe the responsibilities for providing and receiving information and reports about the contract work status;
- Establish a process for changing contract terms, such as expanding audit work if issues are found;
- State that internal audit reports are the institution's property, designated employees will have reasonable and timely access to the vendor-prepared workpapers, and the institution will receive workpaper copies if needed;
- Specify the locations of internal audit reports and related workpapers;
- Specify the period vendors must maintain the workpapers;
- State that vendor audits are subject to regulatory review and examiners will be granted full and timely access to the internal audit reports and related workpapers;
- Prescribe a process for resolving disputes and for determining who incurs the cost of consequential damages arising from errors, omissions, and negligence;
- State that the vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee; and
- State, as applicable, that the vendor will comply with independence guidance established by the American Institute of Certified Public Accountants (AICPA), U.S. Securities and Exchange Commission (SEC), Public Company Accounting Oversight Board (PCAOB), or regulatory agencies.

Management should exercise appropriate due diligence in selecting vendors and periodically review outsourcing arrangements and vendor performance thereafter.

Communication among the internal audit staff, the audit committee, and senior management should not diminish because the institution engages an outside vendor. All work should be well documented, and any identified control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report findings to directors or 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.

Accountant Independence

Accounting firms risk compromising their independence if they perform internal and external audit functions at the same financial institution. The Sarbanes-Oxley Act of 2002 prohibits accounting firms from performing external audits of a public company during the same period they provide internal audit services. Non-publicly traded institutions that engage a firm to perform internal and external audit work in the same period are encouraged to consider the risks associated with compromised independence versus potential cost savings.

External Audit

Financial institutions should design external audit programs to ensure financial statements are prepared in accordance with Generally Accepted Accounting Practices (GAAP) and to alert management of any significant deficiencies in internal controls over financial reporting.

Section 36 of the FDI Act, as implemented by Part 363 of the FDIC Rules and Regulations, establishes annual independent audit and reporting requirements for insured depository institutions with total assets of $500 million or more. The 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations (1999 Policy Statement) includes audit and reporting guidance directed at banks and savings associations with less than $500 million in total assets.

Examiners that identify weaknesses in external auditing programs should include appropriate comments and recommendations in the ROE.

Audit Committees

All banks are strongly encouraged to establish an audit committee consisting entirely of outside directors. Although it may be difficult to establish a committee that includes only outside directors in a small closely held bank, all banks should be encouraged to include outside directors on their board and appoint them to the audit committee.

At least annually, the audit committee or board should analyze the extent of external auditing coverage needed by the bank. The board or audit committee should consider the size of the institution and the nature, scope, and complexity of its operations when evaluating external auditing needs. Institutions should also consider the benefits of:

- Financial statement audits,
- Internal control reviews,
- Additional auditing procedures for specific periods, and
- Additional auditing procedures for high-risk areas or special concerns.

Decisions regarding these considerations and the reasoning supporting the decisions should be recorded in committee or board minutes. If examiners determine risks are present that require additional external auditing, they should make specific recommendations to address the issues.

External Audits of Financial Statements

External audits help boards meet their fiduciary responsibilities and provide greater assurance that financial reports are accurate and complete. The audits can benefit management by providing insight into the effectiveness of accounting and operating policies, internal controls, internal auditing programs, and management information systems.

Each bank is strongly encouraged to adopt an external audit program that includes annual audits of its financial statements by an independent public accountant (unless its financial statements are included in the audit of the parent company's consolidated financial statements). A bank that does so would generally be considered to have satisfied the objectives of the 1999 Policy Statement.

External Audit Reports

Each state nonmember bank that undergoes external auditing work, regardless of the scope, should furnish a copy of any reports by the public accountant or other external auditor, including any management letters, to the appropriate FDIC regional office, promptly after receipt. A bank whose external auditing program combines state-mandated requirements, such as completion of annual directors' audits, with additional procedures may submit a copy of the auditors' report on its state-mandated procedures that is supplemented by a report on the additional procedures. In addition, the FDIC requests each bank to notify the appropriate regional office promptly when any public accountant or other external auditor is initially engaged to perform external audit procedures and when a change in its accountant or auditor occurs.

If a bank chooses an alternative external auditing program, rather than an annual audit of the financial statements, the report produced under the alternative program should include a description of the procedures performed. For example, if the auditor's report states *procedures agreed upon with management* have been performed, the bank should be asked to supply a copy of the engagement letter or other documents that outline the agreed-upon procedures so the FDIC can determine the adequacy of the scope of the external auditing program.

Audits at Institutions Under $500 Million

Regulatory agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. However, institutions of less than $500 million (at the beginning of their fiscal year) may be able to use alternative methods (some of which may be required by individual state statutes) that include:

- *Reporting by an Independent Public Accountant on an Institution's Internal Control Structure Over Financial Reporting* - This is an independent public accountant's examination and report on management's assertion of the effectiveness of the institution's internal control over financial reporting. For a smaller institution with less complex operations, this type of engagement is often less costly than a financial statement or balance sheet audit. It should include recommendations for improving internal controls, including suggestions for compensating controls, to mitigate risks due to staffing and resource limitations. Management's assertion and the accountant's attestation should generally cover lending and investing as these activities usually present the most significant risks affecting an institution's financial reporting.

- *Balance Sheet Audit Performed by an Independent Public Accountant* - This audit involves an institution that engages an independent public accountant to examine and report only on the balance sheet. As with the financial statement audit, the balance sheet audit is performed in accordance with Generally Accepted Auditing Standards (GAAS). The cost of a balance sheet audit is often less than a financial statement audit. However, under this type of program, the accountant does not examine or report on the fairness of the presentation of the institution's income statement, statement of changes in equity capital, or statement of cash flows.

- *Agreed Upon Procedures for State Required Examinations* - Some state statutes require state-chartered depository institutions to have specific procedures performed annually by their directors or independent persons. Depending upon the engagement's scope, the cost of the agreed-upon procedures or a state required examination might be less than the cost of an audit. However, under this type of program, the independent auditor does not report on the fairness of the institution's financial statements or attest to the effectiveness of the internal control structure over financial reporting. Findings or results are usually presented to the board or the audit committee so they may draw conclusions about the quality of financial reporting or sufficiency of internal control. When choosing this type of external auditing program, the board or audit committee is responsible for determining whether the procedures meet the external auditing needs of the institution, considering the institution's size and the nature, scope, and complexity of its business activities.

If the audit committee or board, at institutions with less than $500 million in total assets, determines not to engage an independent public accountant to conduct an annual audit of the financial statements, the reason(s) to use an acceptable alternative or to have no external auditing program should be documented in meeting minutes. Examiners should determine whether the alternative audit selected is appropriate, adequately covers all high-risk areas, and is performed by a qualified independent auditor. Any identified weaknesses in the external audit program should be commented on in the ROE.

If a bank with less than $500 million in total assets chooses not to have an external audit of financial statements by an independent public accountant, examiners should, at a minimum, strongly encourage the bank to engage an independent auditor to perform an external audit. If high-risk areas are evident, examiners should recommend that the auditor review the areas, and that any other deficiencies in the auditing program be corrected, to ensure there is adequate coverage of operational risk areas.

If a bank with less than $500 million in total assets has no external auditing program, examiners should review the board minutes to determine the board's rationale. Strong internal audit programs are fundamental to the safety and soundness of a bank, but are usually an insufficient reason for not implementing an external auditing program. One program should complement the other. Typically the external audit program tests and validates (or invalidates) the strength of internal controls and the internal audit program. In such situations, examiners should discuss the benefits of external auditing programs with the board and recommend the bank reconsider its decision.

Audits at Institutions of $500 Million or More

All depository institutions should implement adequate audit programs. Institutions with total assets of $500 million or more are required to have external audit programs that conform to the audit and reporting requirements of Part 363 of the FDIC Rules and Regulations.

Institutions covered by Part 363 must:

- Prepare annual financial statements,
- Produce annual reports detailing management's responsibilities and assessing management's compliance with laws and regulations, and
- Provide appropriate report signatures.

Annual financial statements must be prepared in accordance with GAAP and audited by an independent public accountant.

Annual reports must contain a statement of management's responsibilities for:

- Preparing financial statements,
- Maintaining adequate internal controls and procedures for financial reporting, and
- Complying with safety and soundness laws and regulations.

Management's assessment of their institution's compliance with laws and regulations must state a conclusion as to whether the institution complied with applicable laws and regulations, and disclose any instances of noncompliance.

Management reports at institutions with $1 billion or more in consolidated assets must also provide an assessment of the effectiveness of the institution's internal control system and include statements that:

- Identify the internal control framework used to evaluate the effectiveness of controls,
- Indicate controls were considered during the assessment,
- Express management's conclusion as to whether the institution's internal control over financial reporting is effective as of the end of the fiscal year, and
- Disclose any material weaknesses in internal controls that were not remediated prior to the fiscal year-end.

The signature requirements for management reports are related to the type of financial statements used to meet annual reporting requirements. For example:

- If financial statements and management reports are prepared at the institution level, the management report must be signed by the chief executive officer and the chief accounting officer or chief financial officer of the institution.
- If financial statements are prepared at the holding company level and the management report is prepared at the holding company level, the management report must be signed by the chief executive officer and the chief accounting officer or chief financial officer of the holding company.
- If financial statements are prepared at the holding company level and the management report is prepared at the institution level (or if parts of the management report are prepared at the holding company level and other parts at the institution level), the management report must be signed by the chief executive officer and the chief accounting officer or chief financial officer of both the holding company and the institution. Note: The management report must clearly indicate the level (institution or holding company) at which each of its components is being satisfied.

Public Accountant Responsibilities

The independent public accountant engaged by the institution is responsible for:

- Auditing and reporting on the institution's annual financial statements in accordance with GAAS or PCAOB standards; and
- Examining, attesting to, and reporting separately on the assertions of management concerning the institution's internal control structure and procedures for financial reporting on institutions with total assets of $1 billion or more.

Reporting Requirements

Part 363 requires insured depository institutions to submit the following reports and notifications to the FDIC, the appropriate federal banking agency, and the appropriate state bank supervisor.

- An annual report must be filed within 90 days after the fiscal year-end for public institutions and 120 days after the fiscal year-end for institutions that are not a public company or a subsidiary of a public company. When required, the annual report must contain audited annual financial statements, the independent public accountant's audit report, management's statements and assessments, and the independent public accountant's attestation concerning the institution's internal control structure and procedures for financial reporting.
- Within 15 days after receipt, the institution must submit any management letter; the audit report and any qualification to the audit report; and any other report, including attestation reports, from the independent public accountant.
- Within 15 days of occurrence, the institution must provide written notice of the engagement of an independent public accountant, the resignation or dismissal of a previously engaged accountant, and the reasons for such an event.
- A written notice of late filing should be filed on or before the filing deadline if an institution is unable to timely file all or any portion of its Part 363 reporting requirements. The late filing notice shall disclose the institution's inability to file on time and the reasons in reasonable detail. It shall also state the date by which the reports will be filed.

In addition, Part 363 requires certain filings from independent public accountants. Prior to commencing any services for an insured depository institution under Part 363, the independent public accountant must have received a peer review or be enrolled in a peer review program that meets acceptable guidelines. Also, accountants must notify the FDIC and the appropriate federal banking supervisor when it ceases to be the accountant for an insured depository institution.

Audit Committee

Each institution subject to Part 363 must establish an independent audit committee of its board of directors. The members of the committee must be outside directors who are independent of management. Their duties include overseeing the internal audit function, selecting the accountant, and reviewing with management and the accountant the audit's scope and conclusions, and the various management assertions and accountant attestations. Part 363 establishes the following additional requirements for audit committees of insured depository institutions with total assets of more than $3 billion: two members of the audit committee must have banking or related financial management expertise; large customers of the institution are excluded from the audit committee; and the audit committee must have access to its own outside counsel.

Holding Company Subsidiaries

Subsidiary institutions of holding companies, regardless of size, may file the audited, consolidated financial statements of the holding company in lieu of separate audited financial statements covering only the institution. Subsidiary institutions with less than $5 billion in total assets may also elect to comply with the other requirements of Part 363 at the holding company level, provided the holding company performs services and functions comparable to those required of the institution. If the holding company performs comparable functions and services, the institution may elect to rely on the holding company's audit committee and may file a management report and accountant's attestations that have been prepared for the holding company. Subsidiary institutions with $5 billion or more in total assets may elect to comply with these other requirements of Part 363 at the holding company level only if the holding company performs services and functions comparable to those required of the institution, and the institution has a composite CAMELS rating of 1 or 2.

The institution's audit committee may be composed of the same persons as the holding company's audit committee only if such persons are outside directors of the holding company and the subsidiary and are independent of both organizations' management.

If the institution being examined is not the lead bank in the holding company, the examiner should confirm that the institution qualified for and invoked the holding company exemption. The examiner should also review the holding company reports to determine if any pertinent information about the institution was disclosed.

Mergers

Institutions subject to Part 363 that cease to exist at fiscal year-end have no responsibility under this rule. If a covered institution no longer exists as a separate entity because it merged into another institution after the fiscal year-end, but before the date its reports must be filed, institutions are not required to file a Part 363 Annual Report for the last fiscal year of its existence. An institution should consult with the Accounting and Securities Disclosure Section in Washington, DC, and its primary federal regulator if other than the FDIC, concerning the statements and reports that would be appropriate to submit under these circumstances.

Review of Compliance with Part 363

When reviewing the audit report, examiners should carefully assess any qualifications in the independent accountant's opinion and any unusual transactions. In reviewing management's report and the accountant's attestation, special attention should be given to any assessment that indicates less than reasonable assurance of effective internal controls over financial reporting, or less than material compliance with designated laws and regulations. Notices referencing a change in accountants should be reviewed for possible *opinion shopping* and any other issues that relate to safety and soundness issues.

The board's annual determination that all members of the audit committee are *independent of the management of the institution* should also be reviewed. For institutions exceeding $3 billion in total assets, the examiner should review board determinations and minutes documenting that at least two members of the audit committee have banking or related financial management expertise and that no member is a large customer of the institution. Appropriate recommendations should be made in the ROE if any determination is deemed unreasonable.

At the first examination of an institution subject to Part 363, examiners should fully discuss any apparent violations with management and the board. Based on their judgment of the situation, examiners should focus discussions on educating officers and directors and making appropriate recommendations about future compliance. The ROE should indicate the status of the institution's implementation efforts if not yet in full compliance with the rule.

Examiners should convey to the regional accountant any concerns regarding an accountant or an accounting firm's auditing, attestation, or accounting policies and procedures that may necessitate evaluating peer reviews. If the regional accountant considers a peer-review workpaper evaluation warranted, the regional accountant will confer with the Accounting and Securities Disclosure Section about conducting the review. This referral does not preclude the regional office from filing a complaint or recommending an enforcement action against the accountant. Peer-review workpaper evaluations are generally appropriate only in unusual or egregious circumstances; therefore, they should be relatively rare.

Examiners should not provide any written representations concerning Part 363 to institutions or their independent outside auditors. Examiners should refer institutions or auditors to regional accountants if they receive such requests.

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OTHER EXTERNAL AUDIT ISSUES

Communication with External Auditors

The Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners (1992 Policy Statement), includes guidelines regarding meetings between external auditors and examiners.

The FDIC encourages communication between its examiners and external auditors with the permission of an institution's management. Permission is deemed to have been given once an institution notifies the FDIC of the accountant's name or the accounting firm that it engaged as external auditor (by letter or by submitting a copy of the auditor's report to an FDIC regional office). Permission continues until the institution notifies the FDIC that its relationship with the external auditor was terminated or another auditor was engaged.

The FDIC encourages external auditors to attend exit meetings and other significant discussions at which examiners and management discuss examination findings. In addition, auditors may request a meeting to discuss relevant supervisory matters with any of the regulatory agencies involved in the institution's supervision. An auditor who determines that communication with the FDIC is warranted concerning a recent examination should contact the appropriate regional office. A regional office staff member, examiner, or field supervisor may discuss pertinent examination findings with the external auditor. Regulatory agencies will usually ask management to be represented at the meeting. However, an external auditor may request a meeting without management representation.

Requests for meetings and information can also originate with regulatory agencies. Examiners may request meetings, including confidential meetings, with an institution's external auditor if questions arise concerning matters on which the external auditor is knowledgeable. FDIC personnel should determine if the external auditor discovered any problems relevant to the FDIC. Furthermore, FDIC personnel may request copies of workpapers relating to services performed by the external auditor. In some instances, an FDIC examiner, field supervisor, or regional office staff member may determine that attending the meeting at which the audit report is discussed between an institution's auditors and its management or board of directors (or an appropriate committee) would be useful. The institution should be advised and asked to present the request to the auditor.

The 1992 Policy Statement encourages open communication between examiners and auditors, and suggests institutions should provide its external auditors a copy of certain reports and supervisory documents including: reports of condition, examination reports, regulatory correspondence, and any formal or informal regulatory agreements or actions.

Similarly, AICPA guidance suggests auditors should communicate with examiners. The guidance indicates auditors should consider reviewing communication from examiners, and when appropriate make inquiries of examiners. The AICPA guidance also indicates auditors should be responsive to examiner's requests to attend meetings between auditors and bank management, and that management's refusal to allow auditors to review regulatory material or to communicate with examiners would ordinarily be an audit scope limitation sufficient to prevent the auditor from rendering an opinion.

Workpaper Review Procedures

Examiners, in consultation with the regional accountant, may review external audit workpapers relating to audits of financial institutions or their holding companies. Workpaper reviews may enhance examiners' ability to scope an examination by identifying areas where audit work was sufficient to allow a reduction in examination procedures and by identifying higher-risk areas where examination procedures should be expanded. A workpaper review may be especially useful if an institution has asset quality problems, complex investments, aggressive accounting practices, mortgage servicing activities, or large deferred tax assets.

Before undertaking any workpaper review, examiners should coordinate activities with the state bank supervisor and primary federal regulator (if other than the FDIC) of the institution, its holding company, and any other holding company subsidiaries. No set of workpapers should be reviewed more than once by the agencies.

Examiners should review the workpapers of the independent public accountant or other auditor performing the institution's external auditing program when an FDIC-supervised institution has undergone a financial statement or balance sheet audit, and:

- Significant concerns exist regarding matters that would fall within the scope of the work performed by the institution's external auditors, or
- The institution has been, or is expected to be, assigned a UFIRS composite rating of 4 or 5.

However, when considering how best to use examination resources, examiners should exercise reasonable judgment with respect to performing an external audit workpaper review for these institutions. For example, it would be appropriate to conduct an external audit workpaper review for FDIC-supervised institutions when significant matters exist and the review is reasonably expected to provide an examination benefit. If examiners determine that a benefit would not be derived from performing an external audit workpaper review for an FDIC-supervised institution, examiners must document, and include in the examination workpapers, the reasons for not conducting the review.

Requests by the regional director for access to a public accountant's workpapers should be in writing and specify the institution to be reviewed, indicate the accountant's related policies and procedures should be available for review, and request that a staff member of the public accounting firm knowledgeable about the institution be available to answer questions. Because workpapers are often voluminous, examiners are expected to view them where they are located. Since these workpapers are highly confidential, examiners are encouraged to take notes of needed information and should request copies of only those workpapers necessary for their records. Examiners should not request copies of all workpapers.

Complaints Against Accountants

An examiner encountering possible violations of professional standards by a CPA or licensed public accountant should, if practical (after consulting with the regional office), discuss the matter with the accountant in an attempt to resolve the concern. If the concern is not resolved, the examiner should send a memorandum to the regional director, with a copy to the regional accountant, summarizing the evidence of possible violations of professional standards and the inability to resolve the matter with the accountant. After conferring with the Accounting and Securities Disclosure Section, the regional office may determine it is appropriate to inform the accountant that a complaint to the AICPA and/or state board of accountancy may be considered. Where notification of apparent violation of professional standards appears appropriate, letters should be concurrently forwarded by the regional director to the state board of accountancy in the institution's home state, the Professional Ethics Division of the AICPA (in the case of certified public accountants), the subject accountant or firm, and the RMS Accounting and Securities Disclosure Section.

In addition to violations of professional standards, complaints should also include evidence of substandard auditing work or lack of independence.

Third-Party Audits at FDIC's Request

Examiners sometimes determine an institution is involved in unique activities or complex transactions that are outside management's expertise. For example, the institution may carry certain complex financial instruments or other unusual assets on its financial statements at values management cannot adequately support and the examiner cannot confirm. Additionally, the institution may have certain internal control problems that require the expertise of an independent consultant to resolve properly.

In these situations, after receiving appropriate approval, examiners may request an institution to contract with an independent public accountant or other professional to perform specific work to address the identified concern. Such an assignment would not be included in the normal scope of work performed in external auditing programs. This additional work, when performed by an independent public accountant, may be considered an engagement to perform *agreed-upon procedures*, to issue a *special report*, or *to report on the application of accounting principles* under applicable professional standards. These latter two engagements are performed by an independent public accountant under GAAS or PCAOB standards, while agreed-upon procedures are performed under Generally Accepted Standards for Attestation Engagements (GASAE). If another type of professional is contracted to perform services for an institution, the professional may be subject to a different set of professional standards. Nevertheless, the important elements for the examiner to consider when evaluating the adequacy of the institution's contract with the professional are similar in all cases.

When the FDIC requires an institution to contract an independent public accountant or other outside professional for specific work, the regional office should ask the institution to provide the FDIC with a copy of the contract before it is signed. The regional office should review the contract to determine if it sufficiently describes the work to be performed so that the outside professional can understand the FDIC's expectations and be responsive to any specific work requirements. The contract or engagement letter should, at a minimum, include:

- A description of the work to be performed;
- The responsibilities of the accountant or other professional;

- An identification of any specific financial statement elements, accounts, or items on which the work is to be performed; the party responsible for recording them in the financial statements; and the basis of accounting of the specific elements, accounts, or items on which the work is to be performed;
- A reference to any applicable professional standards covering the work, such as auditing, attestation, and appraisal standards;
- A description of:
  - Any specific procedures to be performed,
  - Any specific information sources to be used,
  - The qualifications of employees who perform the work,
  - The time frame for completing the work,
  - Any restrictions on the use of the reported findings, and
  - A provision for examiner access to workpapers. For example:

    The workpapers for this (specify type of engagement, e.g., agreed-upon procedures, special report) are the property of (name of firm) and constitute confidential information. However, (name of firm) agrees to make the workpapers supporting this engagement available to the FDIC and other federal and state banking regulators. In addition to the workpapers, (name of firm) agrees to make any or all of the following available to the FDIC and other federal and state banking regulators:

    - The work plan or similar planning document relating to this engagement;
    - The process used for the selection of samples used in the specific work, if applicable; and
    - Other pertinent information on the firm's policies and procedures that may affect this work plan.

    Access to the workpapers will be provided at (name of firm) local office under the supervision of our personnel. Furthermore, upon the request of the FDIC or other federal and state banking regulators, we agree to provide photocopies of selected workpapers to them.

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SARBANES-OXLEY ACT

The Sarbanes Oxley Act of 2002 (SOX Act) was enacted to protect investors from fraudulent accounting activities by corporations. Protections center on annual financial disclosures and requirements that management and auditors establish internal controls and report on the adequacy of those controls.

The SOX Act is primarily directed toward companies that have a class of securities registered with the Securities and Exchange Commission or a federal banking agency. Applicability of the SOX Act to insured depository institutions depends primarily on an institution's size and whether it is a public company or a subsidiary of a public company.

Public Companies

Some FDIC supervised banks have securities registered pursuant to Part 335 of the FDIC Rules and Regulations and are therefore public companies. Other FDIC supervised banks are subsidiaries of public holding companies. Public companies and their independent public accountants must comply with the SOX Act, including provisions governing audit standards, management responsibilities, and financial disclosures.

Non-public Banks

Non-public banks generally do not fall within the scope of the SOX Act. However, existing regulatory guidance, such as Section 36 of the FDI Act and Part 363 of the FDIC Rules and Regulations, contains audit, internal control, and reporting requirements that mirror portions of the SOX Act. Although such practices are not mandatory for smaller, non-public institutions, the FDIC encourages all institutions to implement accounting, internal control, and reporting practices to the extent possible, given their size, complexity, and risk profile.

Reporting Requirements

Banks with total assets of $500 million or more at the beginning of their fiscal year are subject to the annual audit and reporting requirements of Section 36 of the FDI Act as implemented by Part 363 of the FDIC Rules and Regulations. Under certain circumstances, some institutions may satisfy Part 363 requirements by submitting audited, consolidated financial statements of their holding company. Key reporting requirements applicable to FDIC-supervised banks with $500 million or more in total assets include:

- Preparing annual financial statements in accordance with GAAP that are audited by an independent public accountant; and

- Preparing annual management reports that contain:
  - A statement of management's responsibilities for preparing financial statements, maintaining an adequate internal control structure, and complying with laws and regulations; and
  - An assessment by management of the institution's compliance with such laws and regulations during such fiscal year.

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EVALUATING AUDIT PROGRAMS

Examiners should evaluate audit and control procedures as part of their overall assessment of a bank's internal control program. Each bank presents unique situations to which common sense and technical knowledge must be applied. Examiners should consider an institution's risk profile, size, complexity, number of employees, etc., when determining the overall adequacy of an internal control program.

Recommendation Considerations

Examiners should inform management and the board if they identify material or numerous internal routine and control deficiencies. When deficiencies are considered to be of sufficient importance, appropriate comments should be included in the ROE. Examiners should make recommendations for corrective actions only after considering the following:

- Recommendations should have merit. Criticisms that could be regarded as petty or highly technical may not help improve the bank's control environment.
- The benefit to the bank of implementing a recommendation should be emphasized.
- Recommendations or criticisms should be discussed fully with management prior to bringing it to the board's attention, as the record or procedure being criticized may be more fully understood by a banker who can offer a persuasive reason for its continuance.
- Examiners should not recommend banks maintain records in a specific format, or obtain software or accounting forms from a particular vendor.
- Convincing management to implement corrective actions is best accomplished by identifying material deficiencies and recommending effective solutions. Discussing minor deficiencies with management and making verbal recommendations (which should be documented in examination workpapers) may result in more effective correction of non-critical deficiencies.
- The relative importance of an individual control or lack thereof must be viewed in the context of other related controls.

Troubled Banks

Examiners should identify banks that have not had audits performed by an independent public accountant and at which any of the following conditions exist:

- Internal controls or internal auditing procedures are inadequate,
- The directorate is generally uninformed in the area of internal controls,
- There is evidence of insider abuse,
- There are known or suspected defalcations,
- There is known or suspected criminal activity,
- It is probable that director liability for losses exists,
- Direct verification is warranted, or
- Questionable transactions with affiliates have occurred.

In these situations, the examiner and regional office staff should consider adding a provision to any contemplated administrative order that the bank obtain an audit or, if more appropriate, have an independent public accountant or other qualified independent party perform specified audit procedures. Because each situation is unique, the examiner and regional office must evaluate the type of external audit program most suitable for each troubled bank and, in conjunction with regional counsel, ascertain that the inclusion of such an external audit program as a condition in an order is appropriate. Whenever a condition requiring an audit or specified audit procedures is included in an order, it should include requirements that the bank promptly submit copies of the auditor's reports to the regional office and notify the regional office in advance of any meeting between the bank and its auditors at which audit findings are to be presented.

Management Responsibilities

Assessing internal control programs is a critical part of examinations. In most cases, examiners can assess the adequacy of a bank's internal controls by reviewing:

- The overall structure of audit and control programs, monitoring procedures, and reporting mechanisms;
- Various audit reports in conjunction with the completion of standard examination procedures; and
- A limited number of specific controls or audit procedures.

Examiners should focus on identifying and correcting systemic weaknesses when evaluating internal control programs. Serious program weaknesses may exist if management fails to:

- Delineate clear lines of authority and responsibility,

- Standardize risk assessment procedures,
- Segregate operating and recording functions,
- Provide adequate and qualified audit personnel, or
- Regularly review and respond to audit reports.

In some instances, internal controls, monitoring procedures, reporting mechanisms, or financial conditions may indicate that more extensive audit tests should be undertaken. Testing procedures that may help identify errors, fraud, or insider abuse are discussed in the Examination Techniques section below. Examiners should refer to the Bank Fraud and Insider Abuse section of this Manual if they identify material errors or irregularities.

Common Controls

The following functions and related audit procedures should be included in most audit programs. The list is not all-inclusive and deficiencies in any one area may not represent an overall inadequate control program.

Cash and Due From Audits

The primary objectives of cash and due from audits are to ensure account balances are properly recorded, cash items clear within a reasonable period, and due-from accounts are substantiated and tested.

Auditors should periodically verify cash on hand, cash items, overdrafts, and other assets or liabilities held in suspense to ensure items are properly controlled, recorded, and disposed.

Due from reconciliations should be reviewed each month by someone who does not regularly reconcile the accounts. Particular emphasis should be placed on reviewing old or recurring items. Auditors should obtain account statements from depository institutions as of the audit date, and subsequent to the audit date, for validating bank reconcilements and ensuring outstanding items are cleared. Auditors should review all return items for an appropriate period after the audit date.

Investments

The primary objectives of investment audits are to ensure:

- Physical security certificates are on hand or held in safekeeping by others;
- Book entries are properly recorded;
- Interest and dividend income and security gains or losses are properly recorded;
- Securities are properly recorded as held-to-maturity, trading, or available-for-sale;
- Personnel follow segregation-of-duty and joint-custody directives, and
- Temporary declines in value are identified.

Auditors should:

- Prove subsidiary records to the general ledger,
- Verify securities on hand or held by others for safekeeping,
- Check the gain and loss entries on securities sold or matured since the previous audit,
- Review accrued interest accounts and substantiate computations and dispositions of interest income, and
- Assess premium-amortization and discount-accretion calculations.

Loans

Auditors should periodically:

- Prove subsidiary records to the general ledger,
- Verify a sampling of loan balances on a positive or negative basis,
- Verify the existence of negotiable collateral,
- Review accrued interest accounts and confirm the computation and disposition of interest income,
- Verify leases and related balance sheet accounts,
- Test unearned discount accounts, and
- Check rebate amounts for prepaid loans.

Allowance for Loan and Lease Losses (ALLL)

Auditors should:

- Review the balance of loans with charge-offs and the debit entries to the ALLL account,
- Review the balance of loans with recoveries and the credit entries in the ALLL account,
- Check supporting documentation for loans charged off, and
- Determine compliance with GAAP regarding the ALLL methodology used to estimate credit losses on individually and collectively evaluated loans.

Bank Premises and Equipment

Auditors should:

- Review entries and documentation relative to purchases and sales of premises and equipment since the previous audit;
- Verify computations of depreciation, amortization, and impairment;
- Check computations of gains or losses on property sold; and

- Trace sale proceeds.

Other Assets and Other Liabilities

Auditors should ascertain the appropriateness of other-asset and other-liability accounts by reviewing related policies, procedures, and internal controls and ensuring transactions are properly authorized, recorded, and balanced.

Deposits

Auditors should:

- Reconcile subsidiary records to general ledger accounts,
- Verify account balances on a test basis,
- Review closed accounts and determine if the accounts were properly closed,
- Review activity in dormant accounts and insider accounts,
- Review overdrafts,
- Check the computation of service charges and trace postings to appropriate income accounts,
- Review accrued interest accounts and check the computation of interest expenses,
- Verify the numerical sequence of pre-numbered certificates of deposit and official checks,
- Reconcile and determine the validity of outstanding official checks,
- Examine documentation supporting paid official checks, and
- Test certified checks to customers' collected funds.

Borrowed Funds

Auditors should:

- Confirm borrowings were authorized in accordance with internal policies,
- Verify balances of borrowed funds,
- Ensure collateral for borrowings is properly identified and disclosed,
- Verify changes in capital notes outstanding, and
- Review related accrued interest computations and interest expense balances.

Capital Accounts and Dividends

Auditors should account for all unissued stock certificates, review capital account changes since the previous audit, check computations for dividends paid or accrued, and review board minutes to determine the propriety of dividend payments and accruals.

Other Control Accounts

Auditors should test rental income for safe deposit boxes, examine and confirm safekeeping items, and reconcile consigned items on hand.

Income and Expenses

Auditors should test income and expenses by examining supporting documentation for authenticity and proper approval, and should test accruals by either re-computing amounts or examining documents supporting such accruals.

Direct Verification

Direct verification is an effective method of confirming the accuracy and validity of certain accounts, particularly loan and deposit accounts. Direct verification should be an important part of all internal and/or external audit programs, and may be employed as an internal control separate from regularly scheduled audits.

There are two primary types of direct verification, positive and negative. When the positive method is used, the customer is asked to confirm whether the balance, as shown, is correct. When the negative method is used, a reply is not requested unless an exception is noted.

The positive method has advantages from an audit standpoint as it provides considerable assurance the customer has carefully checked the confirmation form. The negative method is less costly and provides a measure of protection in those institutions having a strong program of internal control. The positive method is recommended for loan accounts. The positive method is preferred for deposit accounts, but because of high volume and cost factors, the negative method is often employed.

It is suggested that at a minimum, large deposit accounts, public fund accounts, dormant accounts, and accounts with unusual or high volumes of activity be positively verified. Additionally, overdue loans and charged-off loans should be confirmed through positive verification.

Direct verification may be conducted for all customers within a specific account type or through an appropriate sample. The necessity for a complete verification of loans or deposits is rare. A partial verification of representative accounts is usually satisfactory.

Direct verification may be performed by bank staff or contracted to a third party. To be effective, the verification procedure (including follow-ups) must be completely controlled by someone that does not have responsibility for the accounts or records being verified.

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FRAUD AND INSIDER ABUSE

Introduction

Financial institutions are highly susceptible to fraud, embezzlements, and theft; and bank personnel at every level have opportunities to commit dishonest acts. Uncovering fraud is not the primary reason examinations are conducted; however, examiners must be able to recognize fraudulent or abusive actions.

The following items include higher-risk accounts and common methods for manipulating financial records.

Loans

Forged or fictitious notes; accommodation loans; loans to insider-related shell companies; embezzlement of principal and interest payments; failure to cancel paid notes; use of blank, signed notes; embezzlement of escrow and collection accounts; commissions and kickbacks on loans; fraudulent loans to cover cash items and overdrafts; and diverted recoveries of charged-off loans.

Loan Collateral

Loans secured by fraudulent collateral such as altered, stolen, or counterfeit securities; certificates of deposit issued by illegitimate offshore banks; and brokered loans and link-financing arrangements where underlying collateral is not properly pledged or is prematurely released.

Deposits

Unauthorized withdrawals from dormant accounts; fictitious charges to customer accounts; unauthorized overdrafts; payment of bank-personnel checks against customer accounts or fictitious accounts; manipulation of items used to reconcile deposit trial balances; unauthorized withdrawals from accounts where the employee is acting as an agent or in some other fiduciary capacity; withholding and destroying deposit tickets and checks; misappropriation of service charges; check kiting; and manipulation of certificates of deposit, money orders, and official checks.

Correspondent Bank Accounts

Concealing a shortage by unreasonably delaying the recording of cash letters; delayed remittance of cash letters; fictitious credits and debits; manipulations to prevent the detection of overstated balances, such as issuing drafts without corresponding recordation on the bank's books or credit to the account; overstatement of cash letters and return items; and false collection items.

Tellers and Cash

Lapping deposits (covering one day's shortage with the next day's receipts); theft of cash; excessive over and short activity; fraudulent checks drawn on customers' accounts; fictitious cash items; manipulation of cash items; and intentional failure to report large currency transactions or suspicious activity.

Income and Expense

Embezzlement of income; fraudulent rebates on loan interest; fictitious expense charges; overstated expenses; and misapplication of credit life insurance premiums.

Investment Securities

Collusion between a bank employee and a securities dealer to trade securities at inflated prices; concealing trading losses from bank management and examiners; and unauthorized purchases and sales of securities, futures, or forward contracts with benefits accruing to a bank employee. Improper securities trading practices include:

- Placing personal trades through bank accounts, thereby obtaining the advantage of the bank's volume discounts on commissions;
- Purchasing or selling an issue of securities prior to executing bank or trust account trades, which could be expected to change the price of the security thereby providing a personal price advantage (front-running);
- Purchasing and selling the same securities on the same day with the trader retaining the gains from any price increase, but assigning losses to trust accounts if prices decrease; and
- Buying or selling based on nonpublic, inside information, which might affect the price of securities thereby enabling the trader to benefit personally from the transaction.

Additional Risks

Numerous methods are used to defraud banks and pose an ongoing problem. While no bank is exempt from the threat of defalcations by management, employees, or outsiders, certain institutions are more vulnerable than others. Any of the following situations may indicate the need to use more comprehensive audit techniques:

- An institution has one officer with dominant control over a bank's operations.
- Audit programs are inadequate.

- Internal control deficiencies are evident, such as weak vacation policies or ineffective segregation of duties.
- Records are poorly maintained or carelessly handled.
- Close supervision by the board of directors or senior management is inadequate, especially where rapid growth has occurred or numerous inexperienced managers are employed.
- A bank has grown substantially in a short time period. (The growth may have involved the use of high deposit rates, brokered funds, fraudulent or poor quality loans, or dishonest acts to conceal the bank's true condition.)
- A bank has had limited growth or a steady decline in deposits despite general economic prosperity in their operating area or strong growth by competing institutions.
- Earnings and yields are below average and expenses are high in comparison with past operating periods with no apparent explanation for the change.
- The bank is experiencing abnormal fluctuations in individual revenue or expense accounts, either in terms of dollar amounts or in relation to other operating accounts.

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EXAMINATION TECHNIQUES

Introduction

Numerous methods for concealing fraud exist, and even comprehensive audit techniques may not expose deceptive practices. However, when necessary, examiners should conduct detailed audit procedures. The audit techniques described below are not intended to be used at every examination; however, examiners should consider using these or similar techniques when appropriate.

Examiners should consult with the regional office if fraud-related examination procedures appear warranted.

Account Reconcilements

Examiner-prepared reconcilements of asset, liability, and capital accounts help ensure entries are properly recorded and subsidiary account records balance to the general ledger.

Direct Verification

Direct verifications are rarely initiated by regulatory personnel. Typically, financial institutions perform the verifications as part of their comprehensive audit function. If examiners, in consultation with regional office personnel, determine direct verifications are necessary, it is preferred that the bank or its external auditors make the customer contacts as these parties can more efficiently verify transactions with bank customers.

However, in certain situations it may be necessary for the FDIC or another banking agency to perform direct verifications. This may be appropriate if significant unreconciled items are disclosed, or evidence of potential fraud exists. Regional director approval must be obtained before examiners initiate direct verification of bank accounts or transactions. The following basic procedures or guidelines should be used if direct verifications are performed by FDIC staff.

- Addressing, stuffing, sealing, and mailing of envelopes should be done by examination personnel only.
- Franked envelopes furnished for reply should be preaddressed to the field office, regional office, or a post office box rented for the purpose.
- Duplicate records of all items verified should be maintained for control purposes.
- Examiners should watch for borrowers with common addresses or post office box numbers and for accounts having the same addresses as bank officers and employees.
- Loan verifications should include charged-off notes; separate notices should be sent to primary obligors, co-makers, endorsers, and guarantors.
- Third-party guarantees on lines of credit or individual notes should be verified directly with guarantors, not through primary obligors.
- Deposit verifications should be considered for recently closed dormant accounts, overdrawn accounts, and pledged accounts.
- All replies should be compared against retained duplicate records. Exceptions should be fully investigated against bank records or through follow-up correspondence with customers.
- Undelivered and returned tracers, unacknowledged verifications, and unexplained differences should be discussed with the entire board, not just with officers.

Loans

Examiners should consider using the techniques discussed below during loan reviews, especially if credit administration is weak or if they identify potential irregularities.

- Compare the signature on a note with other notes or documents signed by the maker.
- Review bank records to determine who actually pays the interest and principal (and the source of the funds) on large lines of continuous credit.

- Review records for power-of-attorney agreements giving an individual other than the named borrower(s) control of loan proceeds. (The agreements may be a sign of straw/nominee loans.)
- Review records for any changes to the official signers on deposit accounts established to receive loan proceeds. This may allow individuals other than the named borrower(s) to control loan proceeds.
- Investigate weak credit lines where directors or management may be the interested party although the bank's records do not reflect their interests.
- Spot check a cross section of out-of-territory loans to verify the disbursement of loan proceeds and the source of principal and interest payments.
- Audit the interest collected on a sampling of loans. Review the loan interest account for several days and compare the total with journal figures and the amount credited to the general ledger.
- Compare collateral records to loans secured by such collateral, and compare the collateral receipt date with the date the loan was granted.
- Review charge-offs in banks with large or numerous charge-offs. Verify the amount charged off was the approved amount; determine who prepares the list of charge-offs, who collects recoveries, and the accuracy of the reporting of these items. Compare actual loan documents with the bank's records to confirm balances and signatures.
- Consider tracing the proceeds of large loans and lines of credit that are subsequently charged off. (Tracing loan proceeds involves following the trail of funds from initial and subsequent loan disbursements to determine the person or entity that ultimately received the funds and how the funds were used. Disbursements may be transmitted by cash, check, wire transfer, other electronic means, or a credit to deposit/loan accounts at the bank.) When large loans are funded or material loan losses incurred, it may be advisable to analyze credits by tracing disbursement of loan proceeds and reviewing the borrower's deposit account(s) for possible payments of commissions or fees to a bank officer.
- Consider the following when reviewing the recordkeeping and monitoring of principal and interest receipts, especially payments relating to revolving accounts-receivable (A/R) financing:
    - Review records for occurrences of lapping payments. (Lapping occurs when an employee misappropriates funds (such as a loan payment), and covers the theft with payments from another loan customer or from advance (early) payments from the same customer.)
    - Review records for occurrences of payments made through the creation of fraudulent notes or unauthorized use of dealer reserve accounts.
    - Check records for an unusually large number of advance payments or overdue loans. In suspect cases, trace a sample of transfers to and from borrowers' checking accounts.
    - Spot check a cross-section of loans for appropriate signatures, disposition of proceeds, collateral, and sources of payment (particularly if outstanding loan volumes increased substantially between examinations for no apparent reason and overdue loans are unusually low or high).
    - Review records for occurrences of loan payments that come from the proceeds of other loans. Be watchful for multiple payments made on the same date for a particular note or borrower and compare the total of the payments with new loans granted on or about the same date.
    - Spot check for adequate recordkeeping if indirect dealer-paper lines are poorly monitored.

Deposits

Risks associated with inappropriate deposit account transfers are elevated in banks with weak internal controls and audit programs. Consider the following items when investigating potentially improper activities relating to deposit accounts.

- Reconcile subsidiary and general ledger accounts and any related adjustment items such as return items, overdrafts, holdovers, or service charges.
- Review any unusual or unapproved withdrawals from inactive or dormant accounts.
- Compare cash items, rejects, and exception items to individual account records to determine if the accounts exist, have sufficient funds, or have been closed.
- Cross check the interest paid on certificates of deposit to the interest expense account to verify ownership, dates, amounts due, and amounts actually paid.
- Be alert for possible check kiting when reviewing accounts. When available, review reports on kiting suspects and uncollected funds. Kiting characteristics include a high number of daily deposits, a high percentage of deposits coming from accounts under common control of a kiting suspect, large round-dollar checks, total daily debits and credits of similar amounts, and small average balances.
- With a bank employee, reconcile incoming cash letters and local clearings, and sight-post items to demand account records to determine if there is an account for each item. If the cash letter has already been opened, compare the number of items listed on the tape accompanying the letter with actual items to ascertain whether any items have been removed.

Correspondent Bank Accounts

The following audit steps can be used when evaluating correspondent accounts:

- Reconcile subsidiary and general ledger accounts, and compare a sample of paid and cancelled drafts drawn on correspondent banks to ledger entries for the same days. Select appropriate test periods, such as the date, and for several subsequent days after, material business activities occurred or the date institutions were notified of upcoming examinations.
- Review prior internal reconcilements of cash due from correspondents and statements received from correspondents. Ensure the reconcilements identify large outstanding items, unusual activity, forced balancing, and unreasonable or ongoing delays in crediting correspondents for their charges. (Delays in remitting for cash letters can be used to cover defalcations.) Also, ensure irregular items are properly reported.
- Review entries of similar amounts and dates between correspondent accounts that may indicate possible kiting or shortages between correspondent accounts.
- Compare coin and currency transactions reflected on correspondent accounts to the bank's increase or decrease in the cash account on corresponding days.

Tellers and Cash

When warranted, tellers' daily cash records can be inspected for possible discrepancies such as mathematical errors, forced balancing, unusual charges or adjustments, and excessive total balances or number of cash items. Items drawn on or by bank personnel should always be verified as to final payment or disposition. All work can be checked for proper endorsements and dates that indicate a teller is carrying items for an excessive period.

Suspense Accounts

Suspense accounts are sometimes used to conceal shortages, worthless assets, and deposit diversions. Review suspense accounts for material, stale, or unusual items, especially noting the recurring use and aging of reconciling items.

Income and Expense Accounts

Examiners can test interest computations on a sample of loans and securities. Verify large, recurring, or unusual debits to income accounts, and test interest rebates on loans and monthly service charges on demand deposits. Finally, compare interest paid on time and savings deposits to the amount credited to respective control accounts.

General Ledger Accounts

Determine the reason for any unusual activity in general ledger accounts, or abnormal variations between various general ledger accounts, and assess the validity of any reversing or correcting entries. Select appropriate test periods, such as the date, and for several subsequent days after, material business activities occurred or the date institutions were notified of upcoming examinations. Trace all closing income entries to the undivided profits account.

Other

Be alert for any major changes, particularly growth, in asset or liability totals. In cases of rapid loan expansion, check for possible out-of-territory loans to insiders. Also, if loans and certificates of deposit have increased beyond normal expectations, check the source of certificates of deposit; check for tie-ins between new notes and new certificates of deposit as to common names, amounts, and dates; trace the proceeds and determine the source of principal and interest payments on potentially inappropriate new loans.

Secretary of State Websites

Many states have websites examiners can use to obtain useful information on an entity's corporate structure, principal shareholders, or officers and directors. The websites may also contain information on the principals' other business relationships.

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RELATED CONTROL ISSUES

Information Technology

Part 364 of the FDIC Rules and Regulations requires financial institutions to have internal controls and information systems commensurate with the size of their institution and the nature, scope, and risk of their activities. Appendix B of Part 364 requires banks to have information security programs that include administrative, technical, and physical safeguards. Program standards should be designed to:

- Ensure the security and confidentiality of customer information;
- Protect against anticipated threats to the security or integrity of such information;
- Protect against unauthorized access to, or use of, information that could result in substantial harm or inconvenience to any customer; and
- Ensure the proper disposal of consumer information.

A bank's board of directors, or an appropriate board committee, should:

- Approve a written information security program;
- Oversee the development, implementation, and maintenance of the program;
- Assign specific responsibility for implementing the program; and
- Review reports from management.

Information systems present a variety of risks that, if not adequately managed, can negatively affect the safety and soundness of the institution. Therefore, examiners should assess information technology controls and operations at every examination. If an institution's internal control systems do not meet the program standards described above, the deficiencies should be described in the ROE.

Institutions should maintain a comprehensive security plan in order to maintain the confidentiality, integrity, and reliability of information. The plan should include regular risk assessments and, at a minimum, address physical and logical security, and backup and contingency strategies.

Generally, IT risk assessments consist of the identification of hardware, software, and information; an analysis of internal and external threats to the assets; and an evaluation of existing controls. The findings can provide management valuable information regarding the security of IT assets and any controls that may need strengthening. Management should use the information to develop strategies for improving identified control weaknesses and mitigating identified risks.

The FFIEC IT Examination Handbook, which comprises a series of booklets, serves as a reference for managing and examining IT systems. The Handbook contains IT examination procedures, workprograms, and references to related laws, regulations, and examination policies. It also provides examiners with fundamental principles of internal controls applicable to information processing environments. The FFIEC procedures and workprograms are the primary tools for the examination of large, complex data centers in financial institutions and independent technology service providers.

Examiners can also use portions of the FFIEC procedures and workprograms when necessary to review complex or high-risk areas during IT reviews of less complex, well-managed institutions.

Management Information Systems

The term *management information system* (MIS) broadly refers to a comprehensive process, supported by computer-based systems, that provides the information necessary to manage an organization. An effective MIS is essential in all institutions, but becomes increasingly important for managing risks in larger institutions with diverse business lines or a wide geographic footprint. Essential components of an effective MIS include timeliness, accuracy, completeness, consistency, and relevance. Management decisions may be invalid if any one of these components is compromised.

To evaluate an MIS, and ultimately the foundation upon which management's decisions are based, examiners should scrutinize each of the essential components. First, information must be current and available in a useful format to all appropriate users. This necessitates the prompt collection and editing of data. Second, an effective system of internal controls must be in place to ensure information is accurate and complete. Third, strategies and decisions cannot be adequately monitored or measured unless the information provided is consistent. Variations in how data is collected or reported can distort its usefulness, particularly in trend analyses. Any change in information collection or reporting procedures should be clearly defined, documented, and communicated to all users. Finally, the information provided must be relevant to the user. Reports that are overly complex or include unnecessary information impede users' ability to make effective decisions. Conversely, reviewing information from numerous reports can hinder analysis; therefore, a key consideration in the adequacy of reports is that they present information in a comprehensive, yet concise format.

Payment Systems

Financial institutions process a variety of payment instruments using various clearing and settlement systems. The systems are generally differentiated as wholesale or retail systems.

Although there is no definitive division between retail and wholesale payments, retail payment systems generally involve transactions between two consumers or between consumers and businesses and have higher transaction volumes and lower average dollar values.

Key risks in payment and settlement systems include:

- Credit Risk - The possibility a counterparty will not settle an obligation for full value either when due, or anytime thereafter.
- Liquidity Risk - The possibility a counterparty will not settle an obligation for full value when due.
- Operational Risk - The possibility of loss resulting from external events or inadequate internal processes,

people, or systems. This type of risk includes physical and logical security threats.
- Legal Risk - The possibility of loss because of the unexpected application of a law or regulation, or because a contract cannot be enforced.

Risk profiles vary significantly based on the size and complexity of an institution's payment-system products and services, IT infrastructure, and dependence on third parties. All financial institutions should maintain an effective internal control environment commensurate with the level of payment products and services offered. Detailed procedures for reviewing retail and wholesale payment systems are covered in the FFIEC IT Examination Handbooks.

Lost and Stolen Securities Program

The SEC started the Lost and Stolen Securities Program in 1977 to reduce trafficking in lost, stolen, missing, and counterfeit security certificates. Security certificates are documents representing, or claiming to represent, ownership in a security.

A security may be certificated or uncertificated. Ownership of a certificated security is represented by a security certificate. Ownership of an uncertificated security is not represented by a physical document, but simply by registration on financial records (book entries). The vast majority of securities are held in book entry form with a custodian.

Banks may acquire certificated securities when investing, holding securities as trust assets or collateral for loans, or through transfer agent activities. In each situation, a bank might acquire a security certificate that was reported as lost, stolen, counterfeit, missing, or otherwise encumbered.

The SEC implemented Rule 17f-1 to govern the reporting and recordkeeping of securities as a means for reducing trafficking in lost, stolen, missing, and counterfeit securities. The Securities Information Center (SIC) operates the SEC's Lost and Stolen Securities Program. The SIC may be contacted at the Securities Information Center, Inc., P.O. Box 55151, Boston, MA 02205-5151 or at www.secic.com.

Registration

All registered FINRA[1] broker dealers, FDIC-insured banks, and transfer agents that handle physical certificates must be registered with the SIC in order to report securities to the SIC database, or make database inquiries. Banks that did not handle certificated securities within the last six months do not need to be registered.

Registration can be direct or indirect. Banks registered as direct inquirers are allowed to make inquiries against the SIC database. Banks registered as indirect inquirers must have an agreement with a direct inquirer who makes inquiries on their behalf. In either event, institutions may inquire of the SIC whether a certificate has been reported as lost, stolen, counterfeit, missing, or otherwise encumbered (restricted, cancelled, escheated, etc.).

Inquiries

Insured depository institutions are required to make inquiries by the end of the fifth business day after a securities certificate comes into their possession, provided that such inquiries shall be made before the certificate is sold, used as collateral, or sent to another reporting institution (which includes broker dealers, transfer agents, and clearing agencies). Inquiries are not required if the securities certificate:

- Was received directly from the issuer or issuing agent at the time it was issued;
- Was received from another reporting institution or Federal Reserve bank or branch;
- Was received from a bank customer and is registered in the name of the customer or its nominee, or was previously sold to the customer as verified by internal bank records;
- Was part of a transaction having an aggregate face value of $10,000 or less in the case of bonds, or an aggregate market value of $10,000 or less in the case of stocks; or
- Was received directly from a drop that is affiliated with a reporting institution for the purposes of receiving or delivering certificates on behalf of the reporting institution.

Reporting

Reporting requirements vary based upon the type of issue being reported and the type of entity doing the reporting. In general, banks should report:

- Stolen security certificates (or the loss of any securities where criminal activity is suspected), to the SIC and the registered transfer agent for the issue, within one business day of the discovery. If the certificate numbers of the securities cannot be determined within one business day, they should be reported as soon as possible. Stolen securities must also be promptly reported to the Federal Bureau of Investigation.

1 The Financial Industry Regulatory Authority (FINRA) is an independent regulator for securities firms doing business in the U.S.

- Security certificates missing or lost for a period of two business days, to the SIC and the registered transfer agent, within one business day of the discovery. Certificates lost, missing, or stolen while in transit shall be reported by the delivering institution.
- Counterfeit securities to the SIC, transfer agent, and Federal Bureau of Investigation within one business day of the discovery.
- Otherwise impaired security certificates on a voluntary basis. The SEC encourages institutions to report on and inquire about encumbered certificates that are not specifically subject to Rule 17f-1, such as restricted, cancelled, or escheated certificates.

Banks that recover a lost, missing, or stolen securities certificate must report recoveries to the SIC and registered transfer agents within one business day of recovery. The recovery of certificates that were reported lost, missing or stolen and involved allegations of criminality must also be reported to the Federal Bureau of Investigation.

Banks must report lost, stolen, or counterfeit items on SEC Form X-17F-1A. Reports to the Federal Bureau of Investigation may be made on SEC Form X-17F-1A or Suspicious Activity Reports.

Note: Institutions must file a Suspicious Activity Report (SAR) with the Financial Crimes Enforcement Network within 30 days of discovery for:

- Insider abuse involving any amount,
- Transactions aggregating $5,000 or more where a suspect can be identified, or
- Transactions aggregating $25,000 or more regardless of potential suspects.

Refer to 17 CFR Part 240, Rule 17f-1 for a complete description of all reporting requirements.

Exemptions

The following types of securities are not subject to the SEC's inquiry and reporting requirements:

- Security issues not assigned CUSIP numbers,
- Bond coupons,
- Uncertificated securities,
- Global securities issues, and
- Any securities issue for which a negotiable securities certificate cannot be obtained.

Examination Considerations

Examiners should periodically:

- Ensure banks are directly or indirectly registered, or exempt from SEC registration requirements;
- Discuss Rule 17f-1 with bank personnel to evaluate their understanding of the rule;
- Review documentation relating to inquiries and reporting to ensure compliance with the rule; and
- Assess the adequacy of audit procedures covering the lost and stolen securities program.

Examiners should cite noncompliance with SEC Rule 240.17f-1 as an apparent violation on the Violations of Laws and Regulations page.

Improper and Illegal Payments

The Foreign Corrupt Practices Act (FCPA) and the Federal Election Campaign Act (FECA) cover improper and illegal payments by banks and bank holding companies. The FCPA prohibits bribes to foreign government officials to obtain or keep business.

The FECA prohibits national banks from making contributions relating to elections to any political office, including local, state, and federal offices. State-chartered institutions are also prohibited from contributing to any federal office, but may make contributions connected to state and local elections if authorized under their state's laws. However, all contributions must be properly authorized and recorded.

Improper methods for making political contributions may involve falsified expense accounts, below-market rate loans, providing equipment or services without charge, and paying bonuses to employees or excessive fees and salaries to officers that are then contributed to a campaign. These methods involve unacceptable accounting practices, and, if identified, reflect unfavorably on management and internal control and audit programs.

Examiners should consider the following items when evaluating the effectiveness of an institution's controls over political contributions.

1. Determine whether the bank has a policy prohibiting improper or illegal payments, bribes, kickbacks, loans, etc., relating to domestic and foreign governments or political campaigns.

2. If the bank has such a policy, review and analyze it for adequacy, and determine if it is appropriately communicated to officers, employees, and agents of the bank.

3. Review any audits or reports that evaluate policies or operations relating to funds or services provided in

connection with political campaigns. In addition, review any investigative reports generated by other government agencies.

4. Review and analyze any internal or external audit programs relating to political contributions and determine if the programs include appropriate procedures for discovering and reporting improper practices or illegal payments. Determine whether the programs remind auditors to be alert to any unusual entries or charges that might involve improper or illegal payments, and review the results of any related audits.

5. Analyze the general adequacy of internal controls to determine whether there is sufficient protection against improper or illegal payments under the aforementioned statutes.

6. If examination analysis indicates political-contribution audit programs or internal controls are inadequate, examiners should consider performing additional analysis, such as:

   - Reviewing income and expense account entries (and supporting documentation) since the last examination for large or unusual items.
   - Reviewing bank-controlled accounts, such as dealer reserves and cash/collateral accounts, to determine the validity of entries and adequacy of customer notifications. With respect to official bank checks, review copies of the checks and supporting documentation for unusual items or checks to political organizations or related individuals.
   - Reviewing charged-off loan files to determine the appropriateness of any charge-offs to government officials, or political candidates or political organizations.
   - Review new loan and time deposit relationships with public entities and municipalities that originated since the prior examination. Inquire about the nature and source of the new relationship(s). If inquiries raise suspicions, review credit underwriting documents and trace loan proceeds to resolve outstanding questions or concerns. Similar procedures should be conducted for customers identified as Politically Exposed Persons.

7. When performing routine examination procedures, examiners should be alert for any transactions, or the use of any bank services or equipment, that might involve bribes, political campaigns, or inappropriate political activities. The activities may be identified through the review of items such as:

   - Loans or lines of credit;
   - Income and expense entries;
   - Director, officer, and employee deposit accounts or overdrafts; and
   - Official checks and escrow accounts.

References:

- FFIEC IT Examination Handbooks
- Manual Section 9.1, Bank Fraud and Insider Abuse

DEFINITIONS AND AUTHORITIES

Sections 23A and 23B of the Federal Reserve Act (FR Act), as applied by the Federal banking agencies under various Federal banking statutes, govern transactions between banks and affiliated business organizations. The Gramm-Leach-Bliley Act (GLBA) amended many laws governing the affiliation of banks and other financial service providers. Among other laws, the GLBA amended the Banking Act of 1933, the Bank Holding Company Act of 1956, (BHC Act), the Interstate Banking and Branching Efficiency Act of 1994, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, the International Banking Act of 1978, the FR Act, the Federal Deposit Insurance Act (FDI Act), and the Home Owners' Loan Act.

Section 18(j) of the FDI Act extends the provisions of Sections 23A and 23B of the FR Act to state nonmember banks. Section 23A regulates transactions between a bank and its "affiliates," as that term is specifically defined in Section 23A. Section 23B of the FR Act was enacted as part of the Competitive Equality Banking Act of 1987 to expand the range of restrictions on transactions with affiliates. Section 10(b)(4) of the FDI Act authorizes FDIC examiners in the course of examining insured banks "to make such examinations of the affairs of any affiliate of any depository institution as may be necessary to disclose fully --- (i) the relationship between such depository institution and any such affiliate; and (ii) the effect of such relationship on the depository institution." "Affiliate" is defined in Section 3(w)(6) of the FDI Act as having the same meaning as the definition of that term in Section 2(k) of the BHC Act.

FDIC's enforcement authority also extends to certain parents and affiliates which are not bank holding companies. Section 3(u) of the FDI Act defines "institution affiliated parties" to include the controlling stockholder of an insured depository institution, or any shareholder or person who participates in the conduct of the affairs of an insured depository institution, or any independent contractor who participates in certain acts which cause significant adverse affect on an insured depository institution. This would include the parent companies of Industrial Loan Companies and other "non-bank" charters. Under Section 8(b) of the FDI Act, the FDIC can issue Orders against institution affiliated parties.

This section of the Manual discusses affiliates and subsidiaries, including the restrictions on transactions between affiliates and insured banks, exceptions to those restrictions, and the examination authority of the FDIC with respect to affiliates of nonmember insured banks. It also discusses the major provisions of the GLBA as affecting such transactions and the statutory implications for the FDIC examination process.

GRAMM-LEACH-BLILEY ACT (GLBA)

The passage of the GLBA significantly expanded the powers of bank subsidiaries of bank holding companies to engage in "financial activities," including offering insurance and securities products. The GLBA added Section 46 of the FDI Act that prescribes the circumstances in which an insured state bank may engage in financial activities as principal that may be conducted by a national bank only through a financial subsidiary. The GLBA also repealed the restrictions on banks affiliating with securities firms which were contained in Section 20 of the Glass-Steagall Act and repealed the prohibition on interlocking directors between banks and securities firms contained in Section 32.

Financial Holding Company

The GLBA authorizes the organization of a "financial holding company" (FHC) under Section 4 of the BHC Act. A FHC can engage in any activity, and may acquire shares of any company engaged in any activity, that the Board of Governors of the Federal Reserve System (the FRB) determines to be either financial in nature or incidental to such financial activity, or complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

The GLBA identifies some specific activities which are determined to meet this test and prescribes a consultative process involving the shared input of both the FRB and the Secretary of the Treasury for future definition of activities determined to meet the test.

Section 4(k)(4) of the BHC Act identifies a list of specific activities deemed "financial in nature" for these purposes. Qualifying FHCs may engage in such activities without regulatory approval provided notice is given to the FRB within 30 days after the activity is commenced. The listed activities include:

- Lending, exchanging, transferring, investing for others, or safeguarding money or securities,
- Insuring, guaranteeing or indemnifying against loss or illness, or issuing or providing annuities, as principal, agent or broker,

- Providing various forms of financial, investment or economic advisory services, including advising investment companies,
- Issuing and selling instruments representing interests in pools of assets permissible for a bank to hold directly,
- Securities underwriting, dealing and market making,
- Engaging in activities that have been determined to meet the “closely related” and “proper incident” tests under Section 4(c)(8) of the BHC Act,
- Engaging in activities in the United States that the FRB has previously authorized bank holding companies and their subsidiaries to conduct abroad under Section 4(c)(13) of the BHC Act,
- Certain merchant banking activities, and
- Certain “insurance company portfolio investment” activities.

Conditions Precedent to New Activities:

The following guidelines exist relative to a bank holding company entering into new activities:

- All depository institution subsidiaries of the bank holding company must be “well capitalized” and “well managed.”
- A “satisfactory” or better CRA rating must have been received by all of the depository institution subsidiaries at their most recent examination.
- The bank holding company must file with the FRB an election to become a financial holding company.
- There is a grandfather provision for certain non-conforming activities of a company that is not now a bank holding company but then becomes one to continue to engage in commercial activities in an amount not to exceed 15 percent of its consolidated annual gross revenues, excluding bank subsidiaries. The grandfather provision will expire ten years after the date of enactment, unless extended by the FRB for an additional five years.

The FRB is the umbrella supervisor for FHC’s. As such, the FRB assesses the FHC’s overall financial condition and the systems for monitoring risks for the entity as a whole.

Financial Subsidiaries

Implementing Section 121 of the GLBA as it pertains to state nonmember banks, the FDIC added Subpart E to Part 362 of its regulations. For purposes of Subpart E, a “financial subsidiary” is defined as a subsidiary that is controlled by a state nonmember bank and engages as principal in activities which may be conducted by a national bank only through a financial subsidiary. Most activities that were identified in the GLBA as being financial in nature are already permissible for a national bank to conduct directly.

The statutory criteria that must be satisfied in order to engage in activities through a financial subsidiary are:

- The state nonmember bank and each insured depository institution affiliate of the state nonmember bank must be and continue to be well capitalized after deducting the bank’s investment, including retained earnings, in all financial subsidiaries.
- The state nonmember bank must disclose the capital deduction and the separate assets and liabilities of the subsidiary in any published financial statement.
- The state nonmember bank must comply with the ongoing financial and operational safeguards required by Section 5136A(d) of the Revised Statures of the United States, which requires operational safeguards to separate the bank from the risks of the subsidiary.
- The state nonmember bank must comply with the amendments to Sections 23A and 23B of the FR Act made applicable by Section 121(b) of the GLBA that require certain ongoing transactional restrictions.
- The state nonmember bank and all of its insured depository affiliates must have received a CRA rating of not less than a “satisfactory record of meeting community credit needs” in its most recent CRA examination.

Functional Regulation

The GLBA also provides for the functional regulation of securities and insurance activities. This means that similar activities should be regulated by the same regulator so as to promote regulatory efficiencies and eliminate burden and duplication. Accordingly, banking activities are to be regulated by bank regulators, securities activities by securities regulators and insurance activities by State insurance departments. In order for functional regulation to be effective, certain consultation and information-sharing requirements are also contained in the statute.

The BHC Act was amended to restrict the authority of the FRB to require reports, conduct examinations, impose capital requirements or take any other direct or indirect action with respect to any functionally regulated affiliate of a depository institution. Section 45 was added to the FDI Act, which made these restrictions applicable to the FDIC.

It is still necessary to determine the significance of the activities conducted by the functionally regulated subsidiaries and determine whether the level of such activities could pose a material risk to the insured depository institution. This functional regulation concept does not, however, alter the Corporation's authority under Section 10(b)(4) of the FDI Act to examine affiliates "as may be necessary to disclose fully (i) the relationship between the depository institution and the affiliate; and (ii) the effect of such relationship on the depository institution."

A functionally regulated entity under the GLBA means a company:

- Engaged in insurance activities (as agent or principal) supervised by State insurance commissioners;
- Registered with the Securities and Exchange Commission (SEC) as an investment company under the Investment Company Act of 1940;
- Registered as an investment adviser either with the SEC or any State; or
- Engaged in commodity activities regulated by the Commodities Futures Trading Commission.

EXAMINATION AUTHORITY

The authority of examiners to examine all affiliates of State nonmember banks is contained in Section 10(b) and 10(c) of the FDI Act. In exercising the authority to examine State nonmember insured banks and their affiliates, examiners are empowered by Section 10(b) to make a thorough examination of all of the affairs of the bank and its affiliates and are directed to make a full and detailed report of condition of the bank to the FDIC. The authority to examine affiliates extends to those entities set forth in Section 23A of the FR Act.

The manner in which such examinations are conducted, and the format of the reporting on their condition, are not specified by either regulation or specific policy guidance. This is the case for two reasons. First, the type of affiliate and the nature of transactions with the insured institution can vary significantly; requiring sometimes more or less review, and typically a far different type of analysis than would be conducted for financial institution affiliates. Second, the risk presented by the activities of affiliates to the insurance fund is likely to be indirect, especially for those not engaged in direct transactions with the insured institution. Examinations under the FDIC's 10(b) authority will need to be tailored to the level of risk to which the insured institution is exposed as a result of transactions between, and the operations of, the relevant affiliates.

In addition, Section 10(c) of the FDI Act empowers the FDIC to issue, in the course of an examination, subpoenas and to take and preserve testimony under oath related to any matter in respect to the affairs or ownership of any such institution or affiliate. Accordingly, individuals, corporations, partnerships, or other entities which in any way affect the bank's affairs or ownership may be subpoenaed and required to produce documents under the FDIC's Section 10(c) powers.

Proper use of Section 10(c) powers can be a valuable aid to the FDIC in carrying out its supervisory responsibilities. However, the reasons why examinations of affiliates are considered advisable or necessary by the examiner should be documented, and the extent of any such examination should have prior clearance from the Regional Office. The exercise of Section 10(c) powers will require extensive legal documentation and should only be initiated following authorization from the Director, DSC.

BANK HOLDING COMPANIES

Under Section 2 of the BHC Act a "bank holding company" is defined to include any corporation, partnership, business trust, association, or similar organizations, or any long-term trust (one which extends beyond 25 years or 21 years and 10 months after the death of individuals living on the effective date of the trust) which has control over any bank or over any bank holding company. A bank, of course, is a company and, therefore, may be a bank holding company if it controls another bank or bank holding company. By virtue of amendments to the BHC Act, one-bank holding companies, partnerships, and under certain circumstances, bank trust departments are within BHC Act limits. An existing BHC may become an FHC by notifying the FRB of its election to do so. The BHC must certify that each of the FHC's insured depository institution subsidiaries is well capitalized and well managed.

Definition of Control

Under the BHC Act, a company has control over a bank or any other company (1) if it directly or indirectly owns, controls, or has the power to vote 25 percent or more of any class of voting securities of such bank or other company, (2) if it controls, in any manner, the election of a majority of the directors of such bank or other company, or (3) the FRB determines, after notice and hearing, that the company exercises a controlling influence over the management or policies of the bank or company. Shares owned or controlled by any subsidiary of a bank holding company are considered to be indirectly owned or controlled by the holding company. Shares held or controlled directly or indirectly by trustees for the benefit of a company or the shareholders or employees of a company are deemed to be controlled by the company. Refer to FRB Regulation Y, Section 225.2 for further clarification.

There is also a rebuttable presumption of control if the FRB, as authorized, finds that a company directly or indirectly exercises a controlling influence over the management or policies of the bank or bank holding company. In order to establish guidelines implementing these sections of the BHC Act, the FRB has adopted the following presumptions of control that may be rebutted by the affected company:

1. A company that owns, controls, or has power to vote more than 5 percent of the voting securities of a bank or bank holding company if; one or more of the company's directors, trustees or partners, or officers or employees with policy-making functions, serves in any of these capacities with the bank or holding company, and no other person owns, controls or has power to vote as much as 5 percent of any class of voting securities of the bank or bank holding company.
2. A company that owns, controls or has power to vote more than 5 percent of any class of voting securities of a bank or bank holding company if; additional voting securities are owned, controlled or held with power to vote by individuals or members of their immediate families (spouse, children, grandchildren, parents or their ancestors, stepchildren or stepparents, all whether natural or adopted) who are directors, officers, trustees or partners of the company (or own directly or indirectly 25 percent or more of any class of voting securities of the company) and such holdings together with the company's holdings aggregate 25 percent or more of any class of voting securities of the bank or bank holding company. The presumption does not apply under (1) and (2) where securities are held in a fiduciary capacity and the company does not have sole discretionary authority to exercise the voting rights.
3. A company that enters into any agreement or understanding with a bank or bank holding company (other than an investment advisory agreement), such as a management contract, pursuant to which the company or any of its subsidiaries exercises significant influence with respect to the general management or overall operations of the bank or bank holding company presumably controls such bank or bank holding company.
4. A company that enters into an agreement or understanding under which the rights of a holder of voting securities of a bank or other company are restricted in any manner, presumably controls the shares involved unless the agreement; is a mutual agreement among shareholders granting each other a right of first refusal with respect to their shares, is incident to a bona fide loan transaction, or relates to restrictions on transferability and continues only for such time as may reasonably be necessary to obtain from a Federal bank supervisory authority with respect to acquisition by the company of such securities.
5. A company that directly or indirectly owns securities that are convertible immediately at the option of the holder or owner into voting securities, presumably owns or controls the voting securities.

In addition to the foregoing, the FRB may, under its regulations, administratively determine that a company controls a bank or other company. Congress has apparently established 5 percent as the benchmark for determining whether or not “control" exists and the FRB has to a great extent incorporated that benchmark into its regulations dealing with the rebuttable presumption of control. Accordingly, under the BHC Act, there is a presumption that a company does not have control over a bank or other company if the company directly or indirectly owns, controls, or has the power to vote less than 5 percent of the voting securities of such bank or other company. Furthermore, a company does not have control of a bank or other company unless at the time in question that company directly or indirectly owned, controlled, or had power to vote 5 percent% or more of the voting securities of a bank or other company, or had already been found to have control by the FRB after notice and opportunity for hearing.

PARENT COMPANIES WHICH ARE NOT BANK HOLDING COMPANIES

The primary forms of insured bank whose parent company does not fall under the definition of Bank Holding Company (BHC) or Financial Institution Holding Company for the purposes of the Bank Holding Company Act (BHCA), are the Industrial Loan Company (ILC) and the Savings Bank. Both of these insured entities are otherwise defined as banks under Section 3 of the FDI Act.

ILCs are defined for the purposes of the BHCA exemption, Section 2c(2)(H), as “… an institution … which does not accept demand deposits … ; which has total assets of less than $100 million … or ; which is not acquired by any company after the … enactment of the Competitive Equality Amendments of 1987; or is an institution which does not … engage in any activity in which it was not lawfully engaged as of March 5, 1987 …” Savings Banks are defined in Section 3g of the FDI Act, and are essentially State Savings Banks.

The Competitive Equality Banking Act (CEBA) of 1987, in redefining a bank as any bank insured by the FDIC and eliminating the loophole in the BHCA for institutions that accepted demand deposits or made commercial loans but not both, also created a small group of grandfathered institutions. These "CEBA" banks are also known as "non-bank banks," have the same activity restrictions as do ILCs, and their parent companies would also not necessarily have to be Bank Holding Companies. The growth in the "non-bank bank" charter, entities sometimes called limited charter institutions, is now primarily in ILCs.

While some limited charter institutions are owned by bank holding companies, most are owned by parent companies whose limited activities and primary purpose of owning the insured institution, make these parents virtually identical to the shell bank holding company. However, ILCs can be owned by commercial parent companies. Some of these corporations are otherwise engaged in a diversity of business activities which would otherwise preclude them from owning a bank and being a bank holding company. These commercial corporations presently include some of the largest manufacturing, insurance, retail, and investment banking firms.

For more specific information regarding the various definitions, limitations, and restrictions on non-bank financial institutions, see the relevant provisions of the BHC Act, 12 U.S.C. 1843(f)(3) and Regulation Y, 12 C.F.R. 225.2 and 225.52. These are included under the Bank Holding Company Act tab in the Prentice-Hall volumes.

CEBA Credit Card Banks

CEBA credit card banks are also exempt from the BHC Act and may be owned by commercial entities. Their operations are restricted to only issuing credit cards, accepting no demand deposits, accepting only jumbo deposits ($100,000 minimum), having only one office, and not making any commercial loans.

Unitary Thrift Holding Companies

Prior to the enactment of the GLBA, any company, regardless of its activities, could acquire a single savings association if the prospective subsidiary satisfied the qualified thrift lender test (QTL).[1]

The advantages of that charter included preferential taxation, liberal branching rights, expanded subsidiary powers and virtually unlimited holding company activities. Many of the thrifts with this charter were owned by commercial entities.

The GLBA prohibits the creation of new unitary thrift holding companies that engage in commercial or other nonfinancial activities. The GLBA did, however, grandfather most unitary thrift holding companies in existence as of May 4, 1999.

Industrial Loan Companies

Industrial Loan Companies (ILCs), also known as industrial banks, are state-chartered banking institutions. While only permissible in a limited number of states, they generally have broad banking powers, and under certain circumstances ILCs may be owned by commercial entities. Specifically, an ILC that meets certain criteria is not a "bank" under the BHC Act, and any company that controls such an ILC would not be subject to FRB regulation and supervision as a bank holding company.[2] Most ILCs have Federal deposit insurance (made available under the Garn-St. Germain Depository Institutions Act of 1982 legislation) and are regulated in a similar manner to state-chartered commercial banks.

Core ILC functions are traditional financial activities that can commonly be engaged in by institutions of all charter types. An ILC can:

- offer a full range of deposits, except demand deposits (unless grandfathered);
- offer a full range of loans and other financial services to both consumer and commercial customers;
- be an original issuer of Visa or Master Card credit and debit cards;
- fund its operations with deposits and Federal Home Loan Bank (FHLB) borrowings.

If an ILC is organized as a limited purpose or credit card institution, then its products and services would be limited to specified activities.

The GLBA did not repeal the ILC exception contained in the BHC Act. As such, commercial firms may continue, as State law permits, to acquire and control ILCs without complying with the BHCA so long as the ILCs satisfy the criteria for the exception. In the case of a parent subject to the reporting requirements of another regulatory body covered under the GLBA, such as the SEC or a State insurance commissioner, the FDIC has agreements in place to share information with such functional regulators. In examining any insured depository institution, the FDIC has the authority (under 12 U.S.C. § 1820(b)(4)) to examine any affiliate of the institution, including its parent company, as may be necessary to determine the relationship between the institution and the affiliate and to determine the effect of such relationship on the institution.

Unique Characteristics of Commercial Parent Companies

Certain bank charters, such as ILCs, may have commercial parent companies in place of a traditional bank holding company or financial institution holding company. As with bank holding companies, these commercial parents can be a source of strength for their subsidiary bank by providing access to the capital and debt markets, and affording the opportunity to use a variety of technical services not always available to small or mid-size banks.

However, commercial parents also present different management challenges to the insured institution and different analytical challenges to examiners. Commercial parents may not be able to offer additional management expertise directly relevant to financial institutions. In serving the specific financial needs of a commercial company, a niche bank may be insufficiently diversified against credit or liquidity risks. Further a financial catastrophe at a parent or affiliate, unrelated to the business of the insured institution, could result in an unanticipated but immediate disruption to the earnings or operations of the insured entity.

Moreover, assessment of "extra-insured" risk factors cannot be made with the comparatively straight-forward ratio analysis used for evaluating bank holding companies. Commercial firms present more varied revenue streams and business risks. Further, while a clearly identified weakness in the insured institution will generally determine the need to conduct an assessment of the potential source of strength provided by the commercial parent, any determination of a "potential source of weakness" presented by a parent or affiliate to an otherwise healthy insured entity will be far more complex. Examiners should only undertake such an assessment following consultation and direction from the Regional Office.

For non-bank holding companies or commercial parent entities, some possible sources for financial analysis include: parent entity quarterly or annual reports, Securities and Exchange Commission filings such as 10-Ks, 10-Qs, etc., bank records on affiliates, external industry analysis sources (i.e. Moody's Standard and Poor's, etc.), internal and/or external audits, corporate press releases, newspaper articles, etc.

HOLDING COMPANY EFFECT ON SUBSIDIARY BANKS

A sound, well-managed holding company can be a source of strength for unit banks; however, if the condition of the holding company or its nonbank subsidiaries is unsound, the operation of subsidiary banks can be adversely affected.

Management

The long-term health of an institution depends on a strong, independent and attentive board. The board sets the overall tone and direction of the institution and establishes policies and procedures concerning the nature and amount of risk the institution may take.

Solid corporate governance principles recognize the following elements necessary for the successful operation of the depository affiliated institution:

Each member of the board of directors should have the skills, integrity, knowledge, and experience necessary to allow the director to fulfill his or her responsibilities to the insured institution. The qualifications should be considered in light of the institution's size, complexity and risk profile. Board membership should be considered not only on an individual basis, but also collectively such that the composition provides a well rounded set of skills, knowledge, and experience.

The board of directors is responsible for actively overseeing the affairs of the institutions. This oversight should include:

- Reviewing and approving major corporate actions and the institution's overall corporate strategies, business plans, performance objectives, risk policies and risk tolerances,
- Monitoring the institution's adherence to the strategies, plans, objectives, risk policies and risk tolerances approved by the board, including policies and standards relating to conflicts of interest management,
- Reviewing appropriate regulatory and audit reports, and
- Taking appropriate action with respect to all matters requiring board attention.

The board of directors is responsible for ensuring that the institution, its directors, management, principal shareholders, and affiliates avoid potential direct and indirect conflicts of interest and comply with Federal laws and regulations that are designed to prevent misuse of depositors' funds.

The board of directors is responsible for hiring and retaining executive officers with the skills, integrity, knowledge and expertise appropriate to the nature and scope of their responsibilities. Executive officers must have the ability to manage day-to-day operations to achieve the institution's performance goals. They should also possess the industry expertise to assess the institution's current performance and condition and to help the board plan for the institution's future.

The board of directors is responsible for establishing and maintaining appropriate committees, and that written charters delineating each committee's functions, responsibilities and membership qualifications have been adopted by the full board.

The board of directors is responsible for ensuring that the insured depository institution maintains a separate corporate existence from its affiliates. This separateness also pertains to the sound tenet that all financial and other pertinent records for the financial institution affiliate be accessible on location.

Financial Considerations

The holding company structure can provide its subsidiary bank strong financial support because of greater ability to attract and shift funds from excess capital areas to capital deficient areas. The financial support can take the form of equity capital injections and/or the funding of loans and investments. However, when the financial condition of the holding company or its nonbanking subsidiaries is tenuous, pressures can be exerted on the subsidiary banks. In order to service its debt or provide support to another nonbank subsidiary, the holding company may place inordinate financial pressure on its subsidiary banks by any of the following methods: payment of excessive dividends; pressure subsidiary banks to invest in high risk assets to increase asset yields; purchase and/or trade its high quality assets for the other affiliate's lower quality assets; purchase of unnecessary services from affiliates; or payment of excessive management or other fees.

Although no formal policy statement has been issued by the FDIC, it has long been the FDIC's position that management and other fees paid by subsidiary banks should have a direct relationship to the value of actual goods or services rendered based on reasonable costs consistent with current market values for such services. Bank files should contain adequate information to permit a determination as to what goods and services are being provided and on what basis they are being priced. Charges should not be based on resources, deposits, or earnings of the bank. In those instances when payments are large and are not or could not be justified on the basis of services received by the bank, a comment should be included in the Report of Examination.

An additional method of upstreaming funds from a bank to its parent is through the remittance of income taxes to the parent that then files a consolidated income tax return. Due to timing differences arising from the use of different accounting methods for Reports of Condition and Income (Call Reports) and for income tax purposes, a portion of taxes reflected in Reports of Income and Condition will be deferred; however, in certain instances, banks are required to remit to the holding company the entire amount of income tax expense, both current and deferred. The FDIC's Statement of Policy Income Tax Remittance by Banks to Holding Company Affiliates, indicates past transfers of this kind shall be restated on the bank's books and future tax transfers shall only include the current portion of income tax expense.

Even when the holding company is financially sound, supervisory concerns may arise as the parent issues long-term debt to fund equity capital in the subsidiaries. Although this capital raising activity, known as "double leveraging," does increase equity capital in the subsidiary, too much debt at the holding company level can generate pressure on the subsidiary to upstream additional dividends. Since the holding company often services the debt with dividends from the lead bank, holding company debt service requirements which come to exceed historical dividend payment ratios may place undue earnings pressure on the bank. Should dividends be insufficient, the holding company may attempt to create other means of generating cash, such as charging the subsidiary for management and operating expenses.

The double leverage ratio is the equity of the subsidiary, or in the case of multiple subsidiaries the combined equity of all the subsidiaries; divided by the equity of the holding company. A holding company with a ratio of 100% or less, is not using double leverage. The amount of double leverage a holding company can comfortably carry can depend on various factors; but analysis should center on the amount of earnings or cash flow which the subsidiaries, or the lead bank if the lead bank generates most of the combined company's earnings, can upstream to the parent. Even holding companies with comparatively modest double leverage ratios can negatively affect the bank if the non-bank subsidiaries produce negative cash flow. Other leverage ratios which attempt to isolate or incorporate different segments of the holding company's capital structure (preferred stock or minority interests for example) can be useful for assessing more complex organizations.

Fixed charge coverage is a ratio that measures the ability of the parent company to cover its interest expense. The ratio is computed by determining how many times the parent's total interest expense is "covered" by the net of parent operating income (excluding "equity in undistributed earnings") less parent operating expenses other than interest and taxes. Interest expense is defined to include one- third of parent rental expense (if any), as though premises and equipment had been mortgaged rather than leased. A bank holding company parent's position is generally considered comfortable if it shows a coverage ratio of 2 times or better. A ratio of less than 1 points to a condition of cash flow deficit, without taking debt amortization or shareholder dividends into consideration. This ratio can be misleading if there is an abnormal dividend payout from subsidiaries, the major source of income to a parent. If the payout of all subsidiaries is only 20 percent (but could be 60 percent), the coverage ratio could be very low, perhaps well under 2 times. Conversely, if the payout of earnings is an unsustainable high 90 percent, the coverage ratio could temporarily appear adequate. Therefore, it is essential to be aware of actual dividend payout from subsidiaries to the parent before final interpretation of this ratio.

Cash flow match is a more severe test of parent cash availability to meet not only interest expenses, but also operating expenses, taxes, shareholder dividends, and debt maturities. Cash "sources" are defined as all parent operating income plus tax credit (or minus taxes paid). Cash "uses" are defined as operating expenses (including interest), dividends to shareholders, and debt principal due in one year. A coverage ratio of 1.10 "times" (i.e., cash sources are 110 percent of uses) is generally considered comfortable. Many highly profitable, underleveraged BHCs reflect ratios of 1.20 times or better. Ratios under 1.00 need additional study, as the presumption is that cash flow is insufficient to maintain BHC credit, which bears upon the viability of the institution. Like the fixed-charge coverage test, this ratio also needs adjustment to be interpreted in light of subsidiaries' dividend levels. The amount of debt due in one year usually does not reflect a normalized amortization schedule, since balloon and bullet maturities create a year-to-year instability in the "amount due." If sufficient data were available, it would be more appropriate to arbitrarily introduce a "normalized" amortization schedule based on the average life of parent debt outstanding. Finally, not all parent debt needs to be serviced from parent operating income. Much of this debt is covered or matched by advances to profitable subsidiaries, so that servicing of principal is in essence automatic. Therefore, a true cash flow test would apply only to "uncovered" parent debt and only the amortization of this portion needs to be normalized in the manner described.

These cash flow measures are the best indicators of the financial support a parent company can provide to a subsidiary bank. Asset size, capitalization, revenue or profitability; even relative to the size of the insured institution, are imperfect measures for gauging potential support.

Other ratios that can be used when analyzing holding companies are included on the Relationship with Affiliates and Holding Companies page of the Report of Examination. These ratios are generally available from the Uniform Bank Holding Company Performance Report.

Economies of Scale

The holding company structure can provide significant benefits from economies of scale in areas such as audit, and data processing services, etc. Effective review of the examination report by the holding company and implementation of recommendations contained therein should assist the FDIC in the supervision of subsidiary banks.

Dual Employees

These economies of scale could extend to the employees in the case of “dual employees” or those that perform essentially the same duties for a banking entity and the affiliated organization. The use of dual-employees can be a cost-effective manner for leveraging in-house expertise or for employees that specialize in certain core competencies. Nonetheless, the use of dual-employee arrangements may present increased risk to an insured banking entity if the institution, or its management, fails to adequately monitor the hiring, training, activities, reporting, or expertise of dual-employees.

Any dual officer or employee arrangements should be consistent with sound principles of corporate governance. All bank activities, including those performed by dual employees, should be subject to the authority of an independent board of directors. Bank officers (whether they are dual employees or direct employees) must have sufficient expertise, authority, and information to act in the best interests of the insured institution at all times, under the direction of the board. A comprehensive framework of policies, procedures, legal agreements, controls, and audit must be established to govern the activities of dual officers and employees. A formal written employee sharing agreement should be established to define the employment relationship between the banking entity and affiliate. The following factors should be addressed:

- The agreement needs to be independently reviewed by the bank's board of directors to ensure that it is fair and in the best interest of the insured bank.
- Compensation arrangements need to be clearly delineated to ensure they are equitable for both the bank and affiliated entity.
- The location where the dual employee is to perform duties needs to be established and detailed, along with reporting and authority.
- The agreement should require dual employees to avoid conflicts of interest. Additionally, the agreement should state that dual employees or officers must act in the best interest of the bank while performing any activities on behalf of the bank.
- Sanctions for noncompliance should be contained in the bank's agreement.
- The agreement should provide for a periodic determination concerning the status of a dual-employee and the factors to be considered for terminating the dual-employee relationship in favor of either full-time bank or affiliated entity employment.
- Authority for managing the dual-employee relationships should be clearly assigned.
- Lines of authority for dual employees should be established. While dual employees may have other responsibilities, they must also report through appropriate lines of authority within the banking institution. The dual employee's bank responsibilities and decision-making should take precedence over any affiliate responsibilities. All activities conducted on behalf of the bank must be subject to appropriate review and authorization by bank officers, and ultimately the bank's board of directors.

Affiliate officers and employees who conduct activities on behalf of the bank (even if not formally designated as dual employees) are subject to the same level of legal and corporate duties and liabilities as a direct officer or employee of the bank. Additionally, examiners should have reasonable access to dual employees and any other affiliate employees who perform services on behalf of the bank.

Bank officers must retain control over certain key functions, including general ledger entries, regulatory reporting, cash accounts, lending activities, and investments. While dual officers and employees can provide advice and other supporting services, bank officers must retain final decision making authority. Reasonable systems should be established to ensure that bank officers have sufficient information to oversee the activities of dual officers and employees who provide services to the bank.

The institution needs to be able to devote sufficient resources for monitoring and measuring performance under the terms of the employment sharing agreement.

The extent of the relationships, including the amount of time devoted between the bank and an affiliated entity, need to be periodically reported to the directorate or an appropriate committee.

The insured banking institution utilizing a dual-employee needs to have policies and procedures in place covering account settlement for dual-employees that stipulate the manner and timing for payment in order to ensure an unanticipated affiliated loan does not occur in contravention of Sections 23A & 23B of the FR Act.

Policies and procedures dealing with dual-employee relationships should include a mechanism to ensure compliance with 12 U.S.C 1831g (Adverse Contracts). Under that statute, an institution may not enter into a written or oral contract with any person to provide goods, products, or services to, or for the benefit of, a depository institution if the performance of such contract would adversely affect the safety and soundness of the insured institution.

Examiners should review and evaluate arrangements involving shared employees and/or management for the items discussed above.

Miscellaneous Considerations

The principal benefit of bank holding companies is the tax benefit from issuing debt at the parent company level and concurrently creating equity at the bank level. Most one bank holding companies which engage in minimal other activity aside from holding the stock of the bank, were created for this purpose. The Federal Reserve ruling permitting treatment of Trust Preferred Stock as Tier 1 capital for regulatory purposes, while simultaneously allowing the consolidated holding company to treat it as debt for tax purposes, further added to the attractions of the one bank holding company.

Many of the smaller one-bank holding companies receive infrequent inspection by the Federal Reserve. Ordinarily the holding company financial statements reflect little more than the bank investment and acquisition debt. It is expected that where debt-servicing requirements may impact bank earnings, appropriate comments will be made by the examiner in the examination report. Reference is made to the Earnings section of this Manual as well as the instructions for the preparation of the Relationships with Affiliates and Holding Company report page.

Another major benefit to an individual bank that belongs to a multi-bank holding company is that it can better serve its customers by participating loans exceeding its legal lending limit. A problem could result from this practice if the loan granted exceeds the management expertise of any of the participants.

Examiners should review and evaluate current business plans and any changes thereto since the previous examination. Business plans in most instances should be reduced to written form. It is recognized that the depth and detail of written plans may properly vary, depending on the nature, scope and complexity of their operations. Occasionally, examiners may encounter situations where written plans have not been developed. In these instances, frequent and ongoing communication with management is imperative. The necessity for a written plan may be inferred from the results achieved by management to a considerable degree.

Examiners should assess whether all service relationships provided by affiliates are governed by a written agreement. Refer to Sections 23A and 23B of the FR Act for additional information on affiliate transactions.

Examiners should also determine whether the bank should have a contingency plan for all critical business functions performed by affiliated companies. Refer to outstanding Information Technology (IT) examination guidance for specifics on contingency planning.

The Potential Impact of Holding Companies on Uniform Bank Ratings

The relationship between a bank and its parent holding company and the financial condition of the holding company could affect, to a significant degree, each of the component factors in the CAMELS rating as well as the composite rating.

The financial, technical, and managerial capacity of holding companies, commercial parents, and other affiliates can provide significant and often substantial support to a subsidiary bank. This is particularly true when the bank is a comparatively small component of a much larger corporate organization.

It will not always be necessary for examiners to conduct a detailed assessment of whether a parent company can be considered a source of strength for the subsidiary financial institution. If the subsidiary bank ratings are not dependent on the resources or support of the holding company, it will not normally be necessary to conduct a detailed assessment of the parent company or affiliates. Most bank holding companies have little financial capacity independent of the bank; and are likely to provide little independent support.

In the case where a complex commercial parent company has the potential capacity to support the subsidiary bank but does not clearly dominate the bank by virtue of size, revenues, or earnings, a more detailed examination of the parent may have to be conducted if it should become necessary to show conclusively that the bank ratings should reflect the holding company as a source of strength. However, conduct of a parent company examination should be dependent first on the independent financial condition of the insured institution, the extent of risk exposure resulting from direct transactions between the insured institution and the parent company, and the extent to which the capacity of the parent company supports the Uniform Bank Ratings assigned.

When a holding company or parent is considered a potential source of strength to the insured institution, the weight of this influence on the assigned Uniform Bank Ratings should only incorporate the actual support provided at the current examination. A potential source of strength determination should not be based on projected future resources of the parent, but rather on a current assessment of the parent's actual financial condition. Furthermore, the benefits of parental resources and the influence of these resources on the Uniform Bank Ratings will likely change if the condition of the insured institution deteriorates. In this event, evaluation of potential source of strength should incorporate not just the capacity of the parent to support the bank, but also its present willingness to do so.

Some additional factors that may be considered in assigning a rating to the financial institution subsidiary could include:

- Capital – the ability and commitment of affiliates to contribute additional capital if needed and an assessment of the pressure from the parent organization for dividends.
- Asset Quality – the quality of the assets generated through programs associated with affiliates; ability of affiliates to provide financial guarantees or collateral, purchase low quality assets, or to arrange or develop risk mitigation transactions such as credit default swaps.
- Management – independence of management and the board of directors; ability of the financial institution affiliate to make decisions independent of parent company; adequacy of audit procedures; demonstrated willingness to address examination recommendations and follow safety and soundness principles; documentation and protocols for affiliate relationships.

- Earnings - reasonable fee structure of servicing relationships; suitability of management fees paid to affiliates.
- Liquidity – access to funding sources that would not otherwise be available.
- Sensitivity – funds management strategies that are coordinated with those of affiliates; efficacy of hedging or other market activities employed by affiliates.

TYING ARRANGEMENTS

The Bank Holding Company Act Amendments of 1970 and Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 added the so-called anti-tie-in provisions to the BHC Act. (See "Tying Arrangements" under the Bank Holding Company Act tab in the Prentice-Hall volumes.) Non-bank banks, including ILCs, are subject to the anti-tying provisions of the BHC Act as well.

Essentially, the anti-tying provisions prohibit a bank from conditioning the availability or price of any of its products or services upon the customer obtaining some other product or service from the bank or an affiliate, or upon the customer providing some other product or service to the bank or an affiliate. These provisions also preclude a bank from tying its products or services to a requirement that the customer not obtain some product or service from a competitor of the bank or an affiliate. The purpose of these provisions is to prevent banks from using their ability to offer financial products, credit in particular, in a coercive manner to gain a competitive advantage in markets for nonbanking products and services. For example, a bank may not require as a necessary condition to obtaining a loan or extension of credit that the prospective borrower lease personal property or equipment from the bank's holding company or a subsidiary thereof or that the prospective borrower provide the bank, its holding company or any subsidiary thereof with office supplies or equipment.

However, it is not intended that this provision interfere with the conduct of traditional banking practices. For example, a bank may restrict the availability or vary the price of its credit, property, or services on the condition that the customer also obtains a traditional bank product from the bank or an affiliate. A "traditional bank product" is a loan, discount, deposit, and trust service. For further information regarding other exceptions and safe harbors contact Regional Office staff. For purposes of these provisions, a natural person is treated as a bank holding company if he or she controls a bank or a company that controls a bank.

Violations of these anti-tying provisions may be addressed by the bank's appropriate Federal banking agency through an enforcement action, by United States Attorneys under the direction of the Attorney General through an action for injunctive relief, or by private parties through an action for injunctive relief as well as treble damages when they have sustained damages, or are threatened by loss or damage, by reason of a violation of these provisions.

Prohibition of Preferential Loans

Title VIII essentially prohibits preferential loans to executive officers, directors, and principal shareholders of a bank from its correspondent bank. Therefore, a bank which maintains a correspondent account for another bank is precluded from making an extension of credit on preferential terms to an executive officer, director, or principal shareholder of that bank, and a bank is precluded from opening a correspondent account for another bank if such bank has outstanding an extension of credit to an executive officer, director, or principal shareholder of that bank if it is on preferential terms. Conversely, a bank which maintains a correspondent account at another bank is precluded from making an extension of credit on preferential terms to an executive officer, director, or principal shareholder of that bank, and a bank is precluded from opening a correspondent account at another bank if such bank has outstanding an extension of credit to an executive officer, director, or principal shareholder of that bank on preferential terms. Any bank that violates or any officer, director, employee, agent, or other person participating in the conduct of the affairs of such bank who violates this prohibition shall forfeit and pay a civil penalty.

CHAIN BANKING GROUPS

From a supervisory standpoint, chain-banking groups are very similar in character to multibank holding companies. They have the ability to provide many of the benefits common to multibank holding companies as well as the ability to provide the potential for unsafe and unsound banking practices. The linkage of several banks or holding companies into a chain creates a concentration of banking resources that can be susceptible to common risks. Mutually shared risks that can arise in chain banking relationships include: poor loan participation practices, common deficiencies in lending and/or investment policies, domineering or absentee ownership, insider abuses or other self-serving practices. Unfortunately, detection and correction of these problems are largely dependent on the examination process and are complicated when the chain is composed of institutions subject to different Federal and/or State regulatory agencies.

Unlike multibank holding companies, chain banking organizations do not have to report financial information on a consolidated basis, thereby making offsite monitoring difficult. In addition, they are not subject to the same types of regulations as holding companies.

A chain banking organization is defined as a group (two or more) of banks or savings and loan associations and/or their holding companies which are controlled directly or indirectly by an individual or a company acting alone or through or in concert with any other individual or company. Control is defined as: ownership, control or power to vote 25 percent or more of an organization's voting securities; the power to control in any manner of the election of a majority of the directors of an organization; or the power to exercise a controlling influence over the management or policies of an organization. These criteria are to be interpreted narrowly. For example, institutions should not be deemed to be a chain organization simply because an individual holds a title such as chairman or president unless the individual actually has control.

The control structure of a chain organization is often complex. There may be registered holding companies within the ownership or control structure of a chain organization, but it would not be deemed to be a chain if the top holder of all the insured institutions in the group is a registered holding company. One bank under a bank holding company or several banks owned by a single bank holding company are not considered a chain banking group for purposes of maintaining a list of chain banking groups.

It is the policy of the Division of Supervision and Consumer Protection to monitor and supervise banks that are a part of a chain banking organization in a manner that fully considers the consolidated chain's financial impact on the safety and soundness of the individual institution(s). The supervisory strategy for monitoring chain organizations is included in the Case Manager's Procedures Manual.

In developing an overall supervisory strategy for chain organizations, the following factors should be considered:

- The relative size and complexity of the chain's organizational structure, including the degree of centralization of operations,
- The degree and nature of control or influence being exerted over individual institutions in the chain and the managerial style and extent of direct control or influence at each institution in the chain,
- The degree of interdependence among institutions in the chain. Particular emphasis should be given to the volume and frequency of inter-institution transactions such as: loan participations or sales; purchases or sales of securities or other assets; bank holding company or bank stock loans; insider loans or transactions; and contractual obligations for services, and
- The overall condition of the institutions in the group and the condition of the chain on a consolidated basis.

AFFILIATES

The relationship of a bank with its affiliated organizations is important to the analysis of the condition of the bank itself. Because of the commonality of ownership or management that exists, transactions with affiliates may not be subject to the same sort of objective analysis that exists in transactions between independent parties. Also, affiliates offer an opportunity to engage in types of business endeavors that are prohibited to the bank itself yet those endeavors may affect the condition of the bank.

In recognition of the importance of relationships with affiliated organizations, the FDIC has been granted authority, under certain conditions, to examine affiliates in connection with its examination of a bank.

There are two primary definitions of "affiliate" which are of importance to examiners. The first is the definition set forth in Section 2(b) of the Banking Act of 1933. The second is the definition set forth in Section 23A of the Federal Reserve Act.

Affiliates as Defined in Section 23A of the Federal Reserve Act

Section 23A of the FR Act (made applicable to insured nonmember banks by Section 18(j) of the FDI Act) contains the restrictive provisions relating to transactions between banks and their affiliates.

Prior to the GLBA amendments to Sections 23A and 23B, non-bank subsidiaries of banks were not covered by the definition of "affiliate." Those sections now provide that non-bank subsidiaries of state banks are "affiliates" in the event that they qualify as "financial subsidiaries." The GLBA amendments to Sections 23A and 23B apply solely to covered transactions between a state nonmember bank and its "financial subsidiaries" as covered in Section 46 of the FDI Act.

The principal purpose of Section 23A is to safeguard the resources of banks against misuse for the benefit of organizations under common control with the bank. It was designed to prevent a bank from risking too large an amount in affiliated enterprises and to assure that extensions of credit to affiliates are properly collateralized. Section 23A, therefore, regulates loans or extensions of credit to and investments in affiliates of an insured bank in two ways; first, by restricting the amount of such loans or extensions of credit and investments, and second, by requiring that the loans or extensions of credit meet certain standards as to collateral. Four major types of affiliates are defined in Section 23A and these are discussed in the following paragraphs.

Parent Holding Company and Its Subsidiaries

The first type pertains to a parent holding company and its subsidiaries. Any company that controls the bank (holding company) as well as any other company that is controlled by the company controlling the bank (sister subsidiary) is considered to be an affiliate of the bank under Section 23A. "Control" is defined as owning, controlling, or having the power to vote (directly or indirectly) 25 percent or more of any class of voting securities; or controlling in any manner the election of a majority of the directors or trustees. The term "company" means a corporation, partnership, business trust, association, or similar organization. These definitions are very similar, although not identical, to the definitions of "control" and "company" used in the BHC Act. It is therefore possible to have a holding company-subsidiary relationship under the BHC Act that is not an affiliate relationship for the purposes of Section 23A. Control relationships existing in certain types of trusts are an example.

Section 23A grants an important exemption with respect to domestic banks that are affiliated under this definition. When a bank is 80 percent controlled by a holding company, its transactions with other banks which are also 80 percent controlled by the same holding company are largely unrestricted. The only restrictions which do apply are the general prohibitions against a bank purchasing low-quality assets from its affiliates (refer to "Restrictions on Covered Transactions with Affiliates" below for a definition of "low quality asset"), and a requirement that all transactions be consistent with safe and sound banking practices. All restrictions and limitations set forth in Section 23A are, however, applicable to transactions by a bank with its parent holding company, its non-bank subsidiaries, and its bank subsidiaries that do not meet the 80 percent exemption. They also apply to an affiliated foreign bank even where the 80 percent test is met. The rationale for the 80 percent ownership test is that it is the minimum ownership generally required for the preparation of consolidated Federal income tax returns.

Bank Subsidiaries

The second category consists of bank subsidiaries of a bank. A domestic bank, which is controlled by another bank, is an affiliate of the controlling institution for the purposes of Section 23A. Where such bank is, however, 80 percent controlled, it is granted the same exemption described above relative to sister bank affiliates in a holding company organization. Thus, the treatment of domestic bank affiliates is consistent whether the bank is affiliated through a holding company or by virtue of direct ownership or control.

A different situation exists with respect to non-bank and foreign bank subsidiaries. Directly owned subsidiaries of this type, whether majority or minority owned, are excluded from the definition of an affiliate for the purposes of Section 23A. This is in contrast to the treatment of such firms when they are holding company subsidiaries. As noted above, non-bank and foreign bank subsidiaries of a holding company are affiliates and are subject to the restrictions of Section 23A. The rationale for this contrast in treatment is that non-bank subsidiaries, when majority owned by a bank, are really an integral part of the bank and transactions between the two should not normally be restricted. With respect to minority owned nonbank subsidiaries, it is noted that most banks are restricted in their ability to own stock and several of the more common types of nonbank subsidiaries (such as bank premises and safe deposit companies) are specifically exempted anyway. While this rationale serves to mitigate concern for transactions with non-bank subsidiaries in many instances, situations may arise where a bank can be exposed to undue risk. For instance, in some states banks may be able to conduct types of businesses through a non-bank subsidiary that would be prohibited to the bank itself. While the bank's investment in such a company may be limited, there may be no restriction on the amount of loans that could be made to the affiliate to fund its operations. Where evidence exists that a particular non-bank subsidiary should be brought under the restrictions of Section 23A, this can be accomplished by specific order or regulation. Any such recommendation should be forwarded to the Regional Office accompanied by supporting information.

Interlocking Companies

The third category of affiliates may be referred to as companies interlocked with a banking organization. Any company that is interlocked with a bank or its holding company by virtue of common ownership or common directors is an affiliate of the bank for the purposes of

Section 23A. Such interlocks will arise any time that 25 percent or more of a company is owned, directly or indirectly, by or for the benefit of shareholders who have a direct or indirect ownership of 25 percent or more in either the bank or its parent holding company; or a majority of a company's board of directors also comprise a majority of the board of the bank or its parent holding company. This definition may frequently be applicable to chains of one-bank holding companies that are interlocked by ownership or board membership at the holding company level. Under this definition both the chain of holding companies and their subsidiary banks will be affiliates of a bank under examination if either of the above relevant criteria is met.

Sponsored and Advised Affiliates

The final category is comprised of sponsored and advised affiliates. For the purposes of Section 23A, a company that is sponsored and advised on a contractual basis by a bank, or by any of the bank's subsidiaries or affiliates, is an affiliate of the bank. Real estate investment trusts are an example of this type of affiliation.

Any investment company that a bank or any of its subsidiaries or affiliates serves as an investment advisor is an affiliate of the bank. An investment advisor is basically one who, pursuant to a contract, regularly furnishes advice with respect to the desirability of investing in, purchasing or selling securities, or is empowered to determine what securities shall be purchased or sold by the investment company. The rationale for the inclusion of these two types of affiliations is that banks may, in order to protect their reputation or to forestall lawsuits alleging that bad advice was given, engage in less than arms length transactions. By applying the provisions of Section 23A to such situations, a bank's potential exposure to loss can be controlled.

Additional Considerations

In addition to the four categories of affiliates defined above, Section 23A also gives to the Board of Governors of the Federal Reserve System considerable latitude in defining which companies are or are not affiliated. This can be accomplished in three ways:

1. The Board of Governors may determine that "control" exists in individual situations not coming within the control definition of the FR Act after giving notice of and opportunity for a hearing. For example, the FRB may determine that a company owning less than 25 percent of a bank's stock nonetheless exercises control over the bank and is therefore an affiliate.
2. The Board of Governors may also determine that an affiliate relationship exists in specific instances by order or regulation. For instance, the FRB may determine that the relationship between an exempted subsidiary and its parent bank is such that the potential for abusive transactions exists. The FRB may issue an order or regulation bringing transactions with such company under the provisions of Section 23A.
3. The FRB also has the power to issue an order or regulation exempting specific types of transactions or affiliate relationships from the restrictions of Section 23A, provided that it finds that such exemption is in the public interest and consistent with the purposes of the FR Act.

Two final notes relating to the definition of affiliates under Section 23A concern "control" held in a trust capacity and companies acquired for debts previously contracted.

The FR Act specifies that no company shall be deemed to own or control another company by virtue of its ownership of shares in a fiduciary capacity with two exceptions. The first relates to affiliations arising out of the "Interlocking Companies" definition. Under this definition a company is an affiliate under a trust relationship whereby a trustee controls 25 percent or more of the voting shares of a company for the benefit of shareholders who control 25 percent or more of the voting shares of a bank or its holding company. The other exception provides that ownership or control of one company by another through a business trust creates an affiliate relationship.

With respect to the acquisition of control through debts previously contracted, the FR Act specifies that such companies are not affiliates for whatever period of time applicable State or Federal law or regulation permits the bank to hold such shares. In the absence of any such law the holding period is two years from the date of acquisition upon a showing of good cause. After the expiration of the allowable holding periods, such companies are deemed affiliates.

Restrictions on "Covered Transactions" with Affiliates

Section 23A (a)(1) permits a bank to engage in covered transactions with affiliates so long as the covered transactions do not exceed, in the aggregate; (1) 10 percent of the bank's capital stock and surplus with respect to a single affiliate; (The GLBA exempted transactions between banks and their financial subsidiaries from this requirement) and (2) 20 percent of capital and surplus with respect to all affiliates. (For this maximum percentage, the GLBA provides that a bank’s investment in a financial subsidiary will not include the retained earnings of the subsidiary in the calculation). Both the FRB and the FDIC have previously interpreted capital stock and surplus to include undivided profits, capital reserves, the loan valuation reserves, and valuation reserves for securities. The GLBA added a form of "anti-evasion" protection regarding the aggregate transaction limits and collateral requirements in Section 23A and the transaction restrictions in Section 23B. Any purchase of, or investment in, the securities of a "financial subsidiary" of a bank by an affiliate of the bank will be considered a purchase of or investment in such securities by the bank.

Covered transactions are specifically described in Section 23A (b)(7)(A) through (E) but basically consist of:

- Loans to an affiliate,
- Purchase of securities issued by an affiliate,
- Purchase of nonexempt assets from an affiliate,
- Acceptance of securities issued by an affiliated company as collateral for any loan, and
- Issuance of a guarantee, acceptance, or letter of credit on behalf of (for the account of) an affiliate.

Reference is made to Section 23A (d)(2) through (7) for a listing of several types of transactions that are specifically exempted from the provisions of Section 23A. These transactions basically consist of deposit balances in bank affiliates, loans secured by U.S. or agency securities or deposit balances in the bank, readily marketable assets purchased at quoted market prices, loans purchased on a nonrecourse basis from affiliated banks, and the repurchase of loans previously sold to an affiliate with recourse.

The FR Act also contains two other important general provisions that relate to covered and exempted transactions. A bank may not purchase any "low quality asset" from an affiliate in any amount unless, pursuant to an independent credit evaluation, the bank had committed itself to purchase such asset prior to the time such asset was acquired by the affiliate. A "low quality asset" is defined as:

- An asset which was classified as "substandard," "doubtful," or "loss" or treated as "other loans especially mentioned" in the most recent report of examination or inspection of an affiliate prepared by either a State or Federal supervisory agency,
- An asset in a nonaccrual status because of deteriorating credit quality and/or past due status,
- An asset on which principal or interest payments are more than 30 days past due, or
- An asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.

This prohibition on the purchase of low quality assets also extends to bank subsidiaries. In other words, neither a bank nor any of its subsidiaries may purchase low quality assets from an affiliate. The other provision is more general but has a similar intent. This provision requires that any covered transaction between a bank and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices.

For purposes of illustration, the following loan purchase transactions provide examples of the application of Section 23A which examiners may find useful.

1. Loans Purchased from Non-Bank Subsidiaries - A bank may purchase any loan, including a classified loan, from its own non-bank subsidiaries since such companies are not considered affiliates under Section 23A. It does not matter whether the subsidiary is minority or majority owned. The only way to control such possibly objectionable activity, other than through use of Section 8 powers, would be to have the nonbank subsidiary brought under the restrictions of 23A by order or regulation.
2. Loans Purchased from Domestic Banks which are 80 Percent Owned by Either the Bank or its Parent Holding Company - A bank may purchase loans in any amount from these affiliates provided they are not "low quality" or constitute "unsound" transactions under the provisions of Section 23A. The loans may be either subject to repurchase by the affiliate or not subject to repurchase.
3. Loans Purchased from Parent Holding Company, Sister Non-Bank Affiliates, Interlocking Non-Bank Affiliates, Sponsored Affiliates and Foreign Bank Affiliates - A bank may purchase good quality loans from these affiliates subject to the 10-20 percent capital stock and surplus limitations. Other covered transactions are aggregated for purposes of applying the amount limitations. Low quality loans or loans whose terms and conditions are unsound may not be purchased in any amount. Loans secured by U.S. securities or repurchased loans which had been sold earlier by the bank to the affiliate on a with-recourse basis are exempted, however, and would be excluded in applying the amount limitations.
4. Loans Purchased from Other Domestic Bank Affiliates - These affiliates are domestic banks controlled by either the bank or its parent holding company but which are less than 80 percent owned. This also includes banks controlled by interlocking affiliates (one-bank holding company chains, for example)

whether more than or less than 80 percent owned. Loan purchase transactions with these affiliates are treated the same as loan transactions with the parent holding company, etc. (#3 above) with one exception; good quality loans may be purchased in any amount provided they are sold by the affiliated bank on a non-recourse basis.

Collateral Requirements

Loans may not be extended directly to an affiliate nor may a bank issue guarantees, acceptances, or letters of credit for the account of an affiliate unless certain collateral and margin requirements are met. Eligible collateral and margins are as follows:

- 100 percent collateral margin if the collateral consists of U.S. Government and agency securities, deposits held in the bank which are specifically segregated and earmarked, or obligations (such as notes, drafts, or acceptances) which are eligible for rediscount or purchase by a Federal Reserve Bank,
- A 110 percent margin is required if the collateral is composed of obligations of a state or political subdivision of a state,
- A 120 percent margin is required if the collateral consists of other types of debt instruments, including receivables, and
- A 130 percent margin is required if the collateral is composed of stocks, leases, or other real or personal property.

It is important to note that market value at the time of the transaction is the appropriate basis for meeting margin requirements in all instances. When any collateral is subsequently retired or amortized and the amount of the remaining collateral does not provide a sufficient margin, additional eligible collateral must be supplied in an amount sufficient to meet the collateral margin required at the inception of the transaction. Where no collateral substitutions or amortizations are involved, a shrinkage in collateral value does not create a violation so long as the margin requirement was met at the inception of the transaction.

As noted above almost any type security is acceptable (provided margin requirements are met) subject to two important limitations. First, low quality assets; as that term is defined, may not be used to meet collateral requirements and, secondly, securities issued by an affiliate of a bank may not be used to secure the obligations of that affiliate or any other affiliate of the bank.

Section 23B of the Federal Reserve Act

Section 23B of the FR Act applies to insured nonmember banks through Section 18(j) of the FDI Act. Violations of Section 23B by nonmember banks are subject to the civil money penalties of subsection (3)(A) of Section 18(j). Section 23B essentially imposes the following four restrictions:

1. A requirement that the terms of affiliate transactions be comparable to terms of similar non-affiliate transactions;
2. A restriction on the extent that a bank may, as a fiduciary, purchase securities and other assets from an affiliate;
3. A restriction on the purchase of securities where an affiliate is the principal underwriter; and
4. A prohibition on agreements and advertising providing or suggesting that a bank is responsible for the obligations of its affiliates.

Section 23B generally incorporates the definitions used in Section 23A; however, banks are not "affiliates" for purposes of Section 23B.

SUBSIDIARIES

A bank subsidiary, as defined by Section 23A of the FR Act, is any company of which 25 percent or more of any class of its voting stock is owned, controlled, or may be voted by the bank; or any company with respect to which the bank controls, in any manner, the election of a majority of its directors or trustees. While several types of subsidiaries (such as bank premises companies or safe deposit companies) have long been excluded from the provisions of Section 23A, post-GLBA, the amendments to 23A and 23B provide that non-bank subsidiaries of state banks are “affiliates” in the event that they qualify as “financial subsidiaries” under new Section 46 of the FDI Act.

The overall condition of a subsidiary can substantially affect the affairs and soundness of a bank. For example, a subsidiary in severe financial distress could precipitate a drain on the management and financial resources of the bank. To determine the overall risk that the functionally regulated entity presents to the insured depository institution as a whole, it is necessary to determine which subsidiaries are functionally regulated within the functional regulation confines (refer to applicable subsection of this chapter).

Requirements for consolidation of subsidiaries are contained in the Call Reports Instructions for essentially all majority-owned bank premises subsidiaries and other majority-owned subsidiaries, which are considered significant according to certain tests, are consolidated. Some major types of subsidiaries are addressed below:

Bank Service Corporation

A bank service corporation is defined in the Bank Service Corporation Act (BSC Act) as a corporation, whose capital stock is all owned by one or more insured banks, organized to perform "authorized services." The BSC Act limits the investment of a bank in a bank service corporation and specifies prior regulatory approval requirements. Authorized services are defined to include services such as: check and deposit sorting and posting, computation and posting of interest and other credits and charges, preparation and mailing of checks, statements, notices, and similar items, or any other clerical, bookkeeping, accounting, statistical, or similar function performed for a bank. In addition, a bank service corporation may perform any services permitted by FR regulation for a bank holding company under Section 4(c) (8) of the BHC Act.

Due to the nature of services performed by these corporations, the importance of analyzing their financial condition is obvious. In addition to authority to examine affiliates the BSC Act provides that for any bank regularly examined by a Federal supervisory agency or any subsidiary or affiliate of such bank subject to examination by that agency, which causes to be performed by contract or otherwise, any bank services for itself, whether on or off premises, such performance shall be subject to regulation and examination by such agency to the same extent as if the services were being performed by the bank itself on its own premises. The bank is also required to notify the appropriate agency of the existence of such a service relationship within 30 days after the making of the service contract or the performance of the service, whichever comes first.

Safe Deposit Corporation

A safe deposit corporation primarily performs the same functions as a safe deposit department of a bank. A primary purpose for establishing such a subsidiary is to limit the bank's liability. These corporations generally are established under applicable State statutes that may contain limits on liability of the corporation for loss to a customer in any box or compartment. The safe deposit corporation should be operated under the same set of internal procedures as a normal bank safe deposit department. Additionally, the subsidiary should be protected by a combination safe depository insurance policy to the extent State law liability limitations do not provide adequate protection.

Corporation Holding Title to Bank Premises

As the name suggests, a bank premises subsidiary holds title to the bank premises and, in most cases leases them back to the bank. Oftentimes construction/acquisition of the bank premises is financed with borrowed money and lease terms are designed to service principal and interest payments of the mortgage. State law for nonmember banks generally limits the maximum investment in a bank premises subsidiary. The amount of investment, direct or indirect, by a bank in bank premises can have a significant effect on overall net earnings. Therefore, it is essential when evaluating a bank's condition and earnings, that majority-owned bank premises subsidiaries be fully consolidated.

Securities Firm

A securities firm subsidiary is a subsidiary that:

- Engages in the sale, distribution or underwriting of stocks, bonds, debentures, notes, or other securities,
- Acts as an investment adviser to any investment company,
- Conducts any activity for which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer, or
- Engages in any other securities activity.

Small Business Investment Companies (SBIC)

A SBIC is a company, organized under the Small Business Investment Act of 1958, which provides long-term credit and equity financing for small business concerns. Section 302(b) of that Act authorizes National banks, other member banks, and nonmember insured banks (to the extent permitted by applicable State law), to invest in stock of SBICs not exceeding (in total) 5 percent of the capital and surplus of such banks. In no event may a bank acquire 50 percent or more of the shares of any class of equity securities issued by an SBIC having actual or potential voting rights.

Agricultural Credit Corporation (ACC)

These subsidiaries, established under State law, are generally a means by which a bank can obtain funding to be able to continue to service the borrowing needs of its agricultural customers. The ACC establishes a financing relationship with the Federal Intermediate Credit Bank (FICB) by buying a participation certificate in the FICB. It is then able to borrow a certain percentage of the face value of loans by discounting those loans at the FICB on a full recourse basis. The ACC is examined and regulated by the FICB and any loans classified Doubtful or Loss at the parent bank, which are discounted at the FICB, must be replaced.

Inasmuch as lending limits to ACC's may be separate from and in addition to the bank's limit; care should be taken to avoid a concentration of credit to any individual borrower. Wholly owned ACCs should be examined by the FDIC with classifications reflected in a consolidated balance sheet and analysis of capital.

Special Purpose Finance Subsidiaries

A finance subsidiary is used as a mechanism for raising funds from outside investors through the issuance of collateralized debt or preferred stock. The parent bank places certain assets in the subsidiary to collateralize or otherwise support the securities issued by the subsidiary. Properly used, a finance subsidiary may enhance a bank's efforts to restructure its assets, obtain cheaper and more widely available funding sources, and improve overall profit performance.

Finance subsidiaries can also be used solely for the purpose of generating arbitrage profits rather than for the purpose of obtaining an additional source of funds. For example, a subsidiary might issue collateralized mortgage obligations and use the proceeds to simultaneously buy the mortgage-related collateral that will secure the collateralized mortgage obligation. Thus, the parent bank would receive no additional funds since the proceeds of the securities issuance are used to purchase the underlying collateral.

Bank management has the responsibility to carefully consider the impact of finance subsidiary transactions on the bank's overall financial position. Areas requiring attention include the following:

- Consolidation Requirements. For Reports of Income and Condition filed with the FDIC, subsidiaries that meet any one of the "significance" tests set forth in the Call Report instructions must be consolidated. Thus, securities issued to outside parties by a finance subsidiary that is wholly owned by the parent bank generally would be reported as a liability on the bank's consolidated financial statements.

- Capital Adequacy Considerations. If required to be consolidated with the parent bank for Call Report purposes, these subsidiaries must also be consolidated for purposes of evaluating capital adequacy under the FDIC's Part 324 capital regulation. As a result, finance subsidiary transactions are normally reflected as additional assets and liabilities on the bank's consolidated Report of Condition balance sheet. Because the transactions generally result in an increase in total assets with no increase in capital, the potential negative impact on the capital to asset ratio effectively limits the total dollar volume of such transactions.

- In addition, banks should carefully evaluate their overall asset/liability management, funding, and liquidity management strategies prior to entering into any proposed finance subsidiary transaction. In situations where finance subsidiary transactions are concluded in an unsafe or unsound manner, examiners should seek appropriate supervisory remedies.

Corporations Engaged in International Banking Activities

Edge Act Corporation - A Federally chartered corporation organized under Section 25(a) of the FR Act and subject to Federal Reserve Regulation K. Edge Act Corporations are allowed to engage only in international banking or other financial transactions related to international business. They are chartered and regulated by the Federal Reserve System and must have a minimum capital of $2,000,000 and a minimum life of 20 years. Their purpose is to aid in financing and stimulating foreign trade. An Edge Act subsidiary is a bank's majority-owned Edge Act Corporation and is treated for purposes of Reports of Income and Condition as a "foreign office."

Agreement Corporation

A State-chartered corporation that has agreed to operate as if it were organized under Section 25 of the FR Act and has agreed to be subject to FR Regulation K (refer to the FDIC Rules and Regulations). Banks must apply to the FR for permission to acquire stock in an Agreement Corporation, which is restricted principally to international banking operations.

Foreign Bank Subsidiary of a Limited Purpose Credit Card Bank

The GLBA adds a new provision to the BHC Act, which permits a credit card bank which is not a bank under the BHC Act to control a foreign bank if the investment in the foreign bank meets the requirements of Section 25 or 25A of the FR Act and the foreign bank qualifies under such sections; the activities of the foreign bank are permissible under otherwise applicable law; and the foreign bank does not offer any products or services in the United States.

Mortgage Banking Subsidiaries

Mortgage banking subsidiaries engage in the origination and/or purchase of mortgages for sale in the secondary market and the servicing of mortgages. The major functions of a mortgage banking subsidiary are:

- Origination, which includes application processing, underwriting, and closing,
- Secondary marketing, which includes purchases and sales, warehousing, packaging and shipping, investor relationships, and risk management, and
- Servicing, which includes mortgage accounting administration, collections, customer service, and investor reporting.

Insurance Subsidiaries

There is considerable variety in the laws and regulations of the states. Some allow bank subsidiaries to engage in insurance agency or brokerage operations, while others do not. Some limit the products that may be offered. Types of insurance products include credit liability, casualty, automobile, life, health, accident, title insurance, and private mortgage insurance. The insurance departments of the various states generally regulate insurance activities.

Real Estate Subsidiaries

State laws vary with respect to permissible real estate activities that may be conducted through bank subsidiaries. A number of states permit real estate brokerage activities. Others permit equity participations, which involve passive investment roles, and some states permit bank subsidiaries to engage in real estate development and ownership in an active role. In many cases investments are limited in terms of percentages of an institution's total assets or capital.

Real estate brokerage, management, development and investment are not permitted for national banks or their subsidiaries. For state non-member banks to invest or develop real estate, this activity must be authorized under State law and approved by the FDIC under Section 24 of the FDI Act. Real estate brokerage is considered to be an agency activity, so no FDIC approval is necessary.

EXAMINATION OF SUBSIDIARIES

Unlike affiliates, whose activities may be shielded from the insured institution through the holding company structure and the provisions of Sections 23A and 23B of the FR Act, the liabilities of a subsidiary may flow directly to the insured institution if appropriate barriers between the insured institution and its subsidiaries are not in place. Even with barriers, the legal precedents are such that there is no guaranty that the liabilities of a subsidiary may not adversely impact the parent. Thus, in order to determine the true condition of the parent organization, the risk presented by the subsidiary to the parent institution needs to be evaluated.

If the subsidiary is functionally regulated, the GLBA requires the FDIC to rely to “the fullest extent possible” on the functional regulator. Therefore, examinations conducted by the appropriate Federal and State regulators of functionally regulated entities should be used, if possible, rather than a direct examination of those entities. Examinations of functionally regulated subsidiaries are generally permissible only if:

- There is a reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to the depository institution,
- That an examination is necessary to assess risk management systems, or
- The subsidiary is not in compliance with a law that the agency has specific jurisdiction to enforce against the subsidiary.

If a high-risk profile is evident, more extensive examination procedures may be required. For a functionally regulated subsidiary, the examiner should contact the Regional Office before proceeding with any direct examination of the subsidiary’s records. Any records that the bank maintains, including any written policies and procedures concerning the bank’s oversight of the subsidiary, should be reviewed and assessed for adequacy. The objective is for examiners to reach a level of comfort sufficient to assess the overall condition of the subsidiary and its impact on the parent.

The Examination (ED) Modules contain examination procedures for examining subsidiaries. Refer to the Related Organizations section for additional guidance in this area.

Depending on the type of subsidiary, a more in-depth evaluation will generally involve assessment of the following areas:

Asset Quality

The examiner should attempt to ascertain the quality of assets, review delinquency reports where appropriate, and evaluate bank management oversight with respect to the subsidiary and any policies in place to determine the extent of any loss.

Funding and Liquidity

A determination should be made of the types of funding necessary for the subsidiary's activities, the reliability of present funding, and the extent to which the subsidiary's activities are being funded by the bank. An excessive reliance on any one source of funding may indicate future liquidity problems or undue reliance on the parent to provide funding.

Adequacy of Capital

To the extent possible, a determination of the adequacy of the subsidiary's capital should be made after reviewing asset quality, sources of funding, earnings, and management. Capital levels should be compared to regulatory requirements or other standards considered appropriate for the type of business the subsidiary is engaged in. This capital cushion is an important insulation to protect the bank from liabilities of the subsidiary.

In reviewing the parent bank's capital adequacy, the bank's investment in its subsidiary should be deducted from both assets and capital. This analysis will indicate the effect on the parent should the subsidiary become insolvent.

Earnings

The earnings stream of the subsidiary should be reviewed to determine if there is reliance on one time gains or if there is a failure to recognize losses on a timely basis. Fees received from the bank, salary structure and overhead expenses should be reviewed to ensure that charges are in line with those that would be made to third parties.

Management

Daily management of the subsidiary should be structured so as not to create the presumption that the activities of the subsidiaries are in any way conducted by the bank. Advertising and any required disclosures should be reviewed to ensure that the public is not given the perception that subsidiary activities are guaranteed by the bank or insured by the FDIC.

Another important management consideration is "firewalls." The term "firewalls" is used to describe a concept of separation of responsibility for entities providing different services but which are commonly owned. Firewalls generally include separate corporate formalities, management, employees, accounting, and policies. Also, the operations of the subsidiary should be physically distinct from the operations of the insured institution. Section 362.4(c)(2) of the FDIC Rules and Regulations is an example of a firewall construction designed to insulate the bank from liability of the subsidiary; compliance with Section 362.4(c)(2) should be reviewed where applicable.

EXAMINATION AND INVESTIGATION OF UNAFFILIATED THIRD PARTY SERVICERS

Situations occasionally arise where the safety and soundness of an insured depository institution is materially affected by transactions, contracts or business arrangements with parties that are not affiliated with the institution. When such situations arise, it is necessary for the FDIC to examine the other side of the transaction. The potential impact of these business relationships on the insured depository institution necessitates a complete understanding of the nature of the transaction and relationship and its effect on the insured institution.

By statute, the FDIC has authority to obtain records of unaffiliated service providers and other counterparties relating to an insured financial institution. Such authority is not unqualified but depends on particular facts and circumstances giving rise to inquiries by the FDIC. Several statutory provisions support this conclusion: Sections 10(b) and 10(c) of the FDI Act; Section 7(c) of the BSC Act; and Sections 3(w)(5) and (6) of the FDI Act. The information that the FDIC can obtain from an unaffiliated service provider or other counterparty is not limited to specific transactions with or relating to the insured depository institution but can extend to the financial books and records of the servicer or entity so long as such documents are needed in furtherance of an examination that relates to the affairs of an insured bank.

It is important that examiners are aware of material transactions, service contracts, or other business arrangements that could have a material affect on an insured bank. If it is concluded that information is needed from an unaffiliated service provider or other counterparty to the bank, then the examiner should consult with the Regional Office. The Regional Office will assist the examiner in determining whether information is needed from an unaffiliated service provider, and if so, in obtaining the appropriate information.

Examination authority covering bank service corporations is set out in Section 7 of the BSC Act.

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[1] Qualified Thrift Lender test requires that at least 65% of the institution's assets be qualified thrift investments, primarily residential mortgages and related investments.

[2] Generally, an ILC is excepted from the BHC Act if (A) it was chartered under a State law that on March 5, 1987 required the ILC to have Federal deposit insurance, and (B) it meets at least one of the following conditions: (1) the institution does not accept demand deposits, (2) the institution's total assets are less than $100,000,000, or (3) control of the institution has not been acquired after August 10, 1987.

INTRODUCTION

Risk management is intended to minimize the cost associated with certain types of risk and provide prudent protection. The maintenance of appropriate levels of necessary insurance coverage is a key aspect in the risk management process. It deals with pure risks that are characterized by chance occurrence and may only result in a financial loss, as opposed to a speculative risk which affords the opportunity for financial gain or loss. Such pure risks are separated into three major exposure categories: liability, property, and personnel.

There are three stages in the risk management process: risk identification and analysis, risk control, and risk treatment. Identification and analysis requires a review of all aspects of the bank's present and prospective operations to determine where the bank is exposed to loss, including consultation with a reliable insurance professional. Risk control is primarily dependent upon the strength of the bank's internal controls, policies and procedures. Risk treatment refers to choosing the appropriate steps or methods to deal with a particular risk. The objective of this process is to minimize the probability of losses and costs associated with them, such as direct costs of loss prevention measures, insurance premiums, losses sustained, and related administrative expenses. A bank has several options in treating a particular risk. It can implement additional controls to minimize yet retain the risk (i.e. become a self-insurer), transfer the risk to another party through insurance or contractual transfer, or utilize a combination of both of these approaches. A basic tenet of risk management is that those risks which carry the potential for catastrophic or significant loss should not be retained, if avoidable. Conversely, it is not cost justified to insure losses which are relatively predictable and not severe. The board of directors must determine the maximum loss the bank is willing and able to assume, and should perform an annual review of the bank's risk and insurance management program.

The real value of insurance lies in the protection it affords against catastrophic losses. To the extent a bank does not have adequate coverage, losses deplete capital and impair the position of depositors and the FDIC. Examiner review and analysis of the adequacy of the bank's insurance program is clearly necessary. The various types of insurance coverage (delineated below) serve only as a guide and a reference of available insurance protection. The specific needs of a bank must be determined on an individual basis, and only by reviewing each policy in force, can the actual degree of coverage and protection be determined. Any material inadequacies of insurance coverage should be directed to management's attention. Lack of any significant coverage, board of director approval and review, or deficiencies in a bank's loss prevention program should be appropriately commented upon in the Report of Examination.

FIDELITY INSURANCE PROTECTION

Fidelity insurance protection is appropriate for all banks because it insures against certain risks that contain the potential for significant loss. Section 18(e) of the Federal Deposit Insurance Act (FDI Act) provides that the FDIC may require such coverage, and if it is not obtained, may contract for such protection and add the cost to the bank's deposit insurance assessment. However, such action would only be taken in rare instances, such as when a bank is able to obtain protection but refuses to do so.

If the bank is without coverage, a thorough investigation should be made to determine the reasons insurance protection is lacking. Such banks must continue diligent, good faith efforts to obtain reasonably priced coverage. Their efforts should be monitored periodically to confirm the actions being taken to obtain coverage, including steps necessary to satisfy any conditions that may have been imposed by an insurer as a prerequisite for coverage.

In some cases, a bank may offer alternate arrangements in lieu of the usual insurance bond. While it is difficult to generalize, these arrangements (i. e. having directors or owners sign personal guarantees or increasing the bank's capital) do not protect the bank against the same risks in essentially the same manner or to the same extent, and therefore, are generally not acceptable as substitutes for insurance coverage. However, each such offer should be appraised on its merits for whatever additional protection it might provide in the interim.

While a periodic review of internal and external security measures and controls is warranted in every bank, it is especially appropriate in a bank that is operating without fidelity insurance coverage. Ideally, this effort should be undertaken as a special project with responsibility fixed in a particular executive officer. Further, it should include a comprehensive review of the bank's existing programs, the design and implementation of additional security procedures and controls, and a formal report to the board of directors, with any actions taken by the board based on the report findings noted in the minutes of the meeting. Management should also consider using outside experts, as necessary, to assist in strengthening internal programs or possibly to help the bank qualify for fidelity protection where a carrier has previously cited specific deficiencies that require correction.

Providing Examination Information to an Insurance Carrier

Occasionally, a bank may ask to release all or part of an examination report to an insurance carrier. These inquiries should be discouraged. A bank should be able to demonstrate its insurability to prospective insurers without having to release confidential information from an FDIC examination report. Adequate information is available from the bank's records and from nonconfidential sources to enable an insurer to accurately assess its underwriting risk.

Protection From Both External and Internal Hazards

External hazard includes the possibility of dishonest, fraudulent, or criminal acts committed against the bank and its employees by the general public. Robbery, burglary, and forgery are the predominate acts. Banks endeavor to guard against losses from these sources by maintaining vaults and safes, reliable alarm systems, and other security devices which should, at a minimum, meet the requirements set forth in Part 326 of the FDIC's Rules and Regulations. Banks should also attempt to limit the size of such losses by keeping exposed cash and negotiable securities at a minimum.

Internal hazard, which poses a far greater risk, deals with the possibility of defalcations by the bank's own personnel. Banks should try to protect themselves against this hazard by maintaining clear records and effective systems of internal routine and controls. The maintenance of an appropriate level of insurance coverage helps to further limit the institution’s level of risk related to employee defalcations and other types of internal fraud.

Bankers Blanket Bond Insurance

The most common form of blanket bond used by commercial and savings banks is the Financial Institution Bond, Standard Form No. 24. Other forms may be encountered and should be thoroughly analyzed to determine the extent of coverage. Standard Form No. 24 has two different limits of liability--a single loss limit of liability and an aggregate limit of liability. The single loss limit applies to individual claims, whereas the aggregate limit applies to the total of all loss recoverable under the bond. For example, if there is a $500,000 single loss limit and a $1,000,000 aggregate limit, payment of the single loss reduces available coverage for further losses during the bond period to $500,000. When the aggregate limit of liability is exhausted, the bond automatically terminates regardless of the remaining term and without any refund of premium. In order to determine the remaining insurance coverage, the amounts of all prior and pending claims against the bond should be deducted from the stated aggregate limit.

Scope of Blanket Bond Coverage

Clause (A) - Fidelity

Covers losses as a result of dishonest or fraudulent acts by officers and employees, attorneys retained by the bank, and non-employee data processors while performing services for the insured. This clause generally excludes loss caused by a director, unless the director is also a salaried employee of the bank. "Dishonest or fraudulent acts" are defined as acts committed by such employee with the manifest intent to cause the insured to sustain such loss and obtain financial benefit for the employee or another party (other than salaries or other employee benefits earned in the normal course of employment). Coverage of losses resulting from loan activity is severely restricted. Such losses are covered only if the employee involved acts in collusion with another party to the transaction and the employee receives a financial benefit of at least $2,500.

Clause (B) - On Premises

Loss of property (as defined in the bond) resulting directly from (a) robbery, burglary, misplacement, mysterious unexplainable disappearance and damage thereto or destruction thereof, or (b) theft, false pretenses, common law or statutory larceny, committed by a person present in an office or on the premises of the insured, while the property is lodged or deposited within offices or premises located anywhere.

Clause (C) - In Transit

Identical coverage as that provided in Clause (B), except that the property is covered while in transit. The property must be in the custody of a person acting as a messenger of the bank while in transit. When an armored vehicle is not used by a transportation company, property is generally limited to written or electronic records, certified securities, and negotiable instruments.

Clause (D) - Forgery or Alteration

Optional coverage for loss through forgery or alteration of, on, or in checks, drafts, acceptances, and other negotiable instruments, as specified, which are received by the bank either over-the-counter or through clearings. Items received as a transmission through an electronic funds transfer system are not covered.

Clause (E) – Securities

Optional coverage for loss resulting from the insured having, in good faith, for its own account or for the account of others, acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of any original security, title document or agreement (as delineated in the bond).

Clause (F) - Counterfeit Currency

Covers loss resulting from the receipt by the insured in good faith, of any counterfeit or altered money of the United States or Canada or any foreign country in which the insured maintains a branch office.

Factors to Consider in Determining Adequate Amount of Blanket Bond Insurance

Often, the most difficult insurance problem confronting bank management is determining the amount of blanket bond coverage that should be maintained. While an estimate of money and securities which might be lost through burglary or robbery can be fairly accurately calculated, there are no ready measures for estimating potential losses that may arise from employee dishonesty.

The problem of determining an adequate amount of insurance coverage to indemnify for losses from external hazards is not a complex problem. Property values at risk can be estimated fairly accurately and the level of exposure from daily operations is also generally ascertainable. The various types and amounts of transactions routinely conducted should also be appraised and considered when determining appropriate levels of insurance coverage. For instance, it may be prudent to reduce the insurance coverage for forged securities (within Clause E) taken as collateral for a loan to the amount of the in-house bank lending limit. If that limit is never exceeded, the bank would not suffer a loss greater than that limit on any given transaction.

Determining an adequate amount of fidelity insurance on the bank's own personnel is a more difficult task that cannot be based solely on one precise factor. It requires the use of management and examiner judgment. Banking associations or the insurance industry may periodically develop schedules indicating the range of blanket bond coverage carried by banks grouped by deposit size. However, a bank's level of risk exposure is influenced by many variables, only one of which is deposit size. Therefore, an overall assessment of the effectiveness of the bank's internal operations must be considered. Other factors which may increase fidelity exposure and should be given consideration are: the amount of cash and securities normally held by the bank; the number of employees and their experience level; delegations of authority to employees; personnel turn-over rates; the extent of trust, information technology, or off-balance sheet activities; and whether an institution is experiencing rapidly expanding operations.

When the bank is a member of a holding company or other group of affiliated banks, one fidelity bond is usually purchased to cover the parent and all affiliated banks. In such situations, the examiner should determine that the policy is sufficient to cover the exposures of the subsidiary bank being examined. Further, examiners should also determine that any policy premiums the subsidiary bank pays to the parent holding company are not disproportionate to the bank’s benefits from the group policy and that such premiums are consistent with the fair market requirements of Section 23B of the Federal Reserve Act.

Basis for Claims Under the Bankers Blanket Bond

It is standard procedure for insurance companies to write blanket bonds on a “claims made” or "discovery" basis. Under this method, the insurance company is liable up to the full amount of the policy for losses covered by the terms of the bond and discovered while the bond is in force, regardless of the date on which the loss was actually sustained by the bank. This applies even though lower coverage amounts or more restrictive terms might have been in effect on the date the loss was sustained. Alternatively, bonds may be written on a "loss-sustained" basis. This means the bonding company is liable only to the extent of the coverage for losses sustained during the period the bond is in force. Situations which prompt an insurer to write a blanket bond on a loss-sustained basis may arise from another insurer having cancelled or refused to renew a bank's bond (i.e. the insurer is not willing to assume the risk of any undiscovered losses which may have occurred while the bank was insured by another company); the loss record of the bank; poor internal controls; or uncertainty concerning management's abilities.

Blanket bonds require that a loss be reported to the bonding company within 30-days after discovery. Failure to file a report once management is aware of discovery, even if there is uncertainty as to reportability, could jeopardize coverage for that loss. In addition, coverage as to any employee automatically cancels as soon as the bank has knowledge of any dishonest or fraudulent act on the part of an employee. Coverage on such employee can only be assured by written affirmation of the insurer. Likewise, an appropriate written waiver from the insurance company should be in evidence for any individual who has been granted consent to serve as a director, officer or employee pursuant to Section 19 of the FDI Act.

Banks must also notify the underwriter within 30-days of receiving any notice of legal action being brought against it which could result in a claim under the bond. The underwriter may elect, at its option, to defend the insured. If timely notice is not given by the bank or if the underwriter elects not to defend the action, the underwriter is not liable for attorneys' fees and court costs, nor does any judgment against the bank determine the existence of bond coverage.

The general agreements to Standard Form No. 24 make the application for insurance coverage part of the bond. Any misrepresentation, omission, concealment or incorrect statement of material fact in the application may be grounds for recession of the bond. Due to this strong language in favor of bonding companies, banks must be absolutely truthful, accurate and thorough in responding to questions on bond applications and questionnaires. There may be instances when it is appropriate for examiners to review such applications and questionnaires for accuracy and completeness.

Under the present Standard Form No. 24, there are no rights of any parties to make claims under the bond after the termination or cancellation of the bond. Banks may no longer purchase the right to extend the discovery period. It is therefore vitally important for banks to make immediate notification to the underwriter upon discovery of loss covered by the terms of the bond. If there is any uncertainty in this regard, the matter should be investigated promptly to determine whether a loss has in fact occurred that is covered by the terms of the bond. Moreover, the results of any such investigation should be documented as the investigation proceeds. There is immediate termination of the bond upon the taking over of the insured by a receiver or other liquidator or by State or Federal officials. The FDIC is thus effectively barred from pursuing any claims against the bonding company which were not discovered by the bank prior to its closing.

It is critical that the examiner in a potential closing situation call to the attention of the bank's board of directors all known facts concerning any loss discovered during the examination, and the bond requirements that notice be given to the bonding company within 30-days of discovery.

Information Technology (IT) Coverage

IT coverage is provided in the bond for serviced banks under the definition of "employee," which is defined to mean each natural person, partnership, or corporation authorized by the insured to perform services as data processor of checks or other accounting records of the insured. Usually the only riders for IT coverage are those to eliminate it from the policy, which is not advisable. To further protect banks with electronic funds transfer systems (EFTS) and those with in-house computers that contract with outside programmers, additional coverage may be obtained by a rider or separate policy referred to as computer/computer related theft insurance. Usual coverage protects banks from criminal acts affecting data processing equipment, communication lines, data elements and program logic located in one or more of the insured's offices, at contract service bureaus (including financial institutions), and at automated clearing houses, switches or other electronic communications systems. For more detailed coverage of IT insurance, refer to the FFIEC IT Examination Handbook.

Blanket Bond Riders

Numerous riders are available to delete or supplement coverage for risks not included in the basic blanket bond. In some instances, a separate policy may be obtained. While not necessarily all inclusive, a list of common riders purchased by financial institutions is detailed below. All riders should be carefully reviewed since additions and deletions to the basic policy can have a significant impact on overall coverage.

Deductible and Self-Insurance Riders

Banks and insurance companies frequently use deductible clauses to customize the blanket bond coverage to a particular bank. The deductible amount generally ranges from $1,000 to $100,000, or higher, and is directly related to the willingness and ability of the bank to absorb risks. A bank with a history of few claims may choose to lower its premium costs by requesting a higher deductible on its blanket bond policy. On the other hand, a bank with a history of numerous losses may be required to utilize a deductible clause as a condition for continued blanket bond coverage. The use of deductibles obviously lowers the cost of insurance.

Automated Teller Machine Riders

Covers loss involving automated mechanical devices for disbursing money, accepting deposits, cashing checks or making credit card loans when such devices are not located within an office of the insured, and not permanently staffed with a bank teller.

Kidnapping, Ransom and Extortion Rider

Covers losses arising from any of the various forms of extortion whereby the physical well-being of a person(s) is or is believed to be imperiled.

Computer Systems Rider

Covers losses resulting from the fraudulent entry of data or from the change of data or programs within a computer system.

Excess Employee Fidelity Coverage

The purpose of such coverage is to extend the basic protection provided under the blanket bond in areas where the dollar volume of assets or exposure is particularly high. Such excess coverage usually is written in multiples of $1 million and either carries a deductible clause equal to the amount of the blanket bond (usually requires primary bond coverage of at least $250,000), or states that coverage will be provided for the full amount of the excess policy when losses exceed a specified amount. Any deductible in excess of underlying primary coverage should be discussed with management. The most common form of this coverage is the Excess Bank Employee Dishonesty Blanket Bond, Standard Form No. 28. The FDIC strongly recommends that all banks acquire this modest cost protection against the possibility of catastrophic fidelity losses, unless the primary blanket bond coverage is large enough to equal or exceed the protection provided by an excess fidelity bond.

Other Specialized Bank Insurance

This is not a comprehensive list of coverage available, but rather those frequently purchased.

Combination Safe Depository

Consists of two coverage sections that can be purchased together or separately. Clause (A) covers losses when the bank is legally obligated to pay for loss (including damage or destruction) of a customer's property held in safe deposit boxes. Clause (B) covers loss, damage, or destruction of property in customer's safe deposit boxes, whether or not the bank is legally liable, when such loss results from other than employee dishonesty. The policy commonly provides for reimbursement of legal fees in conjunction with defending suits involving alleged loss of property from safe deposit boxes.

Registered Mail and Express Insurance

Insures valuable property such as money or securities shipped by registered mail, registered air mail, express, and air express. Coverage is provided from the time the property leaves the bank until delivered to the addressee.

Transit Cash Letter Insurance

Covers loss of cash letter items in transit for collection or to a clearing house of which the insured bank is a member. It also includes costs for reproducing cash letter items. Generally, such policies do not cover items sent by registered mail or air express, or losses due to dishonest acts of employees.

Valuable Papers and Destruction of Records Policy

Covers the cost of reproducing records damaged or destroyed. It also provides the cost of research needed to develop the facts required to replace books of accounts and records.

OTHER DESIRABLE INSURANCE COVERAGE

The banking industry customarily utilizes forms of insurance for which the blanket bond, along with related policies, endorsements and special coverage previously noted, does not provide coverage or provides insufficient protection. Banks may also need many of the same types of insurance required by any business or individual. The following is a brief description of some of those types of coverage.

Liability Insurance

Directors and Officers Liability

These policies provide for the indemnification of directors and officers against legal and other expenses incurred in defending lawsuits brought against them by reason of the performance of their official duties. They protect, under two insuring clauses, against the expense of defending suits alleging director or officer misconduct and against damages that may be awarded. Clause (A) provides coverage directly to the directors and officers for loss resulting from claims made against them for their wrongful acts. Clause (B) reimburses a corporation for its loss when the corporation indemnifies its directors and officers for claims against them. An additional, optional coverage provides protection for the corporation and its own liability. This coverage is written at a minimum of $1 million (deductible $10,000 to $20,000) with the insurance company paying a portion of any claim over the deductible amount. This insurance does not cover criminal or dishonest acts, situations when the involved person obtained personal gain, or when a conflict of interest was apparent.

General Liability

Covers the bank from possible losses arising from a variety of occurrences. Typically, general liability insurance provides coverage against specified hazards, such as personal injury, medical payments, property damage, or other specific risks that may result in or create exposure to a suit for damages against the bank. Where offered, "comprehensive" general liability insurance covers all risks, except specific exclusions.

Automobile Liability and Physical Property Damage

Protects against property and liability losses arising from injury or death when a bank-owned, rented, or repossessed vehicle is involved. Non-ownership liability insurance should be considered if officers or employees use their own vehicles for bank business.

Umbrella Liability

Provides excess coverage over and above existing liability policies, as well as basic coverage for most known risks not covered by existing liability insurance.

Fixed Assets/Property Physical Damage

Adequate insurance should be maintained to cover loss or damage of the bank's fixed assets.

Fire or Extended Coverage

This insurance covers all loss as a direct result of a fire, including damage from smoke or water and chemicals used to extinguish the fire. Covering the building's contents for fire damage is additional, but often is written in combination with the policy on the building and permanent fixtures. Extended coverage indemnifies against losses from windstorm, hail, explosion, riot, civil commotion, aircraft, vehicles, and smoke damage. Damage caused by rising water or the malfunction of a steam boiler is usually not included. Most fire insurance policies contain "coinsurance" clauses, meaning insurance coverage must be maintained at a fixed proportion of the replacement value of the building. If a bank fails to maintain the required relationship of protection, all losses will be reimbursed at the lower ratio of the amount of the insurance carried to the amount required, applied to the actual value of the building at the time of the loss. When determining insurable value for fire insurance purposes, the typical base is the cost of replacing the property with a similar kind or quality at the time of loss.

Boiler and Machinery

Provides coverage for loss due to explosion or other forms of destruction of boilers, heating and/or cooling systems, and similar types of electrical equipment.

Fine Arts

Includes coverage for art objects on display whether owned by the bank or on loan from another source. Protection generally is all-risk and requires that an appraisal of the material be made regularly to establish its insurable value.

Extra Expense

Provides funds for the additional costs of reestablishing the bank's operations after fire or other catastrophe such as renting temporary quarters and/or equipment on an interim basis.

Business Interruption

Provides reimbursement for the gross earnings lost when the bank cannot operate because of fire or other catastrophe, often with a coinsurance clause.

Rental Income

Provides protection when a fire or other hazard renders the insured premises unfit for occupancy and a lessee ceases to pay rent. The policy will pay the building owner an amount equal to the reasonable rental income immediately before the loss, less any avoidable expenses.

Bank Owned/Leased Automobile

Standard coverage for accidental loss sustained through collision involving a bank automobile. Comprehensive coverage also is available for damage to an automobile other than through collision.

Lending Activities

Various types of insurance are available to cover certain risks in lending activities dependent upon what management considers necessary and warranted for the bank.

Mortgage Lending Activity

Mortgage Errors and Omissions

Protects the bank from loss when fire or all-risk insurance on real property held as collateral inadvertently has not been obtained or has expired. Generally, this insurance is not intended to overcome errors in judgment, such as inadequate coverage or insolvency of an original insurer.

Title Insurance

Insures marketability of title, access to the property, validity and enforcement of the mortgage and, subject to the stated exceptions, its priority. The policy also insures that the person to whom the bank is making the loan has title to the real estate pledged as security. Commitments for insurance are issued in advance of closing, outlining the scope of the coverage, stating the specific exceptions from coverage and the standard exceptions.

Mortgagor's Defaults

Contract with a third-party mortgage insurer to absorb all or part of the risk that the value of the mortgaged property will not cover the loan and costs. Government agencies (Federal Housing Administration {FHA} and Veterans Affairs {VA}) and private insurers provide mortgage protection coverage. This insurance is attractive to lenders who intend to sell mortgages in the secondary market.

Installment Lending Activity

Single Interest

This insurance covers losses to uninsured vehicles pledged as collateral for an extension of credit.

Nonfiling Insurance

Covers losses resulting from nonfiling of liens or recording appropriate instruments on personal property pledged as collateral under chattel mortgages, conditional sales contracts and other similar instruments.

Credit Life, Accident and Health

These types of insurance are written in conjunction with an extension of credit, especially an installment loan, and are designed to protect the bank against loss in the event of a debtor's inability to pay because of sickness, accident or death.

Fraudulent Accounts Receivable and Fraudulent Warehouse Receipts

Cover losses resulting from the pledging of fraudulent or nonexistent accounts receivable and warehouse receipts, or from situations in which the pledger does not have title. In addition, this insurance offers protection against loss arising from diversion of proceeds through acts of dishonesty.

Personnel Administration

Depending on the needs of an individual bank, there are various types of coverage that can be obtained to benefit employees or cover the loss of an employee.

Key Person Insurance

Insurance purchased for the benefit of the bank on the life of an officer when the death of such "key person" would be of such consequences as to affect the operation of the bank. The term "key person" is defined to mean any bank officer, regardless of title, who participates in major policy making functions of the bank and whose loss to the bank would be of consequence because of knowledge, experience and related qualifications. Many "key person" insurance programs are designed to provide a fringe benefit to the insured officer and family. The benefit accrues to the officer when, upon death, the board of directors of the bank directs payment of the proceeds to the officer's family.

Employee Benefit Insurance

An employee benefit program, to be effective, must be able to respond to the changing needs of employees; be competitive with other firms in the trade area who employ individuals similarly qualified to those employed by the bank; be of reasonable overall cost; and compare favorably to peer group statistics. Some insurance coverage is legally required, such as unemployment insurance, worker's compensation, and Social Security. Other commonly provided insurance policies are group insurance protection for life, health, accident, medical, hospitalization, vision, and dental. Other programs such as deferred compensation and salary continuance have been developed which provide additional fringe benefits to key officers and/or their designated beneficiaries. The premiums for such insurance are paid either in part or entirely by the bank, with the bank having no beneficial interest in the policy.

VIOLATIONS OF LAWS AND REGULATIONS

INTRODUCTION

Financial institutions operate within a regulatory framework based on state and federal statutes, regulations, and administrative rulings. These laws and regulations are designed to protect the public (depositors, consumers, investors, creditors, etc.) by establishing operational standards and consumer protections for the banking industry. Violations of laws and regulations can reflect negatively on a bank's board of directors and management and can expose an institution to financial and other risks. Accordingly, examiners must have a thorough knowledge of state and federal laws and regulations to ensure that violations are promptly detected and corrected.

Causes

Violations often result from management's unfamiliarity with, or misinterpretation of, governing statutes or regulations. Negligence and willful noncompliance may also lead to violations. To reduce the risk of violations, the board of directors and senior management should develop:

- Policies, procedures, and training programs designed to ensure that directors, officers, and employees are familiar with applicable laws and regulations;
- Monitoring procedures to assure compliance with laws and regulations in daily operations; and
- Procedures for detecting noncompliance, reporting it to the board and management, and correcting identified issues promptly.

Differences of opinion can arise regarding the interpretation of laws and regulations. If management disagrees with the applicability or meaning of a statute or regulation and examiners are in doubt as to its applicability or meaning, the examiners may consult with the regional office to confirm the applicability or meaning.

Willful acts of noncompliance with laws or regulations should be taken seriously and thoroughly investigated by examiners. Depending on the gravity of an offense and other factors, willful noncompliance may result in civil money penalties (CMPs), or other administrative actions under Section 8 of the Federal Deposit Insurance Act (FDI Act).

Significance

The fair and non-discriminatory treatment of stakeholders and customers should be sufficient reason for bankers to operate in accordance with laws and regulations. Bank directors and officers should be aware, however, that there are also more direct and personal reasons to conform to laws and regulations. Federal statutes and regulations (and those of some states) provide for the assessment of civil money penalties against banks and individuals for certain violations. Additionally, most state laws provide that directors can be held personally liable for a bank's losses relating to illegal loans or other nonconforming assets (assets acquired or held by the bank in violation of a law or regulation). Such losses may also prompt requests for restitution or other corrective measures. Finally, infractions of laws and regulations may prompt litigation and requests for money damages by adversely affected parties.

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SCHEDULING VIOLATIONS

Examiners should cite apparent violations on the Violations of Laws and Regulations schedule of the Report of Examination (ROE). Nonconformance with interagency guidelines that are incorporated into regulations (such as Appendix A or B of Part 364, or Appendix A of Part 365 of the FDIC Rules and Regulations) should be segregated under an appropriate subheading, listed after cited apparent violations, and include information similar to apparent violations. Detailing infractions on one schedule allows examiners to present issues to bank officials more effectively and allows readers to evaluate the type and severity of apparent violations more easily. Comments should include:

- Clear, concise headings for each violation or group of related violations;
- Descriptions of each applicable statute or regulation;
- Details of the action or inaction that caused an apparent violation;
- Names and dates of directors' approvals/dissentions;
- Management's response; and
- Commitment/timing of any promised corrective action.

When describing a law or regulation in the ROE, examiners should cite the specific section number and either quote or paraphrase the law or regulation. In controversial situations, examiners should generally quote applicable sections. In non-controversial situations, examiners may paraphrase regulations, but must ensure descriptions accurately convey a statute or regulation's main point. For example, "Section 337.3(b) prohibits banks from making large loans to directors without prior board approval."

Examiners must be accurate when describing the action or inaction that caused an apparent violation; however, it is generally unnecessary to provide lengthy explanations. For example, an infraction of Section 337.3(b) could be described as, "The $3 million loan to Director Smith funded on 12/2/18 is in apparent violation of Part 337 because it was extended without prior board approval."

Examiners may avoid lengthy descriptions of violations relating to classified assets by referencing write-ups included in other ROE schedules, such as the Items Subject to Adverse Classification.

To reflect director responsibility and possible liability, report comments must identify the directors who approved or ratified the apparently unlawful actions, the date of the approvals, and the names of any dissenting directors. Examiners should follow these procedures even if an approval consisted merely of the ratification of a group of loans, possibly identified only by numbers.

General Considerations

- Use the phrase *apparent violation* to describe infractions directly related to laws and regulations, no matter how certain the violation may appear.
- List violations in order of importance, considering the substance and severity of the violation.
- Exercise care when citing apparent violations because incorrectly cited infractions discredit the ROE.
- State if an apparent violation was corrected during the examination.
- Generally, include sample lists when violations involve numerous accounts or credits. (Detail the total number of accounts or credits in the ROE, give complete lists to management, and retain a copy of the list in the workpapers.)
- Cite the specific section or subsection of a regulation, such as Section 337.3 or Section 337.3(b), when referring to specific regulations.
- Cite a regulation's part number, such as Part 337, when referring to general regulations.

The considerations above apply similarly to citations of nonconformance with guidelines incorporated into an appendix to a regulation. Key differences being:

- Use the term *nonconformance* to describe significant deficiencies in adherence to the guidelines contained in appendices to regulations, such as the appendices to Part 364 or 365.
- List nonconformance with such guidelines after apparent violation citations and under the separate heading *Nonconformance with Guidelines Incorporated into Appendices to Regulations*.

Uncorrectable Violations

Examiners should not continue to cite previously cited violations that cannot be corrected. For example, violations of the prior approval requirements of Regulation O are not correctable and should not be cited at subsequent examinations. However, examiners should cite repeat violations (new infractions of previously cited violations), and continuing violations (violations that could have been, but were not, corrected).

Report Comments

If apparent violations of law or regulation, or nonconformance with an appendix to a regulation, are cited in the ROE, the Examination Conclusions and Comments (ECC) page must include, at a minimum, a brief summary comment and reference to the Violations of Laws and Regulations page. References to other report pages may also be necessary if related issues, such as internal control or policy weaknesses, are detailed elsewhere in the ROE.

Examiners should not refer to the FDIC's authority to impose CMPs, or to the possible amount of CMPs that may be imposed, except in serious situations. Examiners can comment that violations may be subject to CMPs if violations cited at previous examinations are repeated or not corrected.

Note: When an examiner concludes that violations detected during the examination warrant a CMP recommendation to the regional office, the home mailing addresses of all directors and any other individuals involved in the violation should be included in the Directors/Trustees and Officers section of the ROE.

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TYPES OF VIOLATIONS

The following sections describe common violations detected in safety and soundness examinations. Most examples relate to nonconforming assets.

Legal Lending Limit Violations

A borrower's debt at a bank may consist of several notes of different dates. When the total of such notes exceeds state or federal lending limits, courts have generally held that only the note(s) that created the excess above the lending limit constitutes an illegal extension. Until the note(s) are paid in full, they represent a violation for which the approving directors may be held liable. Generally, examiners should cite only the note(s) that caused the apparent violation. However, if state law or practice differs from this guidance, state law prevails.

Courts have also held that if several notes constitute a single transaction, all notes should be treated as a unit and the entire loan balance considered an illegal extension for which the approving directors may be held liable.

Note: Loans are sometimes made in conformance with statutory lending limits, but subsequently exceed lending limits due to a decline in capital levels or appraised values. Examiners should not cite violations in these situations unless indicated by state law. However, violations should be cited if the loans were renewed at levels exceeding lending limits.

Nonconforming Loans to Insiders

Bank directors and officers have responsibilities to stockholders and depositors. Their actions must be conducted in good faith and free from self-dealing or conflicts of interest. Loans to directors, officers, employees, principal shareholders, and their interests must be beyond reproach, and illegal loans must be reported and corrected as soon as possible.

Nonconforming extensions of credit to insiders and their interests may violate state laws, Federal Reserve Board Regulation O, or Section 337.3 of the FDIC Rules and Regulations. These statutes limit the dollar amount of loans banks may extend to insiders, prohibit banks from making insider loans on preferential terms or conditions, and establish recordkeeping requirements.

Nonconforming Affiliate Transactions

Sections 23A and 23B of the Federal Reserve Act govern transactions between member banks and their affiliates. Section 18(j) of the FDI Act makes Sections 23A and 23B applicable to state nonmember banks.

All infractions of Sections 23A and 23B, including nonconforming extensions of credit to, and illegal investments in, an affiliate should be cited as apparent violations.

Nonconforming Real Estate Loans

Various laws and regulations govern the extension of loans to purchase, or secured by, real estate. For example, Part 365 of the FDIC Rules and Regulations requires institutions to develop written policies that establish appropriate limits and standards for real estate related loans. Part 323 requires institutions to obtain appraisals from qualified appraisers for various real estate related financial transactions.

Generally, examiners should list the current book value of nonconforming loans if they identify violations of these or other real estate related regulations. In cases where violations involve multiple loans, only the loan(s) that created the violation should be cited.

Nonconforming Securities Securing Loans

Various statutes and regulations govern the process of collateralizing loans with securities. For example, Federal Reserve Board Regulation U restricts loans made for buying margin stock if the loans are collateralized by margin stock. Section 23A of the Federal Reserve Act prohibits banks, with certain exemptions, from securing loans to an affiliate using any affiliate's stock as collateral. Also, Treasury Department regulations prohibit the pledging of certain savings bonds as loan collateral. Where ineligible bonds are designated as collateral, examiners should not recognize the loan as secured. However, the loan itself may not be a violation and should not be included in this schedule unless collateral is required, or it is otherwise nonconforming. For example, it lacks a financial statement required by a state law for unsecured loans.

Loans collateralized in apparent violation of law or regulation should be cited at the current balance of the loans.

Securities Unlawfully Acquired or Held

Part 362 of the FDIC Rules and Regulations and many state laws restrict banks from investing in certain types of securities. For example, banks may be prohibited from acquiring common stock or other forms of equity investments. Exceptions are sometimes allowed for investments in subsidiaries holding title to bank premises, stock in bank service corporations, or securities taken in consideration of debt previously contracted (DPC). If a bank appears to have unlawfully acquired or held a security, examiners should contact the regional office and when appropriate cite the current book value as an apparent violation in the ROE.

Nonconforming Other Real Estate

State laws sometimes require banks to divest of, within defined periods, real estate acquired through foreclosure, repossession, or otherwise in satisfaction of DPC. Examiners do not need to cite violations for real estate acquired DPC and held longer than permitted by statute if the asset is carried on the books at a nominal value. However, real estate acquired illegally (as distinguished from real estate acquired DPC), should be cited as an apparent violation even if fully charged off.

Charged-Off Nonconforming Assets

Illegally held or acquired assets are violations regardless of any related charge-offs. For example, if a bank makes a loan that exceeds legal lending limits and subsequently charges off all or part of the debt, the borrower remains liable for the unpaid loan balance and the loan remains a violation at the original amount. Were this interpretation not in place, bank management, desiring to accommodate a borrower beyond the legal limit, could make excessive loans and simply charge them down to the legal limit or eliminate them from their financial records. The same general rule holds true regarding most other types of nonconforming assets.

All Other Violations

Some violations of laws and regulations are not associated with the acquisition or holding of a nonconforming asset. They include most apparent violations of the FDI Act, FDIC Rules and Regulations, Bank Holding Company Act, and other similar federal and state laws and regulations.

However, some of these apparent violations are not scheduled in the safety and soundness ROE. For example, apparent infractions of the federal criminal code are reported separately, and infractions of the Truth in Lending Act and Equal Credit Opportunity Act are excluded since they are covered in separate consumer compliance ROEs.

Nonconformance with Guidelines Incorporated into Regulations

Nonconformance with guidelines or standards that are incorporated into regulations (such as Appendix A or B of Part 364, or Appendix A of Part 365 of the FDIC Rules and Regulations) should be scheduled in the Violations of Laws and Regulations page, under a separate heading and after apparent violations of laws and regulations. Related supervisory recommendations should be summarized on the ECC page and should include at a minimum, a brief summary comment, and reference to the Violations of Laws and Regulations page, and other pages when applicable. When appropriate, the concerns should be brought forward to the Matters Requiring Board Attention schedule.

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EVALUATION OF MANAGEMENT

Examiners must consider a bank's adherence to laws, regulations, and internal policies when assigning Management and composite ratings. Compliance with statutory and regulatory provisions is more likely achieved when the board of directors and senior management recognize the importance of legally conforming behavior and maintain appropriate internal guidance. The board should establish policies, procedures, and controls designed to ensure compliance with legal and regulatory directives, prompt detection of noncompliance, timely implementation of corrective measures, and adequate training of officers and employees to prevent infractions. Deficiencies in these areas reflect negatively on management and should be appropriately recognized.

For example, regular or willful noncompliance reflects more negatively on management than a minor infraction of a technically complex statute, and examiners should tailor comments and recommendations to match the severity of all infractions of laws and regulations. However, regardless of their perceived importance, it is important that management promptly correct all apparent violations.

References:

- Manual Section 16.1, ROE Instructions
- Manual Section 4.1, Management
- Manual Section 4.3, Related Organizations

REMOTE DISBURSEMENT ACTIVITIES AND ZERO-BALANCE ACCOUNTS

In an effort to establish and/or maintain customer relationships, banks often provide cash management services to corporate accounts. Two of the more common services are remote disbursement services and zero-balance accounts. Remote disbursement is a technique that enables a customer to delay settlement of a financial transaction by taking advantage of the "float" possibilities in the check clearing system. The process occurs when the maker of a check draws the instrument payable at a bank remotely located ("remote bank") from the payee named in the instrument. Remote disbursement is often used in conjunction with zero-balance accounts that permit depositors to draw checks against accounts maintained at or near a zero-balance. A corporate customer utilizing this cash management approach generally maintains a primary deposit account relationship at a bank where the principal borrowing arrangements are maintained. This bank may be referred to as a "concentration bank" and through it the customer consolidates receipts and makes general disbursements.

Zero-balance accounts obviously cannot be considered funding sources for the remote bank. More importantly, they present a credit risk due to the fact that checks are paid on accounts with insufficient collected balances on the expectation that covering funds will be provided by the customer prior to the close of the business day. The intraday exposure to the remote bank, in the form of unsecured lending against uncollected funds, is not reflected in the bank's financial statement. However, the amounts involved may be sizeable and even exceed the bank's capital.

Examiners should analyze the bank's cash management services. If a concentration bank is involved, the focus should be on the potential volatility presented by using corporate deposits as funding sources. If a remote bank is involved, the supervisory interest centers on the exposure resulting from the practice of routinely paying checks against uncollected funds. The absence of prudent safeguards and full knowledge of the creditworthiness of the customer may expose the remote bank to large and unnecessary risks and warrants comment in the examination report and the initiation of remedial measures.

FUNDS TRANSFER SYSTEM RISK

Growth of the commercial banking industry, accompanied by greater customer demand for services, has increased the importance of wire transfer activity. Wire transfer has evolved from the use of elementary Morse code to sophisticated automated switching operations linking the Federal Reserve System with various governmental agencies and commercial banks. Functions of the wire transfer operation include daily funds transfers, securities transactions and the general communication of information.

Banks may effect transfers or related messages by mail, telephone and direct access to several telecommunications systems. The size and complexity of the operation will determine which method the bank uses. Since speed is the primary reason for many wire transfers, mail requests are infrequent. The majority of banks make transfers and execute Federal funds transactions over the telephone or teletype since their size and volume does not justify maintaining automated systems. However, the tendency to automate the operation is increasing with the advent of inexpensive computer technology.

The large-dollar networks are now an integral part of the payments and clearing mechanism. A variety of networks have been established to provide funds transfer services. They include the Federal Reserve Communications System (FedWire), the Clearing House Payments System (CHIPS) and Automated Clearing House (ACH).

The volume of funds which change hands daily in the U.S. through the electronic funds transfer environment is staggering. Present estimates place this volume at over one trillion dollars. It is therefore readily apparent why the financial institutions involved in those transactions and the regulatory authorities who supervise them are concerned with the quality of internal controls and management's awareness of the inherent risks associated with the various systems.

Risk Management

Errors and omissions and fraudulent alteration of the amount or account number to which funds are to be deposited could result in a loss to the bank. Costs can include loss of funds, loss of availability of funds, interest charges, and administrative expenses associated with recovering funds and correcting problems.

Banks are exposed to settlement risk whenever provisional funds are transferred. Provisional funds are irrevocable payments that are subject to final settlement at a later time. Two levels of risk are present:

- Credit risk to participating banks whose overdraft payments for customers (including nonsettling respondents) are not covered.

- Systemic risk to network participants when other participants fail to settle. There is no settlement risk to the recipient of a FedWire transfer. However, payments received through CHIPS are provisional and expose the recipients to settlement risk if funds are released prior to final settlement.

Intraday (or daylight) overdraft risk occurs when payments are released in expectation of the future receipt of covering funds. By definition, they represent credit exposures of a very short duration, usually a few hours. Overnight overdrafts result from failure to receive covering funds or intentional extensions of credit. In either case, a bank is exposed to risks resulting from payments made against insufficient funds or credit extensions.

The examination of funds transfer activities is designed to disclose deficiencies in the internal credit and operational controls of participating institutions and to assess the adequacy of the supervision of such activities by senior management and the boards of directors of those institutions.

Management is responsible for assessing the inherent risks in the system, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of such safeguards. Bank supervisors have the responsibility to ensure that the financial institutions have evaluated their own risks realistically and have provided for accounting records and internal controls which are adequate to keep the exposures within acceptable limits.

Effective risk management requires that:

- An adequate accounting system be in place to determine the extent of any intraday overdrafts and potential overnight overdrafts before releasing payments;
- Payments be within established credit limits and amounts in excess of such limits involving significant credit risk be properly approved by appropriate lending authorities; and
- Institutions responsible for settling the positions of others assign responsibility for monitoring respondents' accounts at an appropriate supervisory level.

To assure that prudent practices are being followed by banking institutions in their funds transfer activities, examinations should focus, with equal emphasis, on the evaluation of credit risks and operational controls. Deficiencies disclosed in either of these areas and suggestions for improvement should be discussed with management and listed in the Report of Examination. Constructive criticism by the examiners should help the institutions strengthen procedures to minimize the risks associated with funds transfer activities. Refer to the Electronic Funds Transfer (EFT) Examination Documentation module for further guidance.

INTRODUCTION

From a bank regulator's standpoint, the essential purpose of bank earnings, both current and accumulated, is to absorb losses and augment capital. Earnings is the initial safeguard against the risks of engaging in the banking business, and represents the first line of defense against capital depletion resulting from shrinkage in asset value. Earnings performance should also allow the bank to remain competitive by providing the resources required to implement management's strategic initiatives.

The analysis of earnings includes all bank operations and activities. When evaluating earnings, examiners should develop an understanding of the bank's core business activities. Core activities are those operations that are part of a bank's normal or continuing business. Therefore, when earnings are being assessed, examiners should be aware of nonrecurring events or actions that have affected bank earnings performance, positively or negatively, and should adjust earnings on a tax equivalent (TE) basis for comparison purposes. Although the analysis makes adjustments for non-recurring events, examiners should also include within their analysis the impact that these items had on overall earnings performance. Examples of events that may affect earnings include adoption of new accounting standards, extraordinary items, or other actions taken by management that are not considered part of the bank's normal operations such as sales of securities for tax purposes or for some other reason unrelated to active management of the securities portfolio.

The exclusion of nonrecurring events from the analysis allows the examiner to analyze the profitability of core operations without the distortions caused by non-recurring items. By adjusting for these distortions, examiners are better able to compare earnings performance against the bank's past performance and industry norms (e.g., peer group data) over time.

The terms level and trend are used throughout this section of the Manual. Level analysis is the process of reviewing financial statement ratios and volumes as of a specific date. Level analysis allows for a comparison of performance, for example, to industry norms or peer group data. Trend analysis is the process of assessing the general direction or prevailing tendency (i.e., increasing, decreasing, or stable) of operating ratios or volumes over several periods (i.e., generally over a five year period) using the level of each period.

The following tools are available to assist the examiner in the assessment of earnings: the Uniform Bank Performance Report (UBPR), the bank's Consolidated Reports of Condition and Income (Call Report), the bank's financial statements and subsidiary ledgers, analytical reports prepared for the bank's senior management and board of directors, and the Examination Documentation (ED) Modules.

The UBPR can be used to perform level and trend analysis of key earnings components. Bank-prepared analytical reports can serve the same purpose while also revealing those elements of earnings of strategic interest to management. In conjunction with the UBPR and any internal analytical reports, the bank's Call Report and corresponding bank financial statements and supplementary schedules should be used for more in-depth review. The information gleaned from these schedules may provide the examiner considerable insight into bank earnings. An analysis of earnings is not complete until the examiner has a full understanding of the bank's business activities and its strategic initiatives, and has discussed the bank's financial performance and strategies with management

Further, examiners should consider the bank's marketplace when assessing earnings because institutions that operate in more competitive environments must continually adapt to current national, regional, and local economic and industry conditions to remain viable over time. Also, examiners should determine whether there are any secular, cyclical, or seasonal factors that may favorably or unfavorably affect bank earnings. Current knowledge of such conditions and factors can be obtained by reviewing economic and industry information in newspapers and industrial journals.

Earnings Analysis Trail

Generally the analysis of earnings begins with the examiner reviewing each component of the earnings analysis trail. The earnings analysis trail provides a means of isolating each major component of the income statement for individual analysis. The earnings analysis trail consists of the following income statement components: net interest income, noninterest income, noninterest expense, provision for loan and lease losses, and income taxes.

Each component of the earnings analysis trail is initially reviewed in isolation. Typically, ratios are examined to determine a broad level view of the component's performance. The level of progression along the analysis trail will depend on a variety of factors including the level and trend of the ratio(s), changes since the previous examination, and the institution's risk profile.

The balance sheet composition, or structure, is determined by management. Any material shifts in the balance sheet structure will cause changes to any ratios using a numerator or denominator from the balance sheet (e.g., average assets and average earning assets). Therefore, examiners should be aware that significant changes in the balance sheet structure can materially affect earnings performance.

Ratio Analysis

Several key UBPR ratios used in the earnings analysis are shown below. Refer to additional ratios and the UBPR User's Guide as needed.

Net Income to Average Assets Ratio

This ratio is also known as the Return on Assets (ROA) ratio and consists of bottom line after-tax net income, including securities gains/losses and extraordinary items, as a percentage of average assets. The ROA is a common starting point for analyzing earnings because it gives an indication of the return on the bank's overall activities. A typical ROA level is different, depending on the size, location, activities, and risk profile of the bank. For example, a "community" bank with a few branches may regularly achieve an ROA ratio that exceeds those realized by large wholesale banks. Although the ROA provides an overall performance measure, the individual components comprising the ROA need to be reviewed. These sub-components will be discussed later in this section.

Net Income Adjusted Subchapter S to Average Assets Ratio

In general, institutions that elect to operate as Subchapter S (Sub S) corporations are treated as pass-through entities and are not subject to Federal income taxes at the corporate level Therefore, an adjustment to net income is needed to improve the comparability between banks that are taxed at the corporate level and those that are not. Refer to the UBPR User's Guide for specific information.

Various other issues specific to Sub S corporations may also exist. For instance, several states do not recognize Federal Sub S elections. Therefore, Sub S institutions may remain subject to State corporate income taxes. Refer to outstanding guidance for additional information and the potential effects of this election on the institution's overall earnings performance.

Net Interest Income (TE) to Average Assets Ratio

The ratio of Net Interest Income (NII) to Average Assets is also known as the NII ratio and measures annualized total interest income, plus the tax benefit on tax-exempt income, less total interest expense, divided by average assets.

TE adjustments are made to enable meaningful comparisons for banks that have tax-exempt income. These adjustments are discussed in detail in the UBPR User's Guide. Consideration should be given to the impact of tax-free investments and the related adjustment(s) made to the ratio(s) when material.

This ratio typically represents the bank's largest revenue component. While a higher NII ratio is generally favorable, it can also be reflective of a greater degree of risk within the asset base. For example, a high NII ratio could indicate management is making a large number of "high-interest, high-risk" loans (for example, subprime loans). Although an increase in the NII ratio would be evident, this would not necessarily be an improvement.

The NII ratio can be broken down into two sub-component ratios: Interest Income (TE) to Average Assets and Interest Expense to Average Assets. These ratios and their related components can be analyzed to determine the root cause(s) of any changes in the ratio and their subsequent effect on the ROA.

Net Interest Income (TE) to Average Earnings Assets Ratio

This ratio is also known as the Net Interest Margin (NIM). The ratio is comprised of annualized total interest income on a TE basis, less total interest expense, divided by average earnings assets. This ratio indicates how well management employed the earning asset base. The NIM is more useful than the NII for measuring the profitability of the bank's primary activities (buying and selling money) because the denominator focuses strictly on assets that generate income rather than the entire asset base.

The sub-components of the NIM - the ratios of Interest Income to Average Earnings Assets and Interest Expense to Average Earning Assets - can be analyzed to determine the root causes of NIM changes. These ratios may change for a variety of reasons, for example, management may have restructured the balance sheet, the interest rate environment may have changed, or bank loan and deposit pricing became more or less competitive.

Noninterest Income to Average Assets Ratio

This ratio is comprised of annualized income from bank services and sources other than interest-bearing assets, divided by average assets. Level, trend, and overall contribution of noninterest income to earnings performance should be analyzed. If the contribution represents a major portion of the bank's total revenue, specific sources of noninterest income need to be identified. An assessment as to whether or not these sources are core versus nonrecurring should be made.

Noninterest income is largely of a fee nature; service charges on deposits, trust department income, mortgage servicing fees, and certain types of loan and commitment fees. The results of trading operations and a variety of miscellaneous transactions are also included. In some institutions, noninterest income is being relied upon more heavily as banks are attempting to diversify their earnings streams.

Noninterest Expense to Average Assets Ratio

This ratio is also referred to as the Overhead (OH) ratio and is calculated by annualizing expenses related to salaries and employees benefits, expenses of premises and fixed assets, and other noninterest expenses, divided by average assets. Levels and trends of each component should be assessed and the types of expenses representing the largest overhead components should be determined. Examples of the type of costs that may lead to an inordinately high level of overhead expenses include: excessive salaries and bonuses, sizable management fees paid to the bank holding company, and high net occupancy expenses caused by the purchase or construction of a new bank building.

Other related ratios such as average personnel expense per employee, average assets per employee, and the efficiency ratio may provide useful information. The level of these ratios and the overall affect on earnings performance should be analyzed. If significant, specific sources of noninterest expense need to be identified. An assessment as to whether these sources are core versus nonrecurring should be considered during the earnings analysis.

The existence of unwarranted and unjust compensation of bank insiders is of particular concern, especially when those expenses are likely to result in harm to the bank and ultimately the deposit insurance fund. In this regard, the FDIC's safety and soundness standards (Appendix A to Part 364) state that both excessive compensation and compensation that could lead to material financial loss to an institution are prohibited as unsafe and unsound practices. While just and equitable employee and directorate compensation is essential for the acquisition and retention of competent management, there are instances where bank insiders profit from unwarranted compensation. Unwarranted and unjust compensation and related expenses to bank insiders should be dealt with through whatever means are necessary to cease these abuses. This is particularly critical in lower-rated banks. In such banks, the directorate should be reminded of their fiduciary responsibility for the preservation and conservation of bank funds. Additionally, management fees assessed by parent bank holding companies should be considered for appropriateness and level since they may be significant.

Provision for Loan and Lease Losses (PLLL) to Average Assets Ratio

This ratio shows the annualized percentage of PLLL in relation to average assets. Material changes in the volume of PLLL (either positively or negatively) should be investigated. Higher provisions should result if the loan mix changes significantly from loans with lower to higher historical loss experience (e.g., from one-to-four family mortgage loans to commercial loans) or if economic conditions have declined and have produced a deterioration of loan quality. In situations where the economy is improving and loan quality is stabilizing or improving, lower PLLLs may be appropriate.

When assessing the PLLL, examiners need to determine whether the level of the ALLL is appropriate to absorb estimated credit losses inherent in the loan and lease portfolio. An ALLL that is not at an appropriate level may be due to any one or a combination of reasons. For example, an ALLL that is below an appropriate level may be caused by a decline in loan quality identified during the examination, an inaccurate ALLL methodology, or an attempt by management to manipulate earnings. If the ALLL is deemed to be materially insufficient during the examination, management will be required to take an additional PLLL to bring the ALLL to an appropriate level, thereby increasing the bank's expenses and adversely affecting earnings. Earnings ratios affected by this charge to the PLLL should be adjusted and reflected in the earnings analysis..

Refer to the Loans section of this manual and the Call Report Instructions for additional information on the ALLL.

Realized Gains/Losses on Securities to Average Assets Ratio(s)

The ratio of securities gains/losses to average assets shows the annualized percentage of net realized gains or losses on available-for-sale and held-to-maturity securities in relation to average assets. The level, trend, and overall contribution that securities transactions have on earnings performance should be analyzed.

Bank management may purchase and sell securities for many reasons, but most banks limit investment activity to ensure adequate liquidity is available to meet unanticipated funding needs and to invest excess funds (i.e., when loan demand is low). Examiners should determine whether management actively engages in the sale of securities. When management actively manages their portfolio, this securities activity should be considered part of the bank's core operations. Examiners should assess management's strategies and their implementation. For example, examiners should be alert for instances where investments with unrealized gains are sold while those with unrealized losses are held and should ascertain the reasons for these transactions. Examiners should consider these types of instances when assessing earnings prospects.

While actively selling securities may not be part of a bank's core operations, there are many reasons why management may sell securities. Among the reasons for which management may sell securities that would not be part of a bank's normal operations would be when management needs to restructure the portfolio to maintain or change portfolio duration, to maintain or change portfolio diversification, or to take advantage of some tax implications or some other combination of these reasons. When not part of a bank's core operations, examiners should eliminate the gains or losses adjusted for taxes so as to not distort core operating results. The elimination of these gains or losses allows for level and trend analysis of core operations.

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Other Considerations

Income Taxes

It is important to judge whether applicable income taxes, that is, the provision for taxes, seems appropriate and whether a shift in the effective tax rate has occurred. In determining the appropriateness of income taxes, several tax ratios are provided within the UBPR. These ratios generally compare the amount of applicable taxes to net operating income. In order to ensure that only taxable income is compared to applicable income taxes, certain adjustments are necessary for income received on municipal securities and other investments which are tax-exempt in nature. If the tax ratios provided on the UBPR differ significantly from the rate of taxes that should have been paid, based upon the bank's tax bracket, further analysis is necessary to determine the reasons for such a discrepancy. For example, a bank with a high tax ratio may have invested too heavily in tax-exempt assets, with the result that the potential tax savings was not fully realized. In addition, certain tax incentives, such as investment tax credits received in connection with the acquisition of bank equipment, may have the effect of lowering the tax rate. The ability or inability to carryback or carryforward operating losses for tax purposes will also impact the bank's effective tax rate. Tax ratios may appear abnormal due to management's failure to adequately accrue for income tax expense on a current basis. Appropriate tax accruals should be made on a regular basis and at least with enough frequency to allow for the preparation of accurate Call Reports.

In almost all cases, applicable income taxes reported in the Call Report will differ from the amounts reported to taxing authorities. The applicable income tax expense or benefit that is reflected in the Call Report should include both taxes currently paid or payable (or receivable) and deferred income taxes. Deferred income tax expense or benefit is measured as the change in the net deferred tax assets or liabilities for the period reported. Deferred tax liabilities and assets represent the amount by which taxes payable (or receivable) are expected to increase or decrease in the future as a result of "temporary differences" and net operating loss or tax credit carry forwards that exist at the Call Report date. Refer to the Call Report Glossary for additional information on FAS 109, *Accounting for Income Taxes*.

A higher than normal ratio of applicable income taxes to NOI may result from upstreaming income tax payments to a bank holding company. The FDIC issued a policy statement (refer to FDIC Law, Regulation, and Related Acts) that covers income tax allocation in a holding company structure. In general, the statement requires that cash transfers paid by the bank to the holding company not exceed the amount of tax the bank would have paid had a tax return been filed on a separate return basis. In addition, any payments made to the holding company shall not be required to be remitted until such time as those payments would have been due to the taxing authority. Thus, deferred income taxes on bank's books should not be upstreamed to the holding company until such time as those taxes would be otherwise payable to the taxing authority. Holding companies and subsidiary institutions are encouraged to enter into a written, comprehensive tax allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. The policy statement was not intended to limit any tax elections under the Internal Revenue Code, and the term "separate return basis" recognizes that certain adjustments due to particular tax elections may, in certain periods, result in larger payments by the affiliated bank to the parent than would have been made by an unaffiliated bank to the taxing authority. Refer to the aforementioned policy statement for additional information.

Dividends

Earnings are also evaluated on their ability to support capital. This support includes maintaining capital, as well as increasing capital. High earnings retention increases capital more rapidly, but may or may not be necessary for the bank. If growth is low, profits high and capital strong, in relation to assets, a relatively high dividend payout ratio may be acceptable. On the other hand, if growth is rapid, profits are low, and capital is weak, a high dividend payout stands in the way of retaining needed capital. Under such circumstances, a lower payout ratio would clearly be appropriate.

The retention rate must be analyzed relative to the bank's potential growth rate. A bank in a developing trade area may forecast substantial growth, which cannot be supported by existing capital even if cash dividends are not paid. Since most bank stocks are viewed by the investor as income generating rather than growth related, a low dividend history may hamper the bank's ability to market a new stock offering.

The bank's flexibility to reduce dividend payments should be considered when analyzing the impact of dividends upon earnings. For example, a bank that has a highly-leveraged holding company may lack flexibility to significantly lower dividend declarations, because those dividends are being used to meet debt service requirements. Another example includes institutions that have elected a Sub S status for income tax purposes. In a Sub S institution, shareholders normally pay income taxes on their proportionate share of the institution's taxable income whether or not a dividend payment or other distribution is made. Therefore, shareholders may attempt to limit the bank's flexibility to reduce these distributions.

In undercapitalized banks, steps should be taken to strongly discourage the continuation of cash dividends and/or other distributions. If necessary, additional steps should be taken to administratively prohibit such dividends/distributions where the bank is undercapitalized and has a high risk profile, or is substantially undercapitalized, no matter what the degree of perceived risk. There may be isolated instances where the continuation of cash dividends/distributions is warranted even under fairly severe circumstances. In such cases, the continuation of these payments without supervisory action should be fully supported.

Extraordinary Items

Extraordinary items are material events and transactions that are unusual and infrequent. Both of these conditions must exist in order for an event or transaction to be reported as an extraordinary item.

To be unusual, an event or transaction must be highly abnormal or clearly unrelated to the ordinary and typical activities of banks. An event or transaction that is beyond bank management's control is not automatically considered to be unusual.

To be infrequent, an event or transaction should not reasonably be expected to recur in the foreseeable future. Although the past occurrence of an event or transaction provides a basis for estimating the likelihood of its future occurrence, the absence of a past occurrence does not automatically imply that an event or transaction is infrequent.

Only a limited number of events or transactions qualify for treatment as extraordinary items. Among these are losses that result directly from a major disaster such as an earthquake (except in areas where earthquakes are expected to recur in the foreseeable future), an expropriation, or a prohibition under a newly enacted law or regulation.

For further information, refer to APB Opinion No. 30, *Reporting the Results of Operations*.

Accounting Considerations

The analysis of earnings may be further complicated by the adoption of new accounting standards or changes in accounting methodologies. For instance, prior to the adoption of FAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, institutions accounted for loan origination fees and costs in different ways. When analyzing earnings, examiners should be aware of changes in accounting standards that may have materially affected related ratios and, when material, make necessary adjustments to the ratios, on a tax adjusted basis, to be able to perform trend analysis. Over time, however, adjustments will no longer need to be made as reported operating performance will reflect the implementation of the accounting changes over enough periods that trend analysis will not be affected.

FAS 91 applies to all lending and leasing transactions originated since it took effect in 1988. This accounting standard established the accounting for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or a group of loans. In general, FAS 91 specifies that:

1. Loan origination fees should be recognized over the life of the related loan as an adjustment of yield;

2. Certain direct loan origination costs should be recognized over the life of the related loan as a reduction of the loan's yield;
3. Most loan commitment fees should be deferred, except for specified exceptions; and
4. Loan fees, certain direct loan origination costs, and purchase premiums and discounts on loans shall be recognized as an adjustment of yield generally by the interest method based on the contractual term of the loan.

Prior to adopting FAS 91, banks generally could immediately recognize loan origination fees in income to the extent that they represented a reimbursement to the bank for actual origination costs incurred by the bank to originate the loan. This practice is no longer acceptable.

A more detailed discussion of FAS 91 can be found in the Call Report Glossary.

Quality of Bank Earnings

Earnings quality is the ability of a bank to continue to realize strong earnings performance. It is quite possible for a bank to register impressive profitability ratios and high dollar volumes of income by assuming an unacceptable degree of risk. An inordinately high ROA is often an indicator that the bank is engaged in higher risk activities. For example, bank management may have taken on loans or other investments that provide the highest return possible, but are not of a quality to assure either continued debt servicing or principal repayment. Short-term earnings will be boosted by seeking higher rates for earning assets with higher credit risk. Eventually, however, earnings may suffer if losses in these higher-risk assets are recognized.

In addition, certain of the bank's adversely classified and nonperforming assets, especially those upon which future interest payments are not anticipated, may need to be reflected on a nonaccrual basis for income statement purposes. If such assets are not placed on a nonaccrual status, earnings will be overstated. Similarly, material amounts of troubled debt restructured assets may have an adverse impact on earnings.

As previously discussed, an institution's asset quality has a close relationship to the analysis of earnings quality. Poor asset quality may necessitate increasing the PLLL to bring the ALLL to an appropriate level and must be reviewed for impact on earnings quality.

Additionally, short-term earnings performance can be enhanced by extraordinary items and tax strategies. For example, a bank may dispose of high-yielding assets to record gains in current periods, but may only be able to reinvest the funds at a lower rate of return. Levels and trends in earnings performance would be positive, although future income potential is sacrificed. Conversely, a bank might dispose of assets at a loss to take advantage of tax loss carryback provisions and enhance future earnings potential. Current earnings levels and trends would be poor in such a case, but funds recaptured through this strategy may greatly improve future earnings capacity. The point is that no analysis of earnings is complete without a consideration of earnings quality and a complete investigation and understanding of the strategies employed by bank management.

Planning and Budgeting

Strategic Plan

A strategic plan is a methodology that an organization uses to accomplish important goals and objectives. Regardless of the institution's size, a strategic plan can help an organization outline future goals and objectives and the steps needed to achieve such. For institutions that plan significant growth, new products, new branches, or other initiatives, strategic planning becomes even more important. Many institutions have formal, written strategic plans, while others rely on a much less formal method. If a formal, written strategic plan does not exist, this matter should be discussed with the board/management to determine the institution's overall goals, objectives, and long-term plans. Additional information on Corporate Planning is contained in the Management section of this manual. The Examination Documentation (ED) Modules also provide guidance in this area.

Profit Plan

A profit plan is an overall forecast of the income statement for the period based on management's decisions, intentions, and their estimation of economic conditions. It addresses such things as the anticipated level and volatility of interest rates, local economic conditions, funding strategies, asset mix, pricing, growth objectives, interest rate and maturity mismatches, etc. The accuracy of any such plan is susceptible to the attainability of the aforementioned assumptions.

Budget

Within the profit plan is a budget. The budget is essentially an expense control technique where management decides how much is intended to be spent during the period on individual overhead expense items. The budget should be consistent with the overall business or profit plan. All banks, regardless of size, should be encouraged to prepare a profit plan and budget that addresses the current year and the next operating year. The degree of sophistication or comprehensiveness of a budget and profit plan may vary considerably based on the size of the institution and the complexity of the assets and income sources.

The FDIC issued Part 364 entitled Standards for Safety and Soundness. Appendix A of Part 364 outlines standard procedures that banks should employ periodically to evaluate and monitor earnings, thereby ensuring that earnings are sufficient to maintain adequate capital and reserves. At a minimum, management's analysis of earnings should:

- Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution's historical results and those of its peers;
- Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;
- Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring or extraordinary income or expenses;
- Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering asset quality and growth rate; and
- Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

A bank's profit plan and budget should be reviewed for reasonableness with particular attention paid to the underlying assumptions. The forecast and assumptions should be consistent with what is known about the bank such as the volume of classified assets, nonaccrual and renegotiated debt levels, the adequacy of the ALLL, and other examination findings that have earnings implications. Comparison between the bank's forecast for the previous year to actual performance as displayed in the bank's own reports and in the UBPR can provide a reasonableness check. Any material discrepancies should be discussed with management; and, if the explanation is unreasonable, the bank's forecast may need to be adjusted to determine the effect of more reasonable assumptions.

If there is no bank plan or budget, examiners may need to develop their own forecast to aid in their judgments. In any case, it will normally be necessary to discuss future prospects with management. Care should be taken in these discussions not to present the examiner's forecast as absolute, or to recommend specific strategies or transactions to management based on an examiner's forecast. Planning is properly the function of management. Examiner efforts are only an attempt to discover any undue risk and highlight any factors that may significantly impact future performance in either a positive or negative manner.

Deficiencies in the profit plan or budget, or the lack thereof, should be documented in the appropriate section of the examination report.

EVALUATION OF EARNINGS PERFORMANCE

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

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

Ratings

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

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

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

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

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

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INTRODUCTION

Liquidity reflects a financial institution's ability to fund assets and meet financial obligations. Liquidity is essential in all banks to meet customer withdrawals, compensate for balance sheet fluctuations, and provide funds for growth. Funds management involves estimating liquidity requirements and meeting those needs in a cost-effective way. Effective funds management requires financial institutions to estimate and plan for liquidity demands over various periods and to consider how funding requirements may evolve under various scenarios, including adverse conditions. Banks must maintain sufficient levels of cash, liquid assets, and prospective borrowing lines to meet expected and contingent liquidity demands.

Liquidity risk reflects the possibility an institution will be unable to obtain funds, such as customer deposits or borrowed funds, at a reasonable price or within a necessary period to meet its financial obligations. Failure to adequately manage liquidity risk can quickly result in negative consequences for an institution despite strong capital and profitability levels. Management must maintain sound policies and procedures to effectively measure, monitor, and control liquidity risks.

A certain degree of liquidity risk is inherent in banking. An institution's challenge is to accurately measure and prudently manage liquidity demands and funding positions. To efficiently support daily operations and provide for contingent liquidity demands, banks must:

- Establish an appropriate liquidity risk management program,
- Ensure adequate resources are available to fund ongoing liquidity needs,
- Establish a funding structure commensurate with risks,
- Evaluate exposures to contingent liquidity events, and
- Ensure sufficient resources are available to meet contingent liquidity needs.

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RISK MANAGEMENT PROGRAM

An institution's liquidity risk management program establishes the liquidity management framework. Comprehensive and effective programs encompass all elements of a bank's liquidity, ranging from how the institution manages routine liquidity needs to managing liquidity during a severe stress event. Elements of a sound liquidity risk management program include:

- Effective management and board oversight;
- Appropriate liquidity management policies, procedures, strategies, and risk limits;
- Comprehensive liquidity risk measurement and monitoring systems;
- Adequate levels of marketable assets;
- Diverse mix of existing and potential funding sources;
- Comprehensive contingency funding plans;
- Appropriate plans for potential stress events; and
- Effective internal controls and independent audits.

The formality and sophistication of effective liquidity management programs correspond to the type and complexity of an institution's activities, and examiners should assess whether programs meet the institution's needs. Examiners should consider whether liquidity risk management activities are integrated into the institution's overall risk management program and address liquidity risks associated with new or existing business strategies.

Close oversight and sound risk management processes (particularly when planning for potential stress events) are especially important if management pursues asset growth strategies that rely on new or potentially volatile funding sources.

Board and Senior Management Oversight

Board oversight is critical to effective liquidity risk management. The board is responsible for establishing the institution's liquidity risk tolerance and clearly communicating it to all levels of management. Additionally, the board is also responsible for reviewing, approving, and periodically updating liquidity management strategies, policies, procedures, and risk limits. When assessing the effectiveness of board oversight, examiners should consider whether the board:

- Understands and periodically reviews the institution's current liquidity position and contingency funding plans;
- Understands the institution's liquidity risks and periodically reviews information necessary to maintain this understanding;
- Establishes an asset/liability committee (ALCO) and guidelines for electing committee members, assigning responsibilities, and establishing meeting frequencies;
- Establishes executive-level lines of authority and responsibility for managing the institution's liquidity risk;
- Provides appropriate resources to management for identifying, measuring, monitoring, and controlling liquidity risks; and
- Understands the liquidity risk profiles of significant subsidiaries and affiliates.

Management is responsible for appropriately implementing board-approved liquidity policies, procedures, and strategies. This responsibility includes overseeing the development and implementation of appropriate risk measurement and reporting systems, contingency funding plans, and internal controls. Management is also responsible for regularly reporting the institution's liquidity risk profile to the board.

Examiners should consider whether an ALCO (or similar entity) actively monitors the institution's liquidity profile. Effective ALCOs typically have sufficient representation across major functions (e.g., lending, investments, wholesale and retail funding, etc.) to influence the liquidity risk profile. The committee is usually responsible for ensuring that liquidity reports include accurate, timely, and relevant information on risk exposures.

Examiners should evaluate corporate governance by reviewing liquidity management processes (including daily, monthly, and quarterly activities), committee minutes, liquidity and funds management policies and procedures, and by holding discussions with management. Additionally, examiners should consider the findings of independent reviews and prior reports of examination when assessing the effectiveness of corrective actions.

Liquidity Management Strategies

Liquidity management strategies involve short- and long-term decisions that can change over time, especially during times of stress. Therefore, the institutions' policies often require management to meet regularly and consider liquidity costs, benefits, and risks as part of the institution's overall strategic planning and budgeting processes. As part of this process, management typically:

- Performs periodic liquidity and profitability evaluations for existing activities and strategies;
- Identifies primary and contingent funding sources needed to meet daily operations, as well as seasonal and cyclical cash flow fluctuations;
- Ensures liquidity management strategies are consistent with the board's expressed risk tolerance; and
- Evaluates liquidity and profitability risks associated with new business activities and strategies.

Collateral Position Management

Assets are a key source of funds for financial institutions as they can generate substantial cash inflows through principal and interest payments. Assets can also provide funds when sold or when used as collateral for borrowings. Financial institutions routinely pledge assets when borrowing funds or obtaining credit lines through Federal Home Loan Banks, the Federal Reserve discount window, or other banks.

Examiners should consider whether the institution established reporting systems that facilitate the monitoring and management of assets pledged as collateral for borrowed funds. At a minimum, pledged asset reports typically detail the value of assets currently pledged relative to the amount of security required and identify the type and amount of unencumbered assets available for pledging.

Examiners should also consider whether the reporting systems are commensurate with borrowing activities and the institution's strategic plans. Institutions with limited amounts of long-term borrowings may be able to monitor collateral levels adequately by reviewing monthly or quarterly reports. Institutions with material payment, settlement, and clearing activities benefit from actively monitoring short- (including intraday), medium-, and long-term collateral positions.

Effective management teams thoroughly understand all borrowing agreements (contractual or otherwise) that may require the bank to provide additional collateral, substitute existing collateral, or deliver collateral. Such requirements may be triggered by changes in an institution's financial condition. Examiners should determine whether management considers potential changes to collateral requirements in cash flow projections, stress tests, and contingency funding plans. Examiners should also determine whether management considers the operational and timing requirements associated with physically accessing collateral (such as at a custodian institution or a securities settlement location where the collateral is held).

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POLICIES, PROCEDURES, & REPORTING

Liquidity Policies and Procedures

Comprehensive written policies, procedures, and risk limits form the basis of liquidity risk management programs. All financial institutions benefit from board-approved liquidity management policies and procedures specifically tailored for their institution.

Even when operating under a holding company with centralized planning and decision-making, the bank's directors are responsible for ensuring that the structure, responsibility, and controls for managing their institution's liquidity risk are clearly documented. To fulfill their oversight responsibilities, directors regularly monitor reports that highlight bank-only liquidity factors.

While there is no reason to criticize the existence of centralized planning and decision-making, each bank's board of directors has a legal responsibility to maintain policies, procedures, and risk limits tailored to its individual bank's risk profile.

Boards that review and approve liquidity policies at least annually ensure such policies remain relevant and appropriate for the institutions' business model, complexity, and risk profile. Written policies are important for defining the scope of the liquidity risk management program and ensuring that:

- Sufficient resources are devoted to liquidity management,
- Liquidity risk management is incorporated into the institution's overall risk management process, and
- Management and the board share an understanding of strategic decisions regarding liquidity.

Effective policies and procedures address liquidity matters (such as legal, regulatory, and operational issues) separately for legal entities, business lines, and, when appropriate, individual currencies. Sound liquidity and funds management policies typically:

- Provide for the effective operation of the ALCO. ALCO policies would address responsibilities for assessing current and projected liquidity positions, implementing board-approved strategies, reviewing policy exceptions, documenting committee actions, and reporting to the board;
- Provide for the periodic review of the bank's deposit structure. Effective reviews typically include assessments of the volume and trend of total deposits, the types and rates of deposits, the maturity distribution of time deposits, and competitor rate information. Other information considered in the reviews, when applicable, includes the volume and trend of large time deposits, public funds, out-of-area deposits, potentially rate sensitive depositors, wholesale deposits, and uninsured deposits;
- Address permissible funding sources and concentration limits. Items addressed generally include funding types with similar rate sensitivity or volatility, such as brokered or Internet deposits and deposits generated through promotional offers.
- Provide a method of computing the bank's cost of funds;
- Establish procedures for measuring and monitoring liquidity. Procedures generally include static measurements and cash flow projections that forecast base case and stress scenarios;
- Address the type and mix of permitted investments. Items addressed typically include the maturity distribution of the portfolio, which investments are available for liquidity purposes, and the level and quality of unpledged investments;
- Provide for an adequate system of internal controls. Controls typically require periodic, independent reviews of liquidity management processes and compliance with internal policies, procedures, and risk limits;
- Include a contingency funding plan that identifies alternate funding sources if liquidity projections are incorrect or a liquidity crisis arises;
- Require periodic testing of liquidity lines;
- Establish procedures for reviewing and documenting assumptions used in liquidity projections;
- Define procedures for approving exceptions to policies, limits, and authorizations;
- Identify permissible wholesale funding sources;
- Define authority levels and procedures for accessing wholesale funding sources;
- Establish a process for measuring and monitoring unused borrowing capacity;
- Convey the board's risk tolerance by establishing target liquidity ratios and parameters under various time horizons and scenarios; and
- Include other items unique to the bank.

Risk Tolerances

Examiners should consider whether liquidity policies accurately reflect the board's risk tolerance and delineate qualitative and quantitative guidelines commensurate with the institution's business profile and balance sheet complexity. Typical risk guidelines include:

- Targeted cash flow gaps over discrete and cumulative periods and under expected and adverse business conditions;
- Expected levels of unencumbered liquid assets;
- Measures for liquid asset coverage ratios and limits on potentially unstable liabilities;
- Concentration limits on assets that may be difficult to convert into cash (such as complex financial instruments, bank-owned life insurance, and less-marketable loan portfolios);
- Limits on the level of borrowings, brokered funds, or exposures to single fund providers or market segments;
- Funding diversification standards for short-, medium-, and long-term borrowings and instrument types;
- Limits on contingent liability exposures such as unfunded loan commitments or lines of credit;

- Collateral requirements for derivative transactions and secured lending;
- Limits on material exposures in complex activities (such as securitizations, derivatives, trading, and international activities).

Examiners should consider whether management and the board establish meaningful risk limits, periodically evaluate the appropriateness of established limits, and compare actual results to approved risk limits. Identified policy exceptions and related corrective actions are typically noted in board or committee minutes.

Liquidity Reporting

Timely and accurate information is a prerequisite to sound funds management practices. Banks benefit from liquidity risk reports that clearly highlight the bank's liquidity position, risk exposures, and level of compliance with internal risk limits.

Examiners should consider the adequacy of liquidity reporting procedures. Typically, bank personnel tasked with ongoing liquidity administration receive liquidity risk reports at least daily. Senior officers may receive liquidity reports weekly or monthly, and the board of directors may receive liquidity risk reports monthly or quarterly. Depending on the complexity of the business mix and liquidity risk profile, institutions may increase, sometimes on short notice, the frequency of liquidity reporting.

The format and content of liquidity reports will vary depending on the characteristics of each bank and its funds management practices. Examiners should consider whether an institution's management information systems and internal reports provide accurate, pertinent information such as:

- Liquidity needs and the sources of funds available to meet these needs over various time horizons and scenarios (reports are often referred to as pro-forma cash flow reports, sources and uses reports, or scenario analyses);
- Collateral positions, including pledged and unpledged assets (and when necessary, the availability of collateral by legal entity, jurisdiction, and currency exposure);
- Public funds and other material providers of funds (including rate and maturity information);
- Funding categories and concentrations;
- Asset yields, liability costs, net interest margins, and variations from the prior month and budget (beneficial reports are detailed enough to permit an analysis of interest margin variations);
- Early warning indicators for contingency funding events;
- Policy exceptions;
- Interest rate projections and economic conditions in the bank's trade area;
- Information concerning non-relationship or higher-cost funding programs;
- The stability of deposit customers and providers of wholesale funds;
- The level of highly liquid assets;
- Stress test results; and
- Other items unique to the bank.

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LIQUIDITY RISK MEASUREMENT

To identify potential funding gaps, banks typically monitor cash flows, assess the stability of funding sources, and project future funding needs. When assessing an institution's liquidity rating, examiners should evaluate the adequacy of an institution's liquidity risk measurement and monitoring procedures.

Pro-Forma Cash Flow Projections

Historically, most financial institutions used single point-in-time (static) measurements (such as loan-to-deposit or loan-to-asset ratios) to assess their liquidity position. Static liquidity measures provide valuable information and remain a key part of banks' liquidity analysis. However, cash flow forecasting can enhance a financial institution's ability to monitor and manage liquidity risk.

Cash flow forecasts can be useful for all banks and become essential when operational areas (loans, deposits, investments, etc.) are complex or managed separately from other areas in the bank. Cash flow projections enhance management's ability to evaluate and manage these areas individually and collectively.

The sophistication of cash flow forecasting ranges from the use of simple spreadsheets to comprehensive liquidity risk models. Some vendors that offer interest rate risk (IRR) models provide options for modeling liquidity cash flows because the base information is already maintained for IRR modeling. When reviewing liquidity risk models, examiners should ensure management compares funding sources and liquidity needs, over various periods, using modeling assumptions that are appropriate for managing liquidity rather than IRR.

Cash flow projections typically forecast funding sources and uses over short-, medium-, and long-term time horizons. Non-complex community banks that are in a sound condition may forecast short-term positions monthly. More complex institutions may need to perform weekly or daily forecasts, and institutions with large payment systems and settlement activities may need to conduct intra-day measurements. All institutions benefit from having the ability to increase the frequency of monitoring and reporting during a stress event.

Effective cash flow analysis allows management to plan for tactical (short-term) and strategic (medium- and long-term) liquidity needs. Examiners should review the bank's procedures, assumptions, and information used to develop cash flow projections. For example, examiners should consider whether funding sources and uses are adequately stratified, as excessive account aggregations in liquidity analysis can mask substantial liquidity risk. Similar to measuring IRR, there are advantages to utilizing account level information. For some institutions, gathering and measuring information on specific accounts may not be feasible due to information system limitations. Although the advantages of using detailed account information may not be as evident for a non-complex institution, generally, all institutions can benefit from using more detailed account information in their liquidity models.

Examiners should carefully assess the assumptions that institutions use when projecting cash flows. The reliability of the projections is enhanced when projections are based on reasonable assumptions and reliable data. Additionally, the accuracy and reliability of cash flow projections is enhanced when projected cash flows consider contractual and expected cash flows. For example, when projecting funding requirements for construction loans, the accuracy of cash flow projections is enhanced when management includes estimates of the amount of available credit that will actually be drawn in a given period, not simply the full amount of contractual obligations. Additionally, to improve the accuracy of forecasting maturing time deposits, particularly those obtained through special rate promotions, the analysis should consider the retention rate of maturing deposits.

Modeling assumptions play a critical role in measuring liquidity risks and projecting cash flows. Therefore, institutions benefit from ensuring key assumptions are reasonable, well documented, and periodically reviewed and approved by the board. Ensuring the accuracy of assumptions is also important when assessing the liquidity risk of complex assets, liabilities, and off-balance sheet positions and can be critical when evaluating the availability of funding sources under adverse, contingent liquidity scenarios. Accurate and reliable cash flow forecasting can benefit institutions by reducing liquidity risks and allowing institutions to maintain a lower liquid asset cushion.

Back Testing

The reliability of cash flow projections may also be enhanced if institutions evaluate assumptions about customer behavior, separately estimate gross cash flows on both sides of the balance sheet, and compare modeling projections to actual results (back testing). Back testing allows management to make adjustments to cash flow models and modeling assumptions, as appropriate, to reflect changes in cash flow characteristics.

Scenario Analysis

Cash flow projections can also be used in scenario analysis and developing contingency funding plans. Institutions typically start with base case projections that assume normal cash flows, market conditions, and business operations over the selected time horizon. Management then tests stress scenarios by changing various cash flow assumptions in the base case scenario. For example, if the stress scenario assumed a change in a Prompt Corrective Action (PCA) capital category that triggered interest rate restrictions and brokered deposit limitations, management should adjust assumptions to reflect the possible limitation or elimination of access to affected funding sources. Management typically uses this information in developing funding plans to mitigate these risks.

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FUNDING SOURCES - ASSETS

The amount of liquid assets that a bank maintains is generally a function of the stability of its funding structure, the risk characteristics of the balance sheet, and the adequacy of its liquidity risk measurement program. Generally, a lower level of unencumbered liquid assets may be sufficient if funding sources are stable, established borrowing facilities are largely unused, and other risk characteristics are predictable. A higher level of unencumbered liquid assets may be required if:

- Bank customers have numerous alternative investment options,
- Recent trends show a substantial reduction in large liability accounts,
- The bank has a material reliance on less stable funding sources,
- The loan portfolio includes a high volume of non-marketable loans,
- The bank expects several customers to make material draws on unused lines of credit,
- Deposits include substantial amounts of short-term municipal accounts,
- A concentration of credits was extended to an industry with existing or anticipated financial problems,

- A close relationship exists between individual demand accounts and principal employers in the trade area who have financial problems,
- A material amount of assets is pledged to support wholesale borrowings, or
- The institution's access to capital markets is impaired.

A bank's assets provide varying degrees of liquidity and can create cash inflows and outflows. Institutions generally retain a certain level of highly liquid assets to meet immediate funding needs, and hold other types of investments to provide liquidity for meeting ongoing operational needs and responding to contingent funding events. To balance profitability goals and liquidity demands, management must carefully weigh the full benefits (yield and increased marketability) of holding liquid assets against the expected higher returns associated with less liquid assets. Income derived from holding longer-term, higher-yielding assets may be offset if an institution is forced to sell the assets quickly due to adverse balance sheet fluctuations.

Cash and Due from Accounts

Cash and due from accounts are essential for meeting daily liquidity needs. Institutions rely on cash and due from accounts to fund deposit account withdrawals, disburse loan proceeds, cover cash letters, fund bank operations, meet reserve requirements, and provide compensating balances relating to correspondent bank accounts/services.

Loan Portfolio

The loan portfolio is an important factor in liquidity management. Loan payments provide steady cash flows, and loans can be used as collateral for secured borrowings or sold for cash in the secondary loan market. However, the quality of the loan portfolio can directly impact liquidity. For example, if an institution encounters asset quality issues, operational cash flows may be affected by the level of non-accrual borrowers and late payments.

For many institutions, loans serve as collateral for wholesale borrowings such as Federal Home Loan Bank (FHLB) borrowings. If asset quality issues exist, an institution may find that delinquent loans do not qualify as collateral. Also, higher amounts of collateral may be required because of doubts about the overall quality of the portfolio. These "haircuts" can be substantial and are an important consideration in stress tests.

Comprehensive liquidity analysis includes consideration of contractual requirements and customers' behavior when forecasting loan cash flows. Prepayments and renewals can significantly affect contractual cash flows for many types of loans. Customer prepayments are a common consideration for residential mortgage loans (and mortgage-backed securities) and can be a factor for commercial and commercial real estate loans (and related securities). Assumptions related to revolving lines of credit and balloon loans can also have a material effect on cash flows. For example, examiners should determine whether management's assumption for loans generating cash flow in accordance with contractual obligations is supported by historical data.

Asset Sales/Securitizations

As noted above, assets can be used as collateral for secured borrowings or sold for cash in the secondary market. Sales in the secondary market can provide fee income, relief from interest rate risk, and a funding source to the originating bank. However, for an asset to be saleable at a reasonable price in the secondary market, it must generally conform to market (investor) requirements. Because loans and loan portfolios may have unique features or defects that hinder or prevent their sale into the secondary market, institutions benefit from thoroughly reviewing loan characteristics and documenting assumptions related to loan portfolios when developing cash flow projections.

Some institutions are able to use securitizations as a funding vehicle by converting a pool of assets into cash. Asset securitization typically involves the transfer or sale of on-balance sheet assets to a third party that issues mortgage-backed securities (MBS) or asset-backed securities (ABS). These instruments are then sold to investors. The investors are paid from the cash flow from the transferred assets. Assets that are typically securitized include credit card receivables, automobile receivables, commercial and residential mortgage loans, commercial loans, home equity loans, and student loans.

Securitization can be an effective funding method for some banks. However, there are several risks associated with using securitization as a funding source. For example:

- Some securitizations have early amortization clauses to protect investors if the performance of the underlying assets does not meet specified criteria. If an early amortization clause is triggered, the issuing institution needs to begin paying principal to bondholders earlier than originally anticipated and have to fund new receivables that would have otherwise been transferred to the trust. Institutions involved in securitizations benefit from monitoring asset performance to better anticipate cash flow and funding ramifications due to early amortization clauses.
- If the issuing institution has a large concentration of residual assets, the institution's overall cash flow

might be dependent on the residual cash flows from the performance of the underlying assets. If the performance of the underlying assets is worse than projected, the institution's overall cash flow will be less than anticipated.
- Residual assets retained by the issuing institution are typically illiquid assets for which there is no active market. Additionally, the assets are not acceptable collateral to pledge for borrowings.
- An issuer's market reputation can affect its ability to securitize assets. If the bank's reputation is damaged, issuers might not be able to economically securitize assets and generate cash from future sales of loans to the trust. This is especially true for institutions that are relatively new to the securitization market.
- The timeframe required to securitize loans held for sale may be considerable, especially if the institution has limited securitization experience or encounters unforeseen problems.

Institutions that identify asset sales or securitizations as contingent liquidity sources, particularly institutions that rarely sell or securitize loans, benefit from periodically testing the operational procedures required to access these funding sources. Market-access testing helps ensure procedures work as anticipated and helps gauge the time needed to generate funds; however, testing does not guarantee the funding sources will be available or on satisfactory terms during stress events.

A thorough understanding of applicable accounting and regulatory rules is critical when securitizing assets. Accounting standards make it difficult to achieve sales treatment for certain financial assets. The standards influence the use of securitizations as a funding source because transactions that do not qualify for sales treatment require the selling institution to account for the transfer as a secured borrowing with a pledge of collateral. As such, institutions must account for, and risk weight, the transferred financial assets as if the transfer had not occurred. Accordingly, institutions should continue to report the transferred assets in financial statements with no change in the measurement of the financial assets transferred.

When financial assets are securitized and accounted for as a sale, institutions often provide contractual credit enhancements, which may involve over-collateralization, retained subordinated interests, asset repurchase obligations, cash collateral accounts, spread accounts, or interest-only strips. Part 324 of the FDIC Rules and Regulations requires the issuing institution to hold capital as a buffer against the retained credit risk arising from these contractual credit enhancements.

There can also be non-contractual support for ABS transactions that would be considered implicit recourse. The recourse may create credit, liquidity, and regulatory capital implications for issuers that provide implicit support for ABS transactions. Institutions typically provide implicit recourse in situations where management perceives that the failure to provide support, even though not contractually required, would damage the institution's future access to the ABS market. For risk-based capital purposes, institutions deemed to be providing implicit recourse are generally required to hold capital against the entire outstanding amount of assets sold, as though they remained on the books.

The federal banking agencies' concerns over the retained credit and other risks associated with such implicit support are detailed in the *Interagency Guidance on Implicit Recourse in Asset Securitizations* (See FDIC's Financial Institution Letter 52-2002).

Investment Portfolio

An institution's investment portfolio can provide liquidity through regular cash flows, maturing securities, the sale of securities for cash, or by pledging securities as collateral for borrowings, repurchase agreements, or other transactions. Institutions can benefit from periodically assessing the quality and marketability of the portfolio to determine:

- The level of unencumbered securities available to pledge for borrowings,
- The financial impact of unrealized gains and losses,
- The effect of changes in asset quality, and
- The potential need to provide additional collateral should rapid changes in market rates significantly reduce the value of longer-duration investments pledged to secure borrowings.

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FUNDING SOURCES – LIABILITIES

Deposits are the most common funding source for many institutions; however, other liability sources such as borrowings can also provide funding for daily business activities, or as alternatives to using assets to satisfy liquidity needs. Deposits and other liability sources are often differentiated by their stability and customer profile characteristics.

Core Deposits

Core deposits are generally stable, lower-cost funding sources that typically lag behind other funding sources in repricing during a period of rising interest rates. The deposits are typically funds of local customers that also have a borrowing or other relationship with the institution. Convenient branch locations, superior customer service, extensive ATM networks, and low or no fee accounts are factors that contribute to the stability of the deposits. Other factors include the insured status of the account and the type of depositor (retail, commercial, municipality, etc.).

Examiners should assess the stability of deposit accounts when reviewing liquidity and funds management practices. Generally, higher-cost, non-relationship deposits, such as Internet deposits or deposits obtained through special-rate promotions, may be considered less-stable funding sources. Brokered deposits are not considered core deposits or a stable funding source due to the brokered status and wholesale characteristics.

Core deposits are defined in the Uniform Bank Performance Report (UBPR) User's Guide as the sum of all transaction accounts, money market deposit accounts (MMDAs), nontransaction other savings deposits (excluding MMDAs), and time deposits of $250,000 and below, less fully insured brokered deposits of $250,000 and less. In some instances, core deposits included in the UPBR's core deposit definition might exhibit characteristics associated with less stable funding sources. For example, out-of-area certificates of deposit (CDs) of $250,000 or less that are obtained from a listing service may have less stability although they are included in core deposits under the UBPR definition. Management and examiners should not automatically view these deposits as a stable funding source without additional analysis. Alternatively, some deposit accounts generally viewed as volatile, non-core funds by UBPR definitions (for example, CDs larger than $250,000) might be considered relatively stable after a closer analysis. For instance, a local depositor might have CDs larger than $250,000 that may be considered stable because the depositor has maintained those deposits with the institution for several years.

While some deposit relationships over $250,000 remain stable when the institution is in good condition, such relationships might become less stable due to their uninsured status if the institution experiences financial problems. Additionally, deposits identified as stable during good economic conditions may not be reliable funding sources during stress events. Therefore, examiners should consider whether institutions identify deposit accounts likely to be unstable in times of stress and appropriately reflect such deposits in its liquidity stress testing.

Examiners should not assume that all deposits meeting the UBPR definition of *core* are necessarily stable or that all deposits defined as *non-core* are automatically volatile. Examiners should determine whether management considers the stability of deposit accounts and significant customer relationships and reflects them accordingly in the bank's liquidity monitoring and reporting systems. When analyzing the stability of deposit funding sources, UBPR accounts and ratios should be considered in light of the balance sheet composition, risk profile, deposit stability trends, and other relevant and unique characteristics of the institution.

Deposit Management Programs

The critical role deposits play in a bank's successful operation demonstrates the importance of implementing programs for retaining or expanding the deposit base. Strong competition for depositors' funds and customers' preference to receive market deposit rates also highlight the benefit of deposit management programs. Effective deposit management programs generally include:

- Regular reports detailing existing deposit types and levels,
- Projections for asset and deposit growth,
- Associated cost and interest rate scenarios,
- Clearly defined marketing strategies,
- Procedures to compare results against projections, and
- Steps to revise the plans when needed.

Deposit management programs generally take into account the make-up of the market-area economy, local and national economic conditions, and the potential for investing deposits at acceptable margins. Other considerations include management expertise, the adequacy of bank operations, the location and size of facilities, the nature and degree of bank and non-bank competition, and the effect of monetary and fiscal policies on the bank's service area and capital markets in general.

Effective deposit management programs are monitored and adjusted as necessary. The long-range success of such programs is closely related to management's ability to identify the need for changes quickly. Effective programs include procedures for accurately projecting deposit trends and carefully monitoring the potential volatility of the accounts (e.g., stable, fluctuating, seasonal, brokered, etc.).

Wholesale Funds

Wholesale funds include, but are not limited to, brokered deposits, Internet deposits, deposits obtained through listing services, foreign deposits, public funds, federal funds purchased, FHLB advances, correspondent line of credit advances, and other borrowings.

Providers of wholesale funds closely track institutions' financial condition and may cease or curtail funding, increase interest rates, or increase collateral requirements if they determine an institution's financial condition is deteriorating. As a result, some institutions may experience liquidity problems due to a lack of wholesale funding availability when funding needs increase.

The Internet, listing services, and other automated services enable investors who focus on yield to easily identify high-yield deposits. Customers who focus primarily on yield are a less stable source of funding than customers with typical deposit relationships. If more attractive returns become available, these customers may rapidly transfer funds to new institutions or investments in a manner similar to that of wholesale investors.

It is important to measure the impact of the loss of wholesale funding sources on the institution's liquidity position. The challenge of measuring, monitoring, and managing liquidity risk typically increases as the use of wholesale and nontraditional funding sources increases. Institutions that rely more heavily on wholesale funding will often need enhanced funds management and measurement processes, such as scenario modeling. In addition, contingency planning and capital management take on added significance.

Brokered and Higher-Rate Deposits

Section 29 of the FDI Act, as implemented by Part 337 of the FDIC Rules and Regulations, defines a brokered deposit as a deposit obtained through or with assistance of a deposit broker. The term deposit broker is generally defined by Section 29 as any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions.

The brokered deposit statute and regulations provide several exceptions to this definition of deposit broker. Some exceptions include an insured depository institution or its employee placing funds with that insured depository institution, certain trust departments of insured depository institutions, certain trustees and plan administrators, an agent whose primary purpose is not to place funds with insured depository institutions, and insured depository institutions acting as an intermediary or agent for a government sponsored minority or women-owned deposit program.

Listing Services

Listing service companies do not fall under the definition of a deposit broker if certain criteria are met. A listing service is a company that connects banks seeking a deposit with those seeking to place a deposit. In doing so, the listing service compiles and posts banks' deposit rate information for consideration by interested depositors. A particular company can be a listing service (compiler of information) as well as a deposit broker (facilitating the placement of deposits). In recognition of this possibility, certain criteria are considered for determining when a listing service qualifies as a deposit broker. A listing service is not a deposit broker if:

- The person or entity providing the listing service is compensated solely by means of subscription fees (fees paid by subscribers as payment for their opportunity to see the rates gathered by the listing service) and/or listing fees (fees paid by depository institutions as payment for their opportunity to list their rates). The listing service does not require a depository institution to pay for other services offered by the listing service or its affiliates as a condition precedent to being listed.
- The fees paid by depository institutions are flat fees (i.e., they are not calculated based on the number or dollar amount of deposits accepted by the depository institution as a result of the listing of the depository institution's rates).
- In exchange for fees, the listing service performs no service except the gathering and transmission of information concerning the availability of deposits.
- The listing service is not involved in placing deposits. Any funds to be invested in deposit accounts are remitted directly by the depositor to the insured depository institution and not, directly or indirectly, by or through the listing service.

Brokered Sweep Accounts

Some brokerage firms, which are investment companies that invest money in stocks, bonds, and other investments on behalf of clients, operate sweep programs in which brokerage customers are given the option to sweep uninvested cash into a bank deposit. This arrangement provides the brokerage customer with additional yield and insurance coverage on swept funds. These swept funds are generally considered brokered deposits unless the third-party brokerage firm meets the primary purpose exception. An institution must receive a favorable determination from the FDIC before it can exclude these funds from regulatory reporting of brokered deposits. Determinations are initially requested through the appropriate regional office. In determining whether the brokerage firm meets the primary purpose exception, staff considers the following criteria:

- The brokerage firm is affiliated with the bank.
- The funds are not swept into time deposit accounts.

- The amount of swept funds does not exceed 10 percent of the total amount of program assets handled by the brokerage firm (permissible ratio) on a monthly basis. When the brokerage also sweeps funds to nonaffiliated banks, which is typically done when the deposit exceeds the $250,000 deposit insurance limit, these deposits are added to the amount of swept funds for purposes of calculating the permissible ratio.
- The fees in the program are flat fees (i.e., equal per-account or per-customer fees representing payment for recordkeeping or administrative services and not representing payment for placing deposits).

Network and Reciprocal Deposits

Banks sometimes participate in networks established for the purpose of sharing deposits. In such a network, a participating bank places funds, either directly or through a third-party network sponsor, at other participating network banks in order for its customer to receive full deposit insurance coverage.

Some bank networks establish reciprocal agreements allowing participating banks to send and receive identical deposit amounts simultaneously. This reciprocal agreement allows banks to maintain the same amount of funds they had when the customer made their initial deposit while ensuring that deposits well in excess of the $250,000 deposit limit are fully insured. While reciprocal network deposits generally meet the definition of a brokered deposit, under certain conditions a limited amount of reciprocal deposits may be excepted from treatment as brokered deposits.

Section 29(i) of the FDI Act (and implemented through Section 337.6(e)(2) of the FDIC Rules and Regulations), excepts a capped amount of reciprocal deposits from treatment as brokered deposits for those insured depository institutions that qualify as an "agent" institution. The amount of reciprocal deposits that an agent institution may except from treatment as brokered deposits may not exceed the lesser of $5 billion or 20 percent of total liabilities (referred to as the general cap). To qualify as an "agent" institution, the institution must meet one of the following:

- When most recently examined, under section 10(d) of the FDI Act, was found to have a composite condition of outstanding or good, and is well capitalized; or
- Has obtained a brokered deposit waiver from the FDIC; or
- Does not receive an amount of reciprocal deposits that causes the total amount of reciprocal deposits held by the agent institution to be greater than the average of the total amount of reciprocal deposits held by the agent institution on the last day of each of the four calendar quarters preceding the calendar quarter in which the agent institution was found not to have a composite condition of outstanding or good or was determined to be not well capitalized (also referred to as the special cap).

Treatment and reporting may be impacted if an institution receives reciprocal deposits that exceed its applicable cap (general cap or special cap). Agent institutions that are in outstanding or good composite condition and are well capitalized, or have obtained a brokered deposit waiver, are subject to the general cap, and therefore would report and treat only the amount of reciprocals deposits that exceed the general cap as brokered deposits. Agent institutions that are not well capitalized or not well rated and have not received a brokered deposit waiver can only receive an amount of non-brokered reciprocal deposits up to its special cap. If an agent institution subject to the special cap receives an amount of reciprocal deposits in excess of its special cap, it is no longer an agent institution. If an institution is not an agent institution, all of its reciprocal deposits should be treated and reported as brokered deposits.

Examiners should determine whether an institution's reciprocal deposits, that are not being report as brokered, conform to the statutory and regulatory definitions under Section 29(i) of the FDI Act and Section 337.6(e) of the FDIC's Rules and Regulations.

Network member banks may receive other deposits through a network such as (1) deposits received without the institution placing into the network a deposit of the same maturity and same aggregate amount (sometimes referred to as "one-way network deposits") and (2) deposits placed by the institution into the network where the deposits were obtained, directly or indirectly, by or through a deposit broker. Such other network deposits meet the definition of brokered deposits and would not be eligible for, as previously described, the statutory and regulatory exception provided for a capped amount of reciprocal deposits.

The stability of reciprocal deposits may differ depending on the relationship of the initial customer with the institution. Examiners should consider whether management adequately supports their assessments of the stability of reciprocal deposits, or any funding source, for liquidity management and measurement purposes.

Brokered Deposit Restrictions

Section 29 of the FDI Act sets forth restrictions on the acceptance of brokered deposits based on an institutions category. Well capitalized banks may accept, renew, or roll over brokered deposits at any time. An adequately capitalized insured depository institution may not accept, renew, or roll over any brokered deposit unless the institution has applied for and been granted a waiver by the FDIC. An undercapitalized insured depository institution may not accept, renew, or roll over any brokered deposits. If a bank is under any type of formal agreement pursuant to Section 8 of the FDI Act with a directive to meet or maintain any specific capital level, it will no longer be considered well capitalized for the purposes of Part 337.

With respect to adequately capitalized institutions that have been granted a brokered deposit waiver, any safety and soundness concerns arising from the acceptance of brokered deposits are ordinarily addressed by the conditions imposed in granting the waiver application. In monitoring such conditions, it is incumbent on the examiner not only to verify compliance, but also to assess whether any unanticipated problems are being created.

Deposit Rate Restrictions

In addition to the brokered deposit restrictions noted above, Section 29 of the FDI Act also places certain restrictions on deposit interest rates for banks that are less than well capitalized. Deposit rate restrictions prevent a bank that is not well capitalized from circumventing the prohibition on brokered deposits by offering rates significantly above market in order to attract a large volume of deposits quickly. Under Section 337.6 of the FDIC's Rules and Regulations, a bank that is not well capitalized may not offer deposit rates more than 75 basis points above average national rates for deposits of similar size and maturity (referred to as the national rate cap).

The national rate is a simple average of rates paid by all banks and branches. On a weekly basis, the FDIC publishes national rate data (at www.fdic.gov) that can be used to determine conformance with the interest rate restrictions. If a bank believes that the national rate does not correspond to the actual rates in the bank's particular market, the bank is permitted to request a determination from the applicable regional office that the bank is operating in a high-rate area.

Examiners should review conformance with interest rate restrictions during examinations of banks that are not well capitalized. If a bank has not received a determination that it is operating in a high-rate area, deposit rates must not exceed the national rate caps posted on the FDIC website. If an institution receives a determination that it is operating in a high-rate area, the institution can establish its market area based on its branch locations and marketing scope. The deposit rates of all FDIC-insured institutions inside the market area must be used when calculating the prevailing rate. An institution may also include as part of its prevailing rate calculation the rates offered by credit unions that the institution competes with inside its local market area. When using the local market approach, the rate cap for local deposits cannot exceed the prevailing rate of the local market plus 75 basis points. Deposits accepted outside the market area are subject to the national rate caps, even for institutions that have received a determination they are operating in a high-rate area. While in some cases the FDIC may grant a brokered deposit waiver to a less than well-capitalized bank, the FDIC may not waive the interest rate restrictions under the brokered deposit regulations.

Brokered Deposits Use

The FDI Act does not restrict the use of brokered deposits for well-capitalized institutions, and brokered deposits can be a suitable funding source when properly managed. However, some banks have used brokered deposits to fund unsound or rapid expansion of loan and investment portfolios, which has contributed to weakened financial and liquidity positions over successive economic cycles. The overuse and failure to properly manage brokered deposits by problem institutions have contributed to bank failures and losses to the deposit insurance fund.

Examiners should consider whether an institution's policies adequately describe permissible brokered and rate-sensitive funding types, amounts, and concentration limits. Key policy considerations include procedures for assessing potential risks to earnings and capital associated with brokered and rate-sensitive deposits, and monitoring how such funds are used. Examiners should ensure management is aware of the restrictions that may apply if the institution's PCA capital category falls below well capitalized.

Examiners should determine whether management performs adequate due diligence before entering any business relationship with a deposit broker or other business partners that help provide rate-sensitive deposits, such as deposit listing services. Deposit brokers and deposit listing services are not regulated by the federal bank agencies.

While the FDI Act does not restrict the use of brokered deposits by well-capitalized institutions, the acceptance of brokered deposits by well-capitalized institutions is subject to the same considerations and concerns applicable to any type of special funding. These considerations relate to volume, availability, cost, volatility, maturity, and how the use of such special funding fits into the institution's overall liability and liquidity management plans.

When brokered deposits are encountered in an institution, examiners should consider the effect on overall funding and investment strategies and if the bank is less than well capitalized, verify compliance with Part 337. Examiners should also consider the source, stability, and use of brokered deposits or rate sensitive funding sources that support asset growth or individual loans. Appropriate supervisory action should be considered if brokered deposits or other rate sensitive funding sources are not appropriately managed as part of an overall, prudent funding strategy. Apparent violations of Part 337 or nonconformance with the Interagency Guidelines Establishing Standards for Safety and Soundness (Appendix A to Part 364) should be discussed with management and the board of directors, and appropriately addressed in the ROE.

Public Funds

Public funds are deposits of government entities such as state or local municipalities. Some states require institutions to secure the uninsured or entire balance of these accounts. Although various forms of collateral may be pledged, high-quality assets such as securities of U.S. government or government-sponsored enterprises (GSE) are most commonly pledged. Some institutions may also use standby letters of credit (SBLCs), such as those from one of the Federal Home Loan Banks (FHLB), to secure public funds.

The stability of public fund accounts can vary significantly due to several factors. Account balances may fluctuate due to timing differences between tax collections and expenditures, the funding of significant projects (e.g., school or hospital construction), placement requirements, and economic conditions. Placement requirements may include rotating deposits between institutions in a particular community, obtaining bids and placing funds with the highest bidder, and minimum condition standards for the institution receiving the deposits (such as specific capital levels or the absence of formal enforcement actions). Economic conditions can affect the volatility of public deposits since public entities may experience lower revenues during an economic downturn.

Although public deposit accounts often exhibit volatility, the accounts can be reasonably stable over time, or their fluctuations quite predictable. Therefore, examiners should closely review public deposit relationships to make informed judgments as to the stability of the balances.

Securing Public Funds with SBLCs

Some financial institutions obtain SBLCs as a supplemental funding source to accommodate public depositors, derivative counterparties, and corporate borrowing needs. Typically, institutions obtain SBLCs from their district FHLB to support uninsured public deposits and secure them with eligible loans and securities. The SBLC guarantees that the issuer will pay the beneficiary on demand if the institution fails or otherwise defaults on its obligation. When used judiciously, these standby credit facilities can complement a diversified funds management program and serve as a practical, cost-effective solution for securing a financial institution's obligations.

Certain state laws require public deposits from state, county, and municipal authorities be protected by federal deposit insurance; a pledge of obligations issued by the U.S. Treasury, U.S. government agencies, or state and local governments; or an SBLC issued by an FHLB. Some institutions prefer to obtain an SBLC rather than pledge government securities because of the standby facility's cost and balance sheet efficiency. FHLBs will accept a variety of loans and securities as collateral subject to certain collateral requirements, or "haircuts."

Similar to FHLB advances or other secured borrowings, SBLCs require collateral. Most institutions depend on eligible loans or securities as collateral. To maximize balance sheet efficiency, institutions frequently secure SBLCs with loans because they would otherwise use unencumbered securities to directly meet pledging requirements (especially for uninsured public deposits). While secured borrowings are a widely accepted form of funding that can be performed in a safe and sound manner, undiversified reliance on secured borrowings or less stable funding can sometimes result in strained liquidity. Funding diversification is important in the case of large-scale secured borrowing programs which can encumber assets that would otherwise be eligible for pledging or conversion to cash. Importantly, funding risk does not arise because of the type of secured borrowing conducted (i.e., FHLB advances or SBLCs); rather, it centers on the extent of borrowing, leveraging previously unencumbered assets, and over-reliance on non-core sources to achieve growth or earnings targets.

SBLCs are generally only exercised by public depositors if the institution fails to fund a withdrawal. If an institution does not have sufficient unencumbered liquid assets to meet a withdrawal request, it may seek a new FHLB advance and contemporaneously cancel or reduce the SBLC. The assets used to collateralize the SBLC would secure at least part of the new advance, depending on the FHLB's revised collateral terms. The FHLB can require additional collateral, possession of collateral, or limits on availability if it views an institution as troubled.

Examiners should recognize that SBLCs may present challenges in times of stress, particularly when an institution's borrowing capacity may be constrained by a large volume of pledged loans and securities. SBLCs encumber assets eligible for FHLB collateral at the time of commitment and throughout the instrument's life, meaning that pledged assets will not be as readily convertible to cash or available to use as collateral for additional borrowings. Further, if an institution's asset quality or financial condition deteriorates, the FHLB may demand more rigorous terms or additional collateral. This may occur precisely when an institution has a heightened need for on-balance sheet liquidity.

Liquidity reviews during examinations should consider the potential impact of standby credit facilities on liquidity and funds management, asset encumbrance, and the protection of uninsured public deposits. Examiners should identify SBLC or other credit facilities that require pledged collateral, followed by a review of related documentation and financial reporting. If an institution relies significantly on wholesale borrowings (such as FHLB advances and SBLCs) to fund its balance sheet, examiners should analyze how asset encumbrances might impair liquidity in a stress scenario and whether these issues are appropriately addressed in the CFP.

Secured and Preferred Deposits

Institutions are usually required to pledge securities (or other readily marketable assets) to cover secured and preferred deposits. Institutions must secure U.S. government deposits, and many states require banks to secure public funds, trust accounts, and bankruptcy court funds. In addition to strict regulatory and bookkeeping controls associated with pledging requirements, institutions often establish monitoring controls to ensure deposits and pledged assets are appropriately considered in their liquidity analysis. Accurate accounting for secured or preferred liabilities is also important if an institution fails, because secured depositors and creditors may gain immediate access to some of the institution's most liquid assets.

Large Depositors and Deposit Concentrations

For examination purposes, a large depositor is a customer or entity that owns or controls 2 percent or more of the bank's total deposits. Some large deposits remain relatively stable over long periods. However, due to the effect the loss of a large deposit account could have on an institution's overall funding position, these deposits are considered to be potentially less stable liabilities.

A large deposit account might be considered stable if the customer has ownership in the institution, has maintained a long-term relationship with the bank, has numerous accounts, or uses multiple bank services. Conversely, a large depositor that receives a high deposit rate, but maintains no other relationships with the institution, may move the account quickly if the rate is no longer considered high for the market. Therefore, examiners should consider the overall relationship between customers and the institution when assessing the stability of large deposits.

Examiners should consider whether institutions actively monitor the stability of large deposits and maintain funds management policies and strategies that reflect consideration of potentially volatile concentrations and significant deposits that mature simultaneously. Key considerations include potential cash flow fluctuations, pledging requirements, affiliated relationships, and the narrow interest spreads that may be associated with large deposits.

Negotiable Certificates of Deposit

Negotiable CDs warrant special attention as a component of large (uninsured) deposits. These instruments are usually issued by large regional or money center banks in denominations of $1 million or more and may be issued at face value with a stated rate of interest or at a discount similar to U.S. Treasury bills. Major bank CDs are widely traded, may offer substantial liquidity, and are the underlying instruments for a market in financial futures. Their cost and availability are closely related to overall market conditions, and any adverse publicity involving either a particular bank or banks in general can impact the CD market. These CDs have many features similar to borrowings and can be quite volatile.

Assessing the Stability of Funding Sources

Assessing the stability of funding sources is an essential part of liquidity risk measurement and liquidity management. Institutions may rely on a variety of funding sources, and a wide array of factors may impact the stability of those funding sources. The following factors should be considered when assessing the stability of funding sources:

- **The cost of the bank's funding sources compared to market costs and alternative funding sources:** If a bank pays significantly above local or national rates to obtain or retain deposits, the bank's deposit base may be highly cost sensitive, and depositors may be more likely to move deposits if terms become more favorable elsewhere. Examiners should determine whether the institution uses rate specials or one-time promotional offerings to obtain deposits or to retain rate-sensitive customers. Examiners should also assess how much of the deposit base consists of rate specials and determine if management measures and reports the level of such deposits.

- **Large deposit growth or large changes in deposit composition:** Strategies that rely on less stable funding sources to fund significant growth in new business lines should be carefully considered. The potential for misjudging the level of risk in new strategies is high and could be compounded with the use of volatile funding sources.
- **Stability of insured deposits and fully secured borrowings:** Insured deposits and borrowings secured by highly liquid assets are more likely to be stable than uninsured deposits or borrowings secured by non-liquid assets. Uninsured deposits should not automatically be considered volatile; however, the historical and projected stability of uninsured deposits should be assessed.
- **The current rate environment:** Depositors may be less rate sensitive in a low-rate environment due to the limited benefits (marginally higher rates) obtained by shifting deposits into longer-term investments.
- **The current business cycle:** If the national or local economy is in a downward cycle, individuals and businesses may decide to keep more cash on hand versus spending or investing it.
- **Contractual terms and conditions:** Terms and requirements related to the condition of the bank, such as the bank's PCA category, credit ratings, or capital levels can materially affect liquidity. Specific contractual terms and conditions are often associated with brokered deposits, funds from deposit listing services, correspondent bank accounts, repurchase agreements, and FHLB advances.
- **The relationship with the funding source:** Large deposits might be more stable if the deposit is difficult to move (e.g., the deposit is in a transaction account used by a payroll provider), if the depositor is an insider in the institution, or if the depositor has a long history with the institution. However, examiners should consider that depositors may withdraw funds during stress periods regardless of difficulties or the effect on the bank.

Borrowings

Stable deposits are a key funding source for most insured depository institutions; however, institutions are becoming increasingly reliant upon borrowings and other wholesale funding sources to meet their funding needs. Borrowings include debt instruments or loans that banks obtain from other entities such as correspondent lines of credit, federal funds, and FHLB and Federal Reserve Bank advances.

Generally, examiners should view borrowings as a supplemental funding source, rather than as a replacement for core deposits. If an institution is using borrowed funds to meet contingent liquidity needs, examiners should determine whether management understands the associated risks and has commensurate risk management practices. Effective practices typically include a comprehensive contingency funding plan that specifically addresses funding plans if the institution's financial condition or the economy deteriorates. Active and effective risk management, including funding-concentration management by size and source, can mitigate some of the risks associated with the use of borrowings.

Key considerations when assessing liquidity risks associated with borrowed funds include the following:

- Pledging assets to secure borrowings can negatively affect a bank's liquidity profile by reducing the amount of securities available for sale during periods of stress.
- Unexpected changes in market conditions can make it difficult for the bank to secure funds and manage its funding maturity structure.
- It may be more difficult to borrow funds if the institution's condition or the general economy deteriorates.
- Banks may incur relatively high costs to obtain funds and may lower credit quality standards in order to invest in higher-yielding loans and securities to cover the higher costs. If a bank incurs higher-cost liabilities to support assets already on its books, the cost of the borrowings may result in reduced or negative net income.
- Preoccupation with obtaining funds at the lowest possible cost, without proper consideration given to diversification and maturity distribution, intensifies a bank's exposure to funding concentrations and interest rate fluctuations.
- Some borrowings have embedded options that make their maturity or future interest rate uncertain. This uncertainty can increase the complexity of liquidity management and may increase future funding costs.

Common borrowing sources include:

- Federal funds purchased,
- Federal Reserve Bank facilities,
- Repurchase agreements,
- Dollar repurchase agreements,
- Bank investment contracts,
- Commercial Paper, and
- International funding sources.

Federal Funds

Federal funds are reserves held in an institution's Federal Reserve Bank account that can be lent (sold) by institutions with excess reserves to other institutions with an account at a Federal Reserve Bank. Institutions borrow (purchase) federal funds to meet their reserve requirements or other funding needs. Institutions rely on the Federal Reserve Bank or a correspondent bank to facilitate federal funds transactions. State non-member banks that do not maintain balances at the Federal Reserve purchase/sell federal funds through a correspondent bank.

Lending and borrowing these balances has become a convenient method for banks to avoid reserve deficiencies or invest excess reserves over a short period of time. In most instances, federal funds transactions take the form of overnight or short-term unsecured transfers of immediately available funds between banks. However, banks also enter into continuing contracts that have no set maturity but are subject to cancellation upon notice by either party to the transaction. Banks also engage in federal funds transactions of a set maturity, but these include only a small percentage of all federal funds transactions. In any event, these transactions should be supported with written verification from the lending institution.

Some institutions may access federal funds as a liability management technique to fund a rapid expansion of its loan or investment portfolios and enhance profits. In these situations, examiners should determine whether appropriate board approvals, limits, and policies are in place and should discuss with management and the board the institution's plans for developing appropriate long-term funding solutions. Liquidity risks typically decline if institutions avoid undue reliance on federal funds purchased, as the funds are usually short-term, highly credit sensitive instruments that may not be available if an institution's financial condition deteriorates.

Federal Reserve Bank Facilities

The Federal Reserve Banks provide short-term collateralized credit to banks through the Federal Reserve's discount window. The discount window is available to any insured depository institution that maintains deposits subject to reserve requirements. The most common types of collateral are U.S. Treasury securities; agency, GSE, mortgage-backed, asset-backed, municipal, and corporate securities; and commercial, agricultural, consumer, residential real estate, and commercial real estate loans. Depending on the collateral type and the condition of the institution, collateral may be transferred to the Federal Reserve, held by the borrower in custody, held by a third party, or reflected by book entry.

Types of discount window credit include primary credit (generally overnight credit to meet temporary liquidity needs), secondary credit (available to institutions that do not qualify for primary credit), seasonal credit (available to banks that demonstrate a clear seasonal pattern to deposits and assets), and emergency credit (rare circumstances).

The Federal Reserve's primary credit program was designed to ensure adequate liquidity in the banking system and is intended as a back-up of short-term funds for eligible institutions. In general, depository institutions are eligible for primary credit if they have a composite CAMELS rating of 1, 2, or 3 and are at least adequately capitalized.

Since primary credit can serve as a viable source of back-up, short-term funds, examiners should not automatically criticize the occasional use of primary credit. At the same time, over-reliance on primary credit borrowings or any one source of short-term contingency funds may indicate operational or financial difficulties. Examiners should consider whether institutions that use primary credit facilities maintain viable exit strategies.

Secondary credit is available to depository institutions that do not qualify for primary credit and is extended on a very short-term basis at a rate above the primary credit rate. This program entails a higher level of Reserve Bank administration and oversight than primary credit.

If a bank's borrowing becomes a regular occurrence, Federal Reserve Bank officials will review the purpose of the borrowing and encourage the bank to initiate a program to eliminate the need for such borrowings. Appropriate reasons for borrowing include preventing overnight overdrafts, loss of deposits or borrowed funds, unexpected loan demand, liquidity and cash flow needs, operational or computer problems, or a tightened federal funds market.

The Federal Reserve will not permit banks that are not viable to borrow at the discount window. Section 10B(b) of the Federal Reserve Act limits Reserve Bank advances to not more than 60 days in any 120-day period for undercapitalized institutions or institutions with a composite CAMELS rating of 5. This limit may be overridden only if the primary federal banking agency supervisor certifies the borrower's viability or if, following an examination of the borrower by the Federal Reserve, the Chairman of the Board certifies in writing to the Reserve Bank that the borrower is viable. These certifications may be renewed for additional 60-day periods.

Repurchase Agreements

In a securities repurchase agreement (repo), an institution agrees to sell a security to a counterparty and simultaneously commits to repurchase the security at a mutually agreed upon date and price. In economic terms, a repurchase agreement is a form of secured borrowing. The amount borrowed against the securities generally is the full market value less a reasonable discount. Typically, the securities do not physically change locations or accounting ownership; instead, the selling bank's safekeeping agent makes entries to recognize the purchasing bank's interest in the securities.

From an accounting standpoint, repurchase agreements involving securities are either reported as secured borrowings, or sales and a forward repurchase commitment based on whether the selling institution maintains control over the transferred financial asset. Generally, if the repurchase agreement both entitles and obligates the selling bank to repurchase or redeem the transferred assets from the transferee (i.e., the purchaser) the selling bank should report the transaction as a secured borrowing if various other conditions outlined in Generally Accepted Accounting Principles have been met. If the selling bank does not maintain effective control of the transferred assets according to the repurchase agreement, the transaction would be reported as a sale of the securities and a forward repurchase commitment. For further information, see the Call Report Glossary entries pertaining to Repurchase/Resale Agreements and Transfers of Financial Assets.

Examiners may encounter two types of repurchase agreements: bilateral and tri-party. Bilateral repurchase agreements involve only two parties. In tri-party repurchase agreements, an agent is involved in matching counterparties, holding the collateral, and ensuring the transactions are executed properly.

The majority of repurchase agreements mature in three months or less. One-day transactions are known as overnight repos, while transactions longer in duration are referred to as term repos. Institutions typically use repurchase agreements as short-term, relatively low cost, funding mechanisms. The interest rate paid on a repurchase agreement depends on the type of underlying collateral. In general, the higher the credit quality of the collateral and the easier the security is to deliver and hold, the lower the repo rate. Supply and demand factors for the underlying collateral also influence the repo rate.

Properly administered repurchase agreements conducted within a comprehensive asset/liability management program are not normally subject to regulatory criticism. However, repos that are inadequately controlled can expose an institution to risk of loss and may be regarded as an unsuitable investment practice. Since the fair value of the underlying security may change during the term of the transaction, both parties to a repo may experience credit exposure. Although repo market participants normally limit credit exposures by maintaining a cushion between the amount lent and the value of the underlying collateral, and by keeping terms short to allow for redemption as necessary, it is critical to conduct a thorough credit review of repo counterparties prior to the initiation of transactions. The Policy Statement on Repurchase Agreements of Depository Institutions with Securities Dealers and Others, dated February 10, 1998, provides additional information on repurchase agreements, associated policies and procedures, credit risk management practices, and collateral management practices.

A reverse repurchase agreement, which requires the buying institution to sell back the same asset purchased, is treated as a loan for Call Report purposes. If the reverse repurchase agreement does not require the institution to resell the same, or a substantially similar, security purchased, it is reported as a purchase of the securities and a commitment to sell securities.

Reverse repos can involve unique risks and complex accounting and recordkeeping challenges, and institutions can benefit from establishing appropriate risk management policies, procedures and controls. In particular, institutions can benefit from controls when relying on reverse repos that are secured with high-risk assets. The value of the underlying assets may decline significantly in a stress event, creating an undesirable amount of exposure.

Dollar Repurchase Agreements

Dollar repurchase agreements, also known as dollar repos and dollar rolls, provide financial institutions with an alternative method of borrowing against securities owned. Unlike standard repurchase agreements, dollar repos require the buyer to return substantially similar, versus identical, securities to the seller. Dealers typically offer dollar roll financing to institutions as a means of covering short positions in particular securities. Short positions arise when a dealer sells securities that it does not currently own for forward delivery. To compensate for potential costs associated with failing on a delivery, dealers are willing to offer attractive financing rates in exchange for the use of the institution's securities in covering a short position. Savings associations, which are the primary participants among financial institutions in dollar roll transactions, typically use mortgage pass through securities as collateral for the transactions.

Supervisory authorities do not normally take exception to dollar repos if the transactions are conducted for legitimate purposes and the institution has instituted appropriate controls.

Bank Investment Contracts

A bank investment contract (BIC) is a deposit contract between a bank and a customer that permits the customer to deposit funds over a period of time and obligates the bank to repay the amounts deposited plus interest at a guaranteed rate at the end of the contract term. Contract terms vary and may include maturities ranging from six months to ten years. Occasionally, BICs have been structured as non-transferable liabilities (i.e., not saleable in a secondary market). Customers for BICs are often sponsors of employee benefit plans such as pension plans or deferred compensation plans.

Examiners should consider the volume, maturity, and cost of BIC funding in relation to the bank's other deposit and non-deposit funding sources. Examiners should also be aware of the terms and conditions of the BICs. A BIC may provide specific periods and conditions under which additional deposits or withdrawals can be made to or from such accounts. The bank's liquidity planning typically estimate cash flows from BIC funding under different interest rate scenarios.

International Funding Sources

International funding sources exist in various forms. The most common source of funds is the Eurodollar market. Eurodollar deposits are U.S. dollar-denominated deposits taken by a bank's overseas branch or its international banking facility. Reserve requirements and deposit insurance assessments do not apply to Eurodollar deposits. The interbank market is highly volatile, and banks typically benefit form analyzing Eurodollar deposit activities within the same context as all other potentially volatile funding sources.

Commercial Paper

Institutions can issue commercial paper to quickly raise funds from the capital markets. Commercial paper is generally a short-term, negotiable promissory note issued for short-term funding needs by a bank holding company, large commercial bank, or other large commercial business. Commercial paper usually matures in 270 days or less, is not collateralized, and is purchased by institutional investors.

Some commercial paper programs are backed by assets referred to as asset-backed commercial paper. Some programs also involve multi-seller conduits where a special-purpose entity is established to buy interests in pools of financial assets (from one or more sellers). Entities fund such purchases by selling commercial paper notes, primarily to institutional investors.

Institutions that provide liquidity lines or other forms of credit enhancement to their own or outside commercial paper programs face the risk that the facilities could be drawn upon during a crisis situation. Prudent institutions plan for such events and include such events in stress scenario analysis and contingency plans. In addition, institutions benefit from addressing the bank's ability to continue using commercial paper conduits as a funding source in the bank's contingency funding plan.

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OFF-BALANCE SHEET ITEMS

Off-balance sheet items, such as those described below, can be a source or use of funds.

Loan Commitments

Loan commitments are common off-balance sheet items. Typical commitments include unfunded commercial, residential, and consumer loans; unfunded lines of credit for commercial and retail customers; and fee-paid, commercial letters of credit. Sound risk management practices include closely monitoring the amount of unfunded commitments that require funding over various periods and detailing anticipated demands against unfunded commitments in internal reports and contingency plans. Examiners should consider the nature, volume, and anticipated use of the institution's loan commitments when assessing and rating the liquidity position.

Derivatives

Financial institutions can use derivative instruments (financial contracts that generally obtain their value from underlying assets, interest rates, or financial indexes) to reduce business risks. However, like all financial instruments, derivatives contain risks that must be properly managed. For example, interest rate swaps typically involve the periodic net settlement of swap payments that can substantially affect an institution's cash flows. Additionally, derivative contracts may have initial margin requirements that require an institution to pledge cash or investment securities that reflect a specified percentage of the contract's notional value. Variation margin requirements (which may require daily or intra-day settlements to reflect changes in market value) can also affect an institution's cash flows and investment security levels. Examiners should consider the extent to which banks engaging in derivative activities understand and manage the liquidity, interest rate, and price risks of these instruments.

Other Contingent Liabilities

Legal risks can have a significant financial impact on institutions that may affect liquidity positions. Examiners should consider whether institutions identify these contingencies when measuring and reporting liquidity risks as exposures become more certain.

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LIQUIDITY RISK MITIGATION

There are many ways management can mitigate liquidity risk and maintain the institution's current and future liquidity positions within the risk tolerance targets established by the board. For managing routine and stressed liquidity needs, institutions typically establish diversified funding sources and maintain a cushion of high-quality liquid assets. Examiners should consider whether contingency funding plans identify back-up funding sources (and action steps to address more acute liquidity needs) and whether management tests various stress scenarios to identify risks that should be mitigated and addressed in contingency funding plans.

Diversified Funding Sources

An important component of liquidity management is the diversification of funding sources. Undue reliance on any one source of funding can have adverse consequences in a period of liquidity stress. Banks typically diversify funding across a range of retail sources and, if utilized, across a range of wholesale sources, consistent with the institution's sophistication and complexity. Institutions that rely primarily on retail deposit accounts are generally not criticized for relying on one primary funding source. However, examiners should determine whether alternative sources are identified in formal contingency plans and periodically tested.

To reduce risks associated with funding concentrations, banks generally benefit from considering the correlations between sources of funds and market conditions and having available a variety of short-, medium-, and long-term funding sources. The board is responsible for setting and clearly articulating a bank's risk tolerance in this area through policy guidelines and limits for funding diversification.

Although banks use diversified funding sources to reduce funding concentration risks, banks also consider other factors when selecting funding sources. For example, the cost of a particular funding source is a critical consideration when developing profitability strategies. Additionally, the stability and availability of a funding source are important factors when planning for asset growth. Examiners should carefully assess strategies that rely on less-stable funding sources, particularly strategies that fund significant growth in new business lines.

When assessing the diversification of funding sources, important factors to consider include:

- Internal evaluations of risks associated with funding sources (e.g., stress tests and diversification limits) and whether or not the evaluations are reasonable and well documented,
- Potential curtailment of funding or significantly higher funding costs during periods of stress,
- Time required to access funding in stressed and normal periods,
- Sources and uses of funds during significant growth periods, and
- Available alternatives to volatile funding sources.

Maintaining market access to funds is also an essential component of ensuring funding diversity. Market access can be critical, as it affects an institution's ability to raise new funds and to liquidate assets. Examiners should consider whether management actively manages, monitors, and tests the institution's market access to funds. Such efforts should be consistent with the institution's liquidity risk profile and sources of funding. For example, access to the capital markets is an important consideration for most large complex banks, whereas the availability of correspondent lines and other sources of wholesale funds are critical for community banks. Reputation risk plays a critical role in a bank's ability to access funds readily and at reasonable terms. For this reason, examiners should determine whether liquidity risk managers are aware of any information, such as an announcement of a decline in earnings, or a downgrade by a rating agency, that could affect perceptions of an institution's financial condition.

The Role of Equity

Issuing new equity is often a relatively slow and costly way to raise funds and should not be viewed as an immediate or direct source of liquidity. However, to the extent that a strong capital position helps an institution quickly obtain additional debt and economically raise funds, issuing equity can be considered a liquidity facilitator.

Cushion of Highly Liquid Assets

One of the most important components of an institution's ability to effectively respond to liquidity stress is the availability of unencumbered, highly liquid assets (i.e., assets free from legal, regulatory, or operational impediments). Unencumbered liquid assets can be sold or pledged to obtain funds under a range of stress scenarios. The quality of the assets is a critical consideration, as it significantly affects a bank's ability to sell or pledge the assets in times of stress.

When determining what type of assets to hold for contingent liquidity purposes, management typically considers factors such as:

- **Level of credit and market risk:** Assets with lower levels of credit and market risk tend to have higher liquidity profiles.
- **Liquidity during stress events:** High-quality liquid assets are generally not subject to significantly increased risk during stress events. Conversely, certain assets, such as specialty assets with small markets or assets from industries experiencing stress, are often less liquid in times of stress in the banking sector.
- **Ease and certainty of valuation:** Prices based on trades in sizeable and active markets tend to be more reliable, and an asset's liquidity increases if market participants are more likely to agree on its valuation. Formula-based pricing is less desirable than data from recent trades. If used, the pricing formula should be easy to calculate, based on active trades, and not depend heavily on assumptions or modeled prices. The inputs into the pricing formula should also be publicly available.

Institutions with high quality liquid assets are generally able to monetize the assets through the sale of the assets or the use of secured borrowings. This generally means an institution's cushion of liquid assets is concentrated in due from accounts, federal funds sold, and high-quality assets, such as U.S. Treasury securities or GSE bonds.

Occasionally, it may be appropriate to consider pledged assets as part of the highly liquid cushion, such as when a bank pledges Treasury notes as part of an unfunded line of credit. In other instances, it may be appropriate to consider an asset that has not been explicitly pledged as illiquid. For example, if an institution is required to deposit funds at a correspondent institution to facilitate operational services, it should generally exclude these funds from its liquidity reports, or denote them separately as unavailable.

Examiners should assess whether the size of the institution's liquid asset cushion is aligned with its risk tolerance and profile, and is supported by documented analysis and stress test results. Factors that may indicate a need to maintain a higher liquid asset buffer include:

- Easy customer access to alternative investments,
- Recent trends showing substantial reductions in large liability accounts,
- Significant volumes of less-stable funding,
- High levels of assets with limited marketability (due to credit quality issues or other factors),
- Expectations of elevated draws on unused lines of credit or loan commitments,
- A concentration of credit to an industry with existing or anticipated financial problems,
- Close ties between deposit accounts and employers experiencing financial problems,
- A significant volume of assets are pledged to wholesale borrowings, and
- Impaired access to funds from capital markets.

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CONTINGENCY FUNDING

Contingency Funding Plans

All financial institutions, regardless of size or complexity, benefit from a formal contingency funding plan (CFP) that clearly defines strategies for addressing liquidity shortfalls in emergency situations. Comprehensive CFPs delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. The reliability of a CFP improves if it is regularly tested and updated to ensure that it is operationally sound. Often, financial institutions coordinate liquidity risk management plans with disaster, contingency, and business planning efforts, as well as with business line and risk management objectives, strategies, and tactics.

While CFPs should be tailored to the business model, risk, and complexity of the individual institution, most CFPs require management to:

- Establish a liquidity event-management framework (including points of contact and public relation plans),
- Establish a monitoring framework,
- Identify potential contingent funding events,
- Identify potential funding sources,
- Require stress testing, and
- Require periodic testing of the CFP framework.

Contingent Funding Events

The primary goals of most CFPs are to identify risks from contingent funding events and establish an operational framework to deal with those risks. Contingent funding events are often managed based on their probability of occurrence and potential effect. CFPs generally focus on events that, while relatively infrequent, could have a high-impact on the bank's operations. Appropriate plans typically set a course of action to identify, manage, and control all significant contingent funding risks.

Stress factors that may provide early warning signs for identifying potential funding risks can be institution-specific or systemic and may involve one or more of the following:

- Deterioration in asset quality,
- Downgrades in credit ratings,
- Downgrades in PCA capital category,
- Deterioration in the liquidity management function,
- Widening of credit default spreads,
- Operating losses,
- Rapid growth,
- Inability to fund asset growth,
- Inability to renew or replace maturing funding liabilities,
- Price volatility or changes in the market value of various assets,
- Negative press coverage,
- Declining institution equity prices,
- Deterioration in economic conditions or market perceptions,
- Disruptions in the financial markets, and
- General or sector-specific market disruptions (e.g., payment systems or capital markets).

Stress events can also be caused by counterparties (both credit and non-credit exposures). For example, if a bank sells financial assets to correspondent banks for securitization and its primary correspondent exits the market, the bank may need to use a contingent funding source.

Comprehensive CFPs identify institution-specific events that may impact on- and off-balance sheet cash flows given the specific balance-sheet structure, business lines, and organizational structure. For example, institutions that securitize loans have CFPs that consider a stress event where the institution loses access to the market but must still honor its commitments to customers to extend loans.

Comprehensive CFPs also delineate various stages and severity levels for each potential contingent liquidity event. For example, asset quality can deteriorate incrementally and have various levels of severity, such as less than satisfactory, deficient, and critically deficient. The CFPs also address the timing and severity levels of temporary, intermediate-term, and long-term disruptions. For example, a natural disaster may cause temporary disruptions to payment systems, while deficient asset quality may occur over a longer term. Institutions can then use the stages or severity levels identified to establish various stress test scenarios and early-warning indicators.

Stress Testing Liquidity Risk Exposure

After identifying potential stress events, institutions often implement quantitative projections, such as stress tests, to assess the liquidity risk posed by the potential events. Stress testing helps the institution better understand the vulnerability of certain funding sources to various risks and helps to determine when and how to access alternative funding sources. Stress testing also helps institutions identify methods for rapid and effective responses, guide crisis management planning, and determine how large of a liquidity buffer should be maintained. Generally, the magnitude and frequency of stress testing is commensurate with the complexity of the financial institution and the level of its risk exposures.

Liquidity stress tests are typically based on existing cash-flow projections that are appropriately modified to reflect potential stress events (institution-specific or market-wide) across multiple time horizons. Stress tests are used to identify and quantify potential risks and to analyze possible effects on the institution's cash flows, liquidity position, profitability, and solvency. For instance, during a crisis an institution's liquidity needs can quickly escalate while liquidity sources can decline (e.g., customers may withdraw uninsured deposits, or lines of credit may be reduced or canceled). Stress testing allows an institution to evaluate the possible impact of these events and plan accordingly.

Examiners should review documented assumptions regarding the cash flows used in stress test scenarios and consider whether they incorporate:

- Customer behaviors (early deposit withdrawals, renewal/run-off of loans, exercising options);
- Prepayments on loans and mortgage-backed securities;
- Seasonality (public-fund fluctuations, agricultural credits, construction lending); and
- Various time horizons.

Effective assumptions generally incorporate both contractual and non-contractual behavioral cash flows, including the possibility of funds being withdrawn. Examples of non-contractual funding requirements that may occur during a financial crisis include supporting auction rate securities, money market funds, commercial paper programs, and structured investment vehicles. Institutions may be compelled to financially bolster shortfalls in money market funds or asset-backed paper that does not sell or roll due to market stress, and assets may be taken on balance sheet from sponsored off-balance sheet vehicles. While this financial support is not contractually required, institutions may determine that the negative press and reputation risks outweigh the costs of providing the financial support.

Effective stress testing generally assesses various stress levels and stages ranging from low- to severe-stress scenarios. To establish appropriate stress scenarios, management may use the different stages and severity levels that the institution assigned to stress events. For example, a low-stress scenario may include several events identified as low severity, while a severe stress scenario may combine several high-severity events. A severe stress scenario may include severe declines in asset quality, financial condition, and PCA category.

Management's active involvement and support is critical to the effectiveness of the stress testing process. Stress test results are typically discussed with the board, and when appropriate, management takes remedial actions to limit the institution's exposures, build up a liquidity cushion, and/or adjust its liquidity profile to fit its risk tolerance. In some situations, institutions may adjust the bank's business strategy to mitigate a contingent funding exposure.

Potential Funding Sources

Identification of potential funding sources for shortfalls resulting from stress scenarios is a key component of adequate contingency funding plans. Banks generally identify alternative funding sources and ensure ready access to the funds. The most important and reliable funding source is a cushion of highly liquid assets. Other common contingent funding sources include the sale or securitization of assets, repurchase agreements, FHLB borrowings, or borrowings though the Federal Reserve discount window. However, in a stress event, many of these liquidity sources may become unavailable or cost prohibitive. Therefore, effective stress tests typically assess the availability of contingent funding in stress scenarios.

Institutions that rely on unsecured borrowings for contingency funding normally consider how borrowing capacity may be affected by an institution-specific or market-wide disruption. Institutions that rely upon secured funding sources for contingency funding also consider whether they may be subject to higher margin or collateral requirements in certain stress scenarios. Higher margin or collateral requirements may be triggered by the deterioration in the institution's overall financial condition or in a specific portfolio.

Potential collateral values are also normally subjected to stress tests because devaluations or market uncertainties could reduce the amount of contingent funding available from a pledged asset. Similarly, stress tests often consider correlation risk when evaluating margin and collateral requirements. For example, if an institution relies on its loan portfolio for contingent liquidity, a stress test may assess the effects of poor asset quality. If loans previously securitized were of poor credit quality, the market value and collateral value of current and future loans originated by the bank could be significantly reduced.

Monitoring Framework for Stress Events

Early identification of liquidity stress events is critical to implementing an effective response. The early recognition of potential events allows the institution to position itself into progressive states of readiness as an event evolves, while providing a framework to report or communicate within the institution and to outside parties. As a result, effective CFPs typically identify early warning signs that are tailored to the institution's specific risk profile. The CFPs also establish a monitoring framework and responsibilities for monitoring identified risk factors.

Early warning indicators may be classified by management as early-stage, low-severity, or moderate-severity stress events and include factors such as:

- Decreased credit-line availability from correspondent institutions,
- Demands for collateral or higher collateral requirements from counterparties that provide credit to the institution,
- Cancelation of loan commitments or the non-renewal of maturing loans from counterparties that provide credit to the institution,
- Decreased availability of warehouse financing for mortgage banking operations,
- Increased trading of the institution's debt, or
- Unwillingness of counterparties or brokers to participate in unsecured or long-term transactions.

Testing of Contingency Funding Plans

Institutions periodically test and update the CFP to assess the plan's reliability under times of stress. Generally, management tests contingent funding sources at least annually. Testing may include both drawing on a contingent borrowing line and operational testing. Operational testing is often designed to ensure that:

- Roles and responsibilities are up to date and appropriate,

- Legal and operational documents are current and appropriate,
- Cash and collateral can be moved where and when needed, and
- Contingent liquidity lines are available.

Effective CFP testing typically includes periodically testing the operational elements associated with accessing contingent-funding sources. The tests help ensure funds are available when needed. For example, there may be extended time constraints for establishing lines with the Federal Reserve or FHLB, and often, the lines are set up in advance to establish availability and to limit the time required to pledge assets and draw on lines. However, examiners should understand that establishing lines in advance and testing the lines does not guarantee funding sources will be available within the same time frames or on the same terms during stress events.

In addition, institutions can benefit by employing operational CFP simulations to test communications, coordination, and decision making involving managers with different responsibilities, in different geographic locations, or at different operating subsidiaries. Simulations or tests run late in the day can highlight specific problems such as difficulty in selling assets or borrowing new funds at a time when the capital markets may be less active. The complexity of these tests can range from a simple communication and access test for a non-complex bank or can include multiple tests throughout the day to assess the timing of funds access.

Liquidity Event Management Processes

In a contingent liquidity event, it is critical that management's response be timely, effective, and coordinated. Therefore, comprehensive CFPs provide for a dedicated crisis management team and administrative structure, and include realistic action plans to execute the various elements of the plan for various levels of stress. The CFPs establish clear lines of authority and reporting by defining responsibilities and decision-making authority. The CFPs also address the need for more frequent communication and reporting among team members, the board of directors, and other affected parties. Critical liquidity events may also require the daily computation of regular liquidity risk reports and supplemental information, and comprehensive CFPs provide for more frequent and more detailed reporting as the stress situation intensifies.

The reputation of an institution is a critical asset when a liquidity crisis occurs, and proactive institutions maintain plans (including public relations plans) to help preserve their reputations in periods of perceived stress. Failure to appropriately manage reputation risk could cause severe damage to an institution.

And finally, comprehensive CFPs also address effective communication with key stakeholders, such as counterparties, credit-rating agencies, and customers. Smaller institutions that rarely interact with the media may benefit from having plans in place for how they will manage press inquiries and training front-line employees on how to respond to customer questions.

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INTERNAL CONTROLS

Adequate internal controls are integral to ensuring the integrity of an institution's liquidity risk management process. An effective system of internal controls promotes effective operations, reliable financial and regulatory reporting, and compliance with relevant laws and institutional policies. Effective internal control systems are designed to ensure that approval processes and board limits are followed and any exceptions to policies are quickly reported to, and promptly addressed by, senior management and the board.

Independent Reviews

A key internal control involves having an independent party regularly evaluate the various components of the liquidity risk management process. A review typically assesses the effectiveness of liquidity risk management programs, taking into account the complexity of the institution's liquidity risk profile. Institutions may achieve independence by assigning this responsibility to the audit function or other qualified individuals independent of the risk management process. To facilitate the independence of the review process, reviewers typically report key issues requiring attention (including instances of noncompliance with laws and regulations or the institution's policies) to the ALCO and audit committee for prompt action.

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EVALUATION OF LIQUIDITY

Liquidity Component Review

Under the *Uniform Financial Institutions Rating System*, a financial institution's liquidity position should be evaluated based on the current level and prospective sources of liquidity compared to funding needs, as well as the adequacy of funds management practices relative to the institution's size, complexity, and risk profile.

In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss.

In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

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

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

Rating the Liquidity Factor

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

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

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

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

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

UBPR Ratio Analysis

The UBPR is an important analytical tool that shows the impact of management's decisions and economic conditions on a bank's earnings performance and balance sheet composition. Examiners should review UBPR ratios when analyzing the institution's liquidity position. UBPR ratios should be viewed in concert with the institution's internal liquidity ratios on a level and trend basis when assessing the liquidity position. Examiners should use caution when reviewing peer group ratios as the comparisons may not be meaningful due to the varying liquidity and funding needs of different institutions.

Some of the more common ratios that examiners should review include:

- Net Non-Core Funding Dependence,
- Net Loans and Leases to Deposits,
- Net Loans and Leases to Total Assets,
- Short-Term Assets to Short-Term Liabilities,
- Pledged Securities to Total Securities,
- Brokered Deposits to Deposits, and
- Core Deposits to Total Assets.

Examiners should recognize that UBPR liquidity ratio analysis might not provide an accurate picture of the institution's liquidity position. Examiners should consider the quality, stability, and unique characteristics of asset and liability accounts before analyzing liquidity ratios. In particular, loans, securities, deposits, and borrowings should be evaluated before using UBPR ratios to draw conclusions concerning the liquidity position.

INTRODUCTION

Sensitivity to market risk reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or capital. For most community banks, market risk primarily reflects exposure to changing interest rates. Therefore, this section focuses on assessing interest rate risk (IRR). However, examiners may apply these same guidelines when evaluating foreign exchange, commodity, or equity price risks. A brief discussion of other types of market risks is included at the end of this section.

Market risks may include more than one type of risk and can quickly impact a financial institution's earnings and the economic value of its assets, liabilities, and off-balance sheet items. In order to effectively manage IRR, each institution should have an IRR management program that is commensurate with its size and the nature, scope, and risk of its activities.

The adequacy of a bank's IRR program is dependent on its ability to identify, measure, monitor, and control all material interest rate exposures. To do this accurately and effectively, institutions need:

- Appropriate IRR policies, procedures, and controls;
- Sufficiently detailed reporting processes to inform senior management and the board of IRR exposures;
- Comprehensive systems and standards for measuring and monitoring IRR; and
- Appropriate internal controls and independent review procedures.

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TYPES AND SOURCES OF INTEREST RATE RISK

IRR can arise from a variety of sources and financial transactions and has many components including repricing risk, basis risk, yield curve risk, option risk, and price risk.

Types of Interest Rate Risk

Repricing risk reflects the possibility that assets and liabilities will reprice at different times or amounts and negatively affect an institution's earnings, capital, or general financial condition. For example, management may use non-maturity deposits to fund long-term, fixed-rate securities. If deposit rates increase, the higher funding costs would likely reduce net yields on fixed-rate securities.

Basis risk is the risk that different market indices will not move in perfect or predictable correlation. For example, LIBOR-based deposit rates may change by 50 basis points while prime-based loan rates may only change by 25 basis points during the same period.

Yield curve risk reflects exposure to unanticipated changes in the shape or slope of the yield curve. It occurs when assets and funding sources are linked to similar indices with different maturities. For example, a 30-year Treasury bond's yield may change by 200 basis points, but a 3-year Treasury note's yield may change by only 50-basis points during the same time period. This risk is commonly expressed in terms of movements of the yield curve for a type of security (e.g., a flattening, steepening, or inversion of the yield curve).

Option risk is the risk that a financial instrument's cash flows (timing or amount) can change at the exercise of the option holder, who may be motivated to do so by changes in market interest rates. Lenders are typically option sellers, and borrowers are typically option buyers (as they are often provided a right to prepay). The exercise of options can adversely affect an institution's earnings by reducing asset yields or increasing funding costs.

For example, assume that a bank purchased a 30-year callable bond at a market yield of 10 percent. If market rates subsequently decline to 8 percent, the bond's issuer will be motivated to call the bond and issue new debt at the lower market rate. At the call date, the issuer effectively repurchases the bond from the bank. As a result, the bank will not receive the originally expected yield (10 percent for 30 years). Instead, the bank must re-invest the principal at the new, lower market rate.

Price risk is the risk that the fair value of financial instruments will change when interest rates change. For example, trading portfolios, held-for-sale loan portfolios, and mortgage servicing assets contain price risk. When interest rates decrease, the value of an institution's mortgage servicing rights generally decrease because the total cash flows from servicing fees decline as consumers refinance. Because servicing assets are subsequently measured at fair value, or carried at amortized cost and tested for impairment, the fair value adjustment or any impairment is reflected in current earnings.

Sources of Interest Rate Risk

Funding sources may involve repricing risk, basis risk, yield curve risk, or option risk, and examiners should carefully evaluate all significant relationships between funding sources and asset structures. Potentially volatile or market-based funding sources may increase IRR, especially when matched to a longer-term asset portfolio.

For example, long-term fixed-rate loans funded by purchased federal funds may involve repricing risk, basis risk, or yield curve risk. As a result, interest rate movements could cause funding costs to increase substantially while asset yields remain fixed.

Derivative instruments may be used for hedging but can introduce complex IRR exposures. Depending on the specific instrument, derivatives may create repricing, basis, yield curve, option, or price risk.

Mortgage banking operations may create price risk within the loan pipeline, held-for-sale portfolio, and mortgage servicing rights portfolio. Interest rate changes affect not only current values, but also future business volumes and related fee income.

Fee income businesses may be influenced by IRR, particularly mortgage banking, trust, credit card servicing, and non-deposit product sales. Changing interest rates could affect such activities.

Product pricing strategies may introduce IRR, particularly basis risk or yield curve risk. Basis risk exists if funding sources and assets are linked to different market indices. Yield curve risk exists if funding sources and assets are linked to similar indices with different maturities.

Embedded options associated with assets, liabilities, and off-balance sheet derivatives can create IRR. Embedded options are features that provide the holder with the right, but not the obligation, to buy, sell, pay down, payoff, withdraw, or otherwise alter the cash flow of the instrument. The holder of the option can be the bank, the issuer, or a counterparty. Many instruments contain embedded options that can alter cash flows and impact the IRR profile of the institution, including:

- Non-maturity deposits: Depositors have the option to withdraw funds at any time.
- Callable bonds: The issuer has the option to redeem all or part of a bond before maturity (based on contractual call dates).
- Structured notes: Options can vary by the type of instrument and may include step-up features, interest rate caps and floors, and cash flow waterfall triggers.
- Wholesale borrowings: Lenders may have a call option (requiring banks to repay borrowings), or borrowing banks may have a put option (allowing them to prepay borrowings).
- Derivatives: Derivative owners may hold an option to purchase additional securities or to exercise an existing derivative contract.
- Mortgage loans: Borrowers may have the option to partially or fully prepay the loan.
- Mortgage-backed securities (MBS): Borrowers' options to prepay individual mortgage loans included in an MBS loan pool can shorten the life of a tranche of loans within a security.

Embedded options can create various risks, such as contraction risk, extension risk, and negative convexity. Contraction risk increases when rates decline and borrowers can refinance at a lower rate, forcing the bank to reinvest those funds at a lower rate. Extension risk increases when rates rise and borrowers become less likely to prepay loans, thereby locking banks into below-market returns. Convexity measures the curvature in the relationship between certain investment prices and yields and reflects how the duration of an instrument changes as rates change.

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RISK MANAGEMENT FRAMEWORK

The IRR management framework sets forth strategies and risk tolerances as established in the institution's policies and procedures that guide the identification, measurement, management, and control of sensitivity to market risk. The framework begins with sound corporate governance and covers strategies, policies, risk controls, measurements, reporting responsibilities, independent review functions, and risk mitigation processes.

The formality and sophistication of the IRR management program should correspond with an institution's balance sheet complexity and risk profile. Less complex programs may be adequate for institutions that maintain basic balance sheet structures, have moderate exposure to embedded options, and do not employ complicated funding or investment strategies. However, all institutions should clearly document their procedures, and senior management should actively supervise daily operations.

More complex institutions need more formal, detailed IRR management programs. In such cases, management should establish specific controls and produce sound analyses that address all major risk exposures. Internal controls at complex institutions should include a more thorough independent review and validation process for the IRR models employed, as well as more rigorous requirements for separation of duties.

At all institutions, management and the board should understand the IRR implications of their business activities, products, and strategies, while also considering their potential impact on market, liquidity, credit, and operational risks.

Board Oversight

Effective board oversight is the cornerstone of sound risk management. The board of directors is responsible for overseeing the establishment, approval, implementation, and annual review of IRR management strategies, policies, procedures, and risk limits. The board should understand and regularly review reports that detail the level and trend of the institution's IRR exposure.

The board or an appropriate board committee should review sensitivity to market risk information at least quarterly. The information should be timely and of sufficient detail to allow the board to assess senior management's performance in monitoring and controlling market risks and to assess management's compliance with board-approved policies.

In order to fulfill its responsibilities in this area, the board is expected to:

- Establish formal risk management policies, strategies, and risk tolerance levels;
- Define management authorities and responsibilities;
- Communicate its risk management strategies and risk tolerance levels to all responsible parties;
- Monitor management's compliance with board-approved policies;
- Understand the bank's risk exposures and how those risks affect enterprise-wide operations and strategic plans; and
- Provide management with sufficient resources to measure, monitor, and control IRR.

Senior Management Oversight

Senior management is responsible for ensuring that board-approved IRR strategies, policies, and procedures are appropriately executed. Management should ensure that risk management processes consider the impact that various risks, including credit, liquidity, and operational risks could have on IRR.

Management is responsible for maintaining:

- Appropriate policies, procedures, and internal controls that address IRR management, including limits and controls that ensure risks stay within board-approved tolerances;
- Comprehensive systems and standards for measuring IRR, valuing positions, and assessing performance;
- Adequate procedures for updating IRR measurement scenarios and documenting key assumptions that drive IRR analysis; and
- Sufficient reporting processes for informing senior management and the board of the level of IRR exposure.

IRR reports should provide sufficient aggregate information and supporting details to enable senior management and the board to assess the impact of market rate changes and the impact of key assumptions in the IRR model.

The Asset/Liability Committee (ALCO) or a similar senior management committee should actively monitor the IRR profile. The committee should have sufficient representation across major functions (e.g., lending, investment, and funding activities) that they can directly or indirectly influence the institution's IRR exposure.

Policies and Procedures

Policies and procedures should be comprehensive and govern all material aspects of an institution's IRR management process. IRR policies and procedures should:

- Address board and senior management oversight;
- Outline strategies, risk limits, and controls;
- Define general methods used to identify risk;
- Describe the type and frequency of monitoring and reporting;
- Provide for independent reviews and internal controls;
- Ensure that significant new strategies, products, and businesses are integrated into the IRR management process;
- Incorporate the assessment of IRR into institution-wide risk management procedures so that interrelated risks are identified and addressed; and
- Provide controls over permissible risk mitigation activities, such as hedging strategies and instruments, if applicable.

Interest Rate Risk Strategies

Management should develop IRR strategies that reflect board-approved risk tolerances and do not expose the bank to excessive risk. An institution's risk profile is a function of the bank's activities and products. For example, an institution's IRR strategy may be to maintain a short-term, non-complex balance sheet. In order to implement that strategy, management may hold loans and securities with short durations and minimal embedded options and fund the assets with nonmaturity deposits and short-term borrowings.

Some institutions may conduct borrowing and investment transactions (leverage strategies) that are separate from the bank's core operations. In a typical leverage strategy, management acquires short- or intermediate-term wholesale funds or borrowings and invests those funds in longer-term bonds. Prior to implementing a leverage strategy, management should have the skills to understand, measure, and manage the risks. Management should be able to demonstrate a transaction's effect on the bank's risk profile and document that the exposure is within established risk limits.

Management should measure and document a strategy's effect on IRR exposure prior to implementation, periodically thereafter, and prior to any significant strategy changes. Institutions should consider stress testing all prospective strategies and ensure IRR exposures are within established risk limits.

Risk Limits and Controls

Risk limits should reflect the board's tolerance of IRR exposure by restricting the volatility of earnings and capital for given rate movements and applicable time horizons. Risk limits should be explicit dollar or percentage parameters. IRR exposure limits should be commensurate with the complexity of bank activities, balance sheet structure, and off-balance sheet items. At a minimum, limits should be expressed over one and two year time horizons, correspond to the internal measurement system's methodology, and appropriately address all key IRR risks and their effect on earnings and capital.

Examiners should carefully evaluate policy guidelines and board-approved risk limits. Institutions should establish limits that are neither so high that they are never breached, nor so low that exceeding the limits is considered routine and unworthy of action. Effective limits will provide management sufficient flexibility to respond to changing economic conditions, yet be stringent enough to prevent excessive risk-taking.

Policies should be in place to ensure excessive IRR exposures receive prompt attention. Controls should be designed to help management identify, evaluate, report, and address excessive IRR exposures. Policies should require management to regularly monitor risk levels, and controls should be altered as needed when economic conditions change or the board alters its risk tolerance level. Reports or stress tests that reflect significant IRR exposure should be promptly reported to the board (or appropriate board committee), and the board should review all risk limit exceptions and management's proposed actions.

Earnings-based risk limits may include volatility considerations involving:

- Net interest margin,
- Net interest income,
- Net operating income, and
- Net income.

Capital-based risk limits may include volatility considerations involving:

- Economic value of equity, and
- Other comprehensive income.

The board should provide staffing resources sufficient to ensure:

- Effective operation of measurement systems,
- Appropriate analytic expertise,
- Adequate training and staff development, and
- Regular independent reviews.

Risk Monitoring and Reporting

Management should report IRR in an accurate, timely, and informative manner. At least quarterly, senior management and the board should review IRR reports. Institutions that engage in complex or higher risk activities should assess IRR more frequently. At a minimum, IRR exposure reports should contain sufficient detail to permit management and the board to:

- Identify the source and level of IRR;
- Evaluate key assumptions, such as interest rate forecasts, deposit behaviors, and loan prepayments; and
- Determine compliance with policies and risk limits.

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INTEREST RATE RISK ANALYSIS

An effective risk management system must clearly quantify and timely report risks. Institutions should have sound IRR measurement procedures and systems that assess exposures relative to established risk tolerances. Such systems should be commensurate with the complexity of the institution. Although management may rely on third-party IRR models, they should fully understand the underlying analytics, assumptions, and methodologies of the models and ensure such systems and processes are incorporated appropriately in the strategic (long-term) and tactical (short-term) management of IRR exposures.

Management should conduct careful due diligence/pre-acquisition reviews to ensure they understand the IRR characteristics of new products, strategies, and initiatives. Management should also consider whether existing measurement systems can adequately capture new IRR exposures. When analyzing whether or not a product or activity introduces new IRR exposures, management should consider that changes to an instrument's maturity, repricing, or repayment terms can materially affect a product's IRR characteristics. Institutions may be able to run alternative scenarios in their IRR models to test the effects of new products and initiatives. If an institution is unable to run alternative scenarios using existing models, they should use other methods to estimate the risk of new products, strategies, and initiatives. All institutions should ensure that the method(s) they use to evaluate new products and initiatives (running alternative scenarios in existing models or through other means), adequately captures potential market risks.

Management should consider earnings and the economic value of capital when evaluating IRR. Reduced earnings or losses can harm capital, liquidity, and the institution's reputation. Risk-to-earnings measurements are normally derived from simulation models that estimate potential earnings variability. Economic value of equity (EVE) measurements allow for longer-term earnings and capital analysis. The analysis may be useful for long-term planning and may also indicate a need for short-term actions to mitigate IRR exposure. Long term earnings-at-risk simulations (5 to 7 years) can be a helpful supplement to EVE measures, but they are not a replacement for EVE measurements.

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INTEREST RATE RISK MEASUREMENT METHODS

Institutions are encouraged to use a variety of measurement methods to assess their IRR profile. Regardless of the methods used, a bank's IRR measurement system should be sufficient to capture all material balance sheet items and to quantify exposures to both earnings and capital. The most common types of IRR measurement systems are:

- Gap Analysis,
- Duration Analysis,
- Earnings Simulation Analysis,
- Earnings-at-Risk,
- Capital-at-Risk, and
- Economic Value of Equity.

Gap Analysis

Gap analysis is a simple IRR methodology that provides an easy way to identify repricing gaps. It can also be used to estimate how changes in rates will affect future income. However, gap analysis has several weaknesses and is generally not sufficient as a financial institution's sole IRR measurement method. Gap analysis can be a first step in identifying IRR exposures and may serve as a reasonableness check for more sophisticated forms of IRR measurement, particularly in less complex institutions with simple balance sheets.

Gap analysis helps identify maturity and repricing mismatches between assets, liabilities, and off-balance sheet instruments. Gap schedules segregate rate-sensitive assets (RSA), rate-sensitive liabilities (RSL), and off-balance sheet instruments according to their repricing characteristics. Then, the analysis summarizes the repricing mismatches for defined time horizons. Additional calculations can then estimate the effect the repricing mismatches may have on net interest income.

A basic gap ratio is calculated as:

$$\frac{\text{RSA}\ ^{\textit{minus}}\ \text{RSL}}{\text{Average Earning Assets}}$$

Gap analysis may identify periodic, cumulative, or average mismatches, or it may show the ratio of RSA-RSL divided by average assets or total assets. However, using those denominators does not produce a standard gap ratio. They simply provide other ways of describing the degree of repricing mismatches.

A bank has a positive gap if the amount of RSAs repricing in a given period exceeds the amount of RSLs repricing during the same period. When a bank has a positive gap, it is said to be asset sensitive. Should market interest rates decrease, a positive gap indicates that net interest income would likely also decrease. If rates increase, a positive gap indicates that net interest income may also increase.

Conversely, a bank has a negative gap when the amount of RSLs exceeds the amount of RSAs repricing during the same period. When a bank has a negative gap, it is said to be liability sensitive, and a decrease in market rates would likely cause an increase in net interest income. Should interest rates increase, a negative gap indicates net interest income may decrease. While the terms asset and liability sensitive are generally used to describe gap results, they can also be used to describe the results of other models, or even the general IRR exposure of a bank.

The gap ratio can be used to calculate the potential impact on interest income for a given rate change. This is done by multiplying the gap ratio by the assumed rate change. The result estimates the change to the net interest margin.

For example, assume a bank has a 15 percent one-year average gap. If rates decline 2 percent, then the projected impact is a 30 basis point decline in the net interest margin (15 percent x 2 percent). This estimate assumes a static balance sheet and an immediate, sustained interest rate shift.

Gap analysis has several advantages. Specifically, it:

- Identifies repricing mismatches,
- Does not require sophisticated technology,
- Is relatively simple to develop and use, and
- Can provide clear, easily interpreted results.

However, the weaknesses of gap analysis often overshadow its strengths, particularly for a majority of financial institutions. For example, gap analysis:

- Generally captures only repricing risk,
- Assumes parallel rate movements in assets and liabilities,
- Generally does not adequately capture embedded options or complex instruments,
- May not identify material intra-period repricing risks, and
- Does not measure changes in the economic value of capital.

Some gap systems attempt to capture basis, yield curve, and option risk. Multiple schedules (dynamic or scenario gap analysis) can show effects from non-parallel yield curve shifts. Additionally, sensitivity factors may be applied to account categories. These factors assume that coupon rates will change by a certain percentage for a given change in a market index. The market index is designated as the driver rate (sophisticated systems may use multiple driver rates). These sensitivity percentages, also called beta factors, may dramatically change the results.

Institutions can also use sensitivity factors in their gap analysis to refine non-maturity deposit assumptions. For example, management may determine that the cost of funds for money market deposit accounts (MMDA) will increase by 75 basis points whenever the six-month Treasury bill rate increases by one percent. Thus, management might consider only 75 percent of MMDA balances as rate sensitive for gap analysis. Management may expand its analysis by preparing gap schedules that assume different market rate movements and changing customer behaviors.

As noted above, gap analysis is generally not suitable as the sole measurement of IRR for the large majority of institutions. Only institutions with very simple balance sheet structures, limited assets and liabilities with embedded options, and limited derivative instruments and off-balance sheet items should consider relying solely on gap analysis for IRR measurements.

Duration Analysis

Duration analysis measures the change in the economic value of a financial instrument or position that may occur given a small change in interest rates. It considers the timing and size of cash flows that occur before the instrument's contractual maturity. Additional information on different types of duration analysis is included below and in the glossary.

Macaulay duration calculates the weighted average term to maturity of a security's cash flows. Duration, stated in months or years, always:

- Equals maturity for zero-coupon instruments,
- Equals less than maturity for instruments with payments prior to maturity,
- Declines as time elapses,
- Is lower for amortizing instruments, and
- Is lower for instruments with higher coupons.

Modified duration, calculated from Macaulay duration, estimates price sensitivity for small interest rate changes. An instrument's modified duration represents its percentage price change given a small change in interest rates.

Modified duration assumes that interest rate shifts will not change an instrument's cash flows. As a result, it does not estimate price sensitivity with an acceptable level of precision for instruments with embedded options (e.g., callable bonds or mortgages). Institutions with significant option risk should not rely solely upon modified duration to measure IRR.

Effective duration estimates price sensitivity more accurately than modified duration for instruments with embedded options and is calculated using valuation models that contain option pricing components. First, the user must determine the instrument's current value. Next, the valuation model assumes an interest rate change (usually 100 basis points) and estimates the instrument's new value based on that assumption. The percentage change between the current and forecasted values represents the instrument's effective duration.

All duration measures assume a linear price/yield relationship. However, that relationship actually is curvilinear, which means that large shifts in rates have a greater effect than smaller changes. Therefore, duration may only accurately estimate price sensitivity for rather small (up to 100 basis point) interest rate changes. Convexity-adjusted duration should be used to more accurately estimate price sensitivity for larger interest rate changes (over 100 basis points).

Duration analysis contains significant weaknesses. Accurate duration calculations require significant analysis and complex management information systems. Further, duration only measures value changes accurately for relatively small interest rate fluctuations. Therefore, institutions must frequently update duration measures when interest rates are volatile or when any significant change occurs in economic conditions, market conditions, or underlying assumptions.

Earnings Simulation Analysis

Earnings simulation models (such as pro-forma income statements and balance sheets) estimate the effect of interest rate changes on net interest income, net income, and capital for a range of scenarios and exposures. Historically, comprehensive simulation models (both long- and short-term) were primarily used by larger, more complex institutions. Current technology allows less complex institutions to perform cost effective, comprehensive simulations of the potential impact of changes in market rates on earnings and capital.

A simulation model's accuracy depends on the use of accurate assumptions and data. Like any model, inaccurate data or unreasonable assumptions lead to inaccurate or unreasonable results.

A key aspect of IRR simulation modeling involves selecting an appropriate time horizon(s) for assessing IRR exposures. Simulations can be performed over any period and are often used to analyze multiple horizons identifying short-, intermediate-, and long-term risks. When using earnings simulation models, IRR exposures are often more accurate when projected over at least a two-year period. Using a two-year time frame better captures the full impact of important transactions, tactics, and strategies, which may be hidden by only viewing projections over shorter time horizons. Management should be encouraged to measure earnings at risk for each one-year period over their simulation horizon to better understand how risks evolve over time. For example, if the bank runs a two year simulation, one- and two-year simulation reports should be generated.

Longer-term earnings simulations of up to five to seven years may be recommended for institutions with material holdings of products with embedded options. Such extended simulations can be helpful for IRR analysis and economic value measurements. It is usually easier for an extended simulation model to identify when long-term mismatches occur (e.g., it can show that a bank is liability sensitive in years two, three, and four, but asset sensitive in years five, six, and seven), whereas EVE models aggregate the effect of such mismatches.

Institutions may vary their simulation rate scenarios based on factors such as pricing strategies, balance sheet compositions, hedging activities, etc. Simulation may also measure risks presented by non-parallel yield curve shifts.

Institutions can run static or dynamic simulations. Static models are based on current exposures and assume a constant balance sheet with no new growth. The models can also include replacement-growth assumptions where replacement growth is used to offset reductions in the balance sheet during the simulation period.

Dynamic simulation models may assume asset growth, changes in existing business lines, new business, or changes in management or customer behaviors. Dynamic simulation models can be useful for business planning and budgeting purposes. However, these simulations are highly dependent on key variables and assumptions that are difficult to project with accuracy over an extended period. Also, when management changes simulation scenarios, it may lose insights on the bank's current IRR positions. Dynamic simulations can provide beneficial information but, due to their complexity and multitude of assumptions, can be difficult to use effectively and may mask significant risks.

Projected growth assumptions in dynamic modeling often alter the balance sheet in a manner that reflects reduced IRR exposure. For example, if a liability-sensitive bank assumes significant growth in one-year adjustable rate mortgages or long-term liabilities and the growth targets are not met, management may have underestimated exposures to changing interest rates. Therefore, when performing dynamic simulations, institutions should also run static or no-growth simulations to ensure they produce an accurate, comparative description of the bank's IRR exposure.

Economic Value of Equity

Despite their benefits, both static and dynamic earnings simulations have limitations in quantifying IRR exposure. As a result, economic value methodologies should also be used to broaden the assessment of IRR exposures, particularly to capital.

Economic value methodologies attempt to estimate the changes in a bank's economic value of capital caused by changes in interest rates. A bank's economic value of equity represents the present value of the expected cash flows on assets minus the present value of the expected cash flows on liabilities, plus or minus the present value of the expected cash flows on off-balance sheet instruments.

Typically, an EVE model projects the value of a bank's economic capital for a base-case scenario, and then compares it to a stress scenario. These models go by various names and acronyms, such as EVE, MVE (Market Value of Equity), or NPV (Net Present Value).

In theory, an economic valuation approach has a broader scope than an earnings approach, since it captures all anticipated cash flows and is generally more effective in capturing embedded options. An economic valuation approach measures all estimated changes to the balance sheet and earnings, as opposed to gap models and earnings simulations, which generally measure shorter-term balance sheet and earnings projections. Economic valuation methods can be an effective supplement to short-term measures.

Many institutions can benefit from the use of economic value methods and should establish EVE risk limits and integrate economic valuation methods into their IRR measurement procedures. Because different EVE models calculate different base-case economic capital values for the same bank, limits should generally be based on the change of economic capital rather than absolute levels of economic capital. Accordingly, examiners should assess the relative changes in economic value of capital as a key indication of risk.

Most economic value models use a static approach where the analysis does not incorporate new business lines and all financial instruments are held until final payout or maturity. The analysis shows a snapshot of the risk inherent in a portfolio or balance sheet. However, this is not always the case as some models incorporate dynamic techniques that provide forward-looking estimates of economic value.

Because EVE estimates the future cash flows of the bank's financial instruments, the cash flows can be difficult to accurately quantify. This can be especially true for non-maturity deposits since the products generally have uncertain cash flows and durations. Consequently, estimating the value of these accounts can be difficult and requires the use of several assumptions. Management should be cautious when making EVE assumptions, as output errors can be more pronounced in long-term measurements. Examiners should consider the significance, accuracy, and sensitivity of underlying assumptions when assessing EVE models.

When modeling complex products with embedded options, the importance of data aggregation and stratification should not be overlooked. Complex or structured securities should be modeled on an individual basis, and homogenous balance sheet accounts should be aggregated by common IRR features. For example, loan portfolios, when possible, should be aggregated by product type, coupon, maturity, and prepayment volatility. For adjustable rate portfolios, modeling should include more IRR attributes, such as coupon reset dates and indexes; embedded caps and floors; and prepayment penalties.

Despite being different methodologies, earnings simulation and EVE models generally provide a consistent view of IRR trends. However, the two approaches may also generate divergent outcomes. In many cases, earnings simulation models provide shorter-term results and EVE models provide a much longer-term risk profile. These divergent outcomes can result from a variety of factors, such as the structure of the balance sheet, including the bank's derivative positions and off-balance sheet items, the interest rate environment, the timing of asset/liability mismatches, the sensitivity of funding sources to interest rate changes, and the volume of fixed- or floating-rate assets. Because many versions of each model type are available, management should ensure that the models used capture all significant risk factors.

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STRESS TESTING

Stress testing, which includes both scenario and sensitivity analysis, is an integral part of IRR management. Scenario analysis estimates possible outcomes given an event or series of events, while sensitivity analysis estimates the impact of change in one or only a few of a model's significant parameters.

Management should assess a range of alternative interest rate scenarios when conducting scenario analyses. The range should be sufficient to fully identify repricing, basis, and yield curve risks as well as the risk of embedded options. In many cases, static interest rate shocks consisting of parallel shifts in the yield curve of only plus and minus 200 basis points are not sufficient to adequately assess IRR exposure. Therefore, management should regularly assess a wide range of exposures across different periods, including changes in rates of greater magnitude (e.g., up and down 300 and 400 basis points). When conducting stress tests, management should give special consideration to financial instruments or markets where concentrations exist, as such positions may be difficult to unwind or hedge during periods of market stress. Management should compare stress test results against approved limits.

Management should ensure their scenarios are rigorous and consistent with the existing level of rates and the interest rate cycle. For example, in low-rate environments, scenarios involving significant declines in market rates can be deemphasized in favor of increasing the number and size of alternative rising-rate scenarios. Alternatively, there may be instances where more extreme stress tests would be desirable.

Depending on a bank's IRR profile, stress scenarios should include:

- Instantaneous and significant rate changes,
- Substantial rate changes over time,
- Changes in the relationships between key market rates, and
- Changes in the shape or slope of the yield curve.

Not all financial institutions need to use the full range of the scenarios discussed above. Non-complex institutions (for instance, institutions with limited embedded options or structured products) may be able to justify running fewer or less intricate scenarios.

Management should run repricing risk scenarios regularly. When applicable, institutions should also run scenarios for other IRR risks, such as basis and yield curve risks. Institutions should assess these risk exposures at least annually or when the risk profile of a bank changes, for example, because of acquisitions, significant new products, or new hedging programs. If a bank shows material exposure to one of these risks, an appropriate scenario should be included in monthly or quarterly IRR monitoring. If an institution has relatively non-complex exposure to basis, yield curve, or options risk, management should document that the exposure is minimal. For example, management may document its assessment with a short narrative description of what percentage of assets and liabilities are tied to various indices and a description of the potential impact of the risks. These reports should typically be reviewed by the board at least annually.

Sensitivity analysis should be included in stress testing to help determine which assumptions have the most influence on a model's output. By identifying key assumptions, management, when necessary, can refine the assumptions to increase the accuracy of their models. The most significant variables can be tested by keeping all other variables constant, changing the variable in question, and comparing the results to the base-case scenario. Additionally, sensitivity analysis can be used to determine the conditions under which key business assumptions or model parameters break down or when IRR may be exacerbated by other risks or earnings pressures. When management includes assumptions based on strategic initiatives, it is imperative that they assess the impact of not meeting projections. (Refer to Sensitivity Testing - Key Assumptions for more details.)

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INTEREST RATE RISK MEASUREMENT SYSTEMS

The IRR measurement system should be appropriate for institution's risk profile. The measurement system should capture all material sources of IRR and generate meaningful reports for senior management and the board of directors. Management should ensure risks are measured over a relevant range of interest rate changes, including meaningful stress situations. Further, the measurement system must be subject to appropriate internal controls and periodic independent reviews. The IRR measurement process should be well documented and administered by individuals with sufficient technical knowledge.

IRR measurement systems can range from simple methods to sophisticated programs that include stochastic data modeling. (Stochastic modeling involves using one or more random variables in a model.) However, all measurement systems should use generally accepted financial concepts and risk measurement techniques and have an adequate level of transparency. If a third-party model is used, management should review the adequacy and comprehensiveness of the vendor's model-validations and internal control reviews. Also, management should consider the capabilities of the software to meet the institution's future needs and the adequacy of ongoing vendor support and training.

A bank's IRR measurement system is a critical part of its overall risk management process. Examiners rely heavily on the output of the measurement systems when assessing sensitivity to market risk. Accordingly, the review of such systems and their operation is a crucial element of the examination process. The review process should address the following items:

- Capabilities of the measurement system,
- Accuracy of system inputs,
- Reasonableness and documentation of material assumptions,
- Usefulness of system output/reports, and
- Adequacy of periodic variance analysis.

Measurement System Capabilities

The IRR measurement system should capture and reliably estimate all material risk exposures. Therefore, the system should consider all significant balance sheet categories, income statement items, and risk factors. For example, if an institution has material holdings of mortgage loans or mortgage-backed securities, then its measurement system should be able to adequately incorporate prepayment projections. Likewise, if the bank has a mortgage banking operation that generates material fee income, its system should capture the rate sensitivity of this noninterest income.

When an institution develops an IRR model internally or considers acquiring a third-party model, management should assess its suitability by evaluating the model's ability to reasonably capture all relevant and material IRR exposures. Additionally, management should periodically re-evaluate the adequacy of a model in use as risk positions, strategies, and activities change.

To effectively use its IRR measurement system, management must fully understand the system's capabilities, limitations, quantitative methodologies, and use of assumptions.

System Documentation

Both purchased and internally developed systems should be supported by adequate documentation. System documentation should provide complete information regarding the factors discussed above. Management should be familiar with and retain all pertinent system documentation. Management should also review and maintain documentation of changes or upgrades to the model.

Adequacy of Measurement System Inputs

A model's accuracy depends on the assumptions and data used. Like any model, inaccurate data or unreasonable assumptions will render inaccurate results.

System data should accurately reflect the bank's current condition. When evaluating the adequacy of a model, management should consider the extent to which the model uses automated versus manual processes; whether the model has automated interfaces with the bank's core systems; and the funds, hardware, staff, and expertise needed to run and maintain the model.

Examination of the system's input process should focus on the procedures for inputting and reconciling system data, categorizing and aggregating account data, ensuring the completeness of account data, and assessing the effectiveness of internal controls and independent reviews.

The internal control process must be comprehensive enough to ensure that data inputs are accurate and complete prior to running the system and generating reports. The bank may input data manually, through data-extract programs, or a combination of both techniques. Internal control procedures should be established to ensure that input data, such as general ledger balances and contractual terms, are accurately captured. Institutions should verify system inputs by having experienced personnel reconcile the balances to the general ledger. This is often done using automated software that can identify and report exception items.

In addition to capturing account balances, institutions with complex balance sheets should use measurement systems that adequately capture the embedded market risk of all material on- and off-balance sheet activity. Most measurement systems allow for the input of the following contractual terms:

- Current balance,
- Contractual maturities,
- Principal and interest payments and frequencies,
- Coupon rates and repricing frequencies,
- Contractual caps and floors, and
- Contractual optionality (such as security or borrowing calls).

Account Aggregation

Account aggregation is the process of grouping together accounts of similar types and cash flow characteristics. This is an important component of the data input process as account aggregation improves the measurement system's efficiencies. Typically, loans of similar rate, maturity, and type (e.g., 6 percent, 30 year, residential loans) are aggregated. Grouping 6 percent, 30 year residential loans together may be appropriate, but grouping together 6 percent fixed-rate loans with 6 percent adjustable-rate loans is not.

The degree of account aggregation will vary from one institution to another. Institutions should ensure the model allows for a sufficient separation of accounts with significantly different cash flow patterns. For example, models that aggregate information based on Call Report data may not provide the granularity necessary for institutions with significant levels of embedded options. When applicable, institutions should ensure their systems have the ability to model highly structured instruments and bank-specific products.

Both contractual and behavioral characteristics should be considered when determining the cash flow patterns of accounts to aggregate. The process of determining which accounts are combined should be transparent, documented, and periodically reviewed. Furthermore, requests for changes to existing groups or new account aggregations should be formalized and documented. Institutions should maintain documentation disclosing the characteristics of aggregated assets and liabilities (including all derivative instruments), and off-balance sheet items.

Assumptions

Assessing the reasonableness of assumptions is a critical part of reviewing an IRR measurement system. It is important that assumptions accurately reflect management's expectations regarding interest rates, customer behaviors, and local and macro-economic factors. Assumptions are typically derived using a combination of internal analysis and external sources. All material assumptions should be regularly updated and supported with thorough analysis and documentation.

IRR measurement systems rely on assumptions regarding key parameters, such as:

- Projected interest rates,
- Driver rate relationships,
- Non-maturity deposits, and
- Prepayments.

It is important that material assumptions be updated regularly to reflect the current market and operating environment. Furthermore, the process for developing material assumptions should be formalized and periodically assessed (at least annually for critical assumptions). This periodic assessment of the information and processes used to generate assumptions may prompt management to reevaluate its assumptions in order to better reflect current strategies or customer behaviors.

Sensitivity Testing - Key Assumptions

Proper IRR management requires an understanding of which assumptions have the greatest impact on results. Through sensitivity testing, management can identify the assumptions that have the most effect on model results. Documentation and monitoring should reflect the relative importance of assumptions. Sensitivity testing can also be used to identify less material assumptions, where assumption documentation, monitoring, and testing are less critical. Sensitivity testing can also be used to identify weaknesses in the model. For example, if an institution tested an assumption that was expected to have a critical impact on the model result, but instead found that it had little or no influence on the model output, further investigation would be warranted.

Sensitivity testing should only be applied to one assumption at a time and should test the effects of both large and small changes in an assumption on the model's overall output. For example, if an institution wanted to test the sensitivity of non-maturity deposit decay rates, it could alter its non-maturity deposit beta assumptions incrementally (up and down) in multiple scenarios (e.g., a 10, 25, and 50 percent increase/decrease from the base-case assumption). The revised results could then be compared to the base-case scenario. If a change in the assumption disproportionately impacts the model, then management should implement more robust assumption documentation, monitoring, and testing. Another sound practice when testing assumptions is to determine how extreme changes in key assumptions impact results and whether the results approach approved tolerance levels.

Conducting sensitivity testing on an annual basis is usually adequate for many institutions. However, more frequent tests should be performed if concerns are identified. Institutions should document the results of sensitivity testing and present the results to management and the board. The results of sensitivity testing should be considered when setting various assumptions. Management should conduct thorough due diligence before changing key assumptions that can materially alter model results. Key assumption changes should be properly documented and reviewed by the board.

Projected interest rate assumptions are a critical part of measuring IRR and may be generated by internal analysis or external sources. Internal interest rate forecasts, which may be derived from implied forward yield curves, economic analysis, or historical regressions, should be documented to support the assumptions used in the analysis. Key rate assumptions that should be considered include assumptions for general market rates, repricing rates, replacement interest rates, and discount rates.

Most institutions perform scenario analysis using deterministic interest rate yield curves. With the deterministic method, all interest rate scenarios are set by the user; that is, management selects the interest rate changes to simulate in the model. The deterministic method differs from the more complex and sophisticated stochastic method where multiple scenarios are generated using random path-dependent variables. (Further discussion of deterministic and stochastic methods may be found in the glossary.)

Analysis should be performed using a base-case interest rate scenario, as well as low-probability/high-risk scenarios, so that management can better estimate the impact to earnings and capital levels in stressed interest rate scenarios. The base-case interest rate scenario should be consistent with other forecasts used in the bank's overall planning process and should remain reasonably consistent across reporting periods. Any changes in the source of interest rate forecasts between reporting periods should be justified and documented.

Driver rates are used extensively in most income simulation and EVE models. The models capture the relationship between primary market interest rates (driver rates) and the rates of bank products. While there may be no direct connection between bank rates and the driver rate, the driver rate is chosen as a proxy for management's reaction to market changes. This frees management from needing to set rates explicitly for each loan or deposit type for each projected scenario. In most cases, bank rates are set to move in relation to the driver rate. The move may be referred to as a spread (when a specified number of basis points are added to or subtracted from a driver rate), or as a beta factor (when based on a percentage change in a driver rate). For example, management might specify that the rate paid on MMDAs will increase 75 basis points if the yield on one-year Treasury bills increases 100 basis points. By designating this relationship, pricing on all products linked to the driver rate will change to reflect the relationship built into the model. More complex systems may use a variety of driver rates tailored for different products. While most systems maintain static rate relationships, more sophisticated systems can alter relationships for different interest rate environments.

Spread or beta assumptions should be based on an analysis of the relationship between the product (e.g., MMDA) and the driver rate (e.g., federal funds rate). To determine the spread or beta, management can perform correlation or regression analysis to quantify the historical relationship between the product and driver rates.

Correlation analysis may also be used to determine the level of basis risk when instruments are tied to different indices. For instance, if an institution enters into a leveraging strategy that uses borrowed funds tied to LIBOR to invest in U.S. Treasury securities, correlation analysis can be performed to determine how closely the related rates move together. Less correlated instruments present greater basis risk.

Non-maturity deposit (NMD) rate sensitivity is typically one of the most critical and most difficult assumptions that management makes when measuring IRR exposure. The potential actions of management and customers need to be considered. Just as customers have control over the level and location of their deposit accounts, management has broad control over the rates paid on these accounts. In setting rates, management must take into account a wide array of factors, including local and national competition, the bank's funding needs, and the relative costs of alternative funding sources.

The assumptions modeled for NMDs should reflect both aspects of this relationship: management's control over rates and customers' control over their funds. Consideration should be given not only to historical correlation analysis, but also to management's intentions regarding future rate movements. If the measurement system has the capacity to reflect different assumptions for rising and falling rates, management should establish rate sensitivity assumptions for both scenarios.

Non-maturity deposits present a unique problem in EVE modeling because they lack contractual maturity dates. Generally an asset or liability must have a maturity date in order to be valued under present value methods. Therefore, in order to successfully model these accounts, an EVE model must use management's assumptions regarding the maturity of the accounts. The most common of these assumptions is the decay rate assumption. The decay rate reflects the amount of nonmaturity (and other) deposits that may be withdrawn or accounts closed in a given rate environment.

Management should use NMD assumptions that reflect institution-specific factors and avoid overreliance on industry estimates or default assumptions contained in off-the-shelf IRR models. Some institutions have difficultly measuring decay rates on NMDs due to limited historical data, acquisitions, mergers, or a lack of technical expertise. Industry averages provide approximations, but are often not the most accurate estimates because they are not tailored to the bank's products, pricing strategies, market, and experience. However, management can use industry estimates as a starting point until they develop adequate data sets. Industry estimates can also serve as a benchmarking tool to test the reasonableness of internal assumptions. Management should consider modeling different decay rates under various rate scenarios and, when appropriate, should consider engaging third parties to assist in determining NMD assumptions. Examiners should recognize that NMD decay rate are often imprecise, yet significant factors in IRR analysis.

Assumptions regarding NMDs are particularly critical in market environments in which customer behaviors may be atypical, or in which institutions are subject to heightened competition for such deposits. Generally, rate-sensitive and higher-cost deposits, such as brokered and Internet deposits, reflect higher decay rates than other types of deposits. Also, institutions experiencing or projecting lower capital levels that may trigger brokered and high interest rate deposit restrictions should adjust deposit assumptions accordingly.

Prepayment assumptions are important considerations when measuring optionality risk. Prepayment risk (or conversely, extension risk) on loans and mortgage-related securities are highly influenced by the direction of interest rates. Prepayment assumptions may also be affected by factors such as loan size, geographic area, credit score, and fixed versus variable rates. It is critical that assumptions be reasonable for each rate scenario measured. For example, in an increasing rate environment, prepayment assumptions should typically reflect lower prepayments than in a declining rate environment.

Financial institutions may actively track internal prepayment data or obtain prepayment statistics from external sources. Management should consider the reliability and applicability of external data and be cognizant that market stress, externalities, or a change in the institution's condition may influence customer behaviors.

Management should ensure that assumptions are appropriate given the characteristics of the institution's various portfolios (i.e., prepayment speeds for a portfolio of five percent loans would likely differ from a portfolio of eight percent loans). In addition, proper aggregation of the assets is necessary before applying assumptions.
Documentation and support of all significant assumptions, including projected rates, spreads, customer behaviors, and NMD rates should be maintained and available for examiner review. Some measurement systems have only limited ability to change model assumptions, in which case documentation may be limited. Even in those cases, an analysis of the applicability of the embedded assumptions to the subject bank should be performed and maintained. More complex systems entail a vast array of assumptions, and thorough documentation of every assumption cannot be realistically expected. However, management should thoroughly support and document assumptions related to the most significant institution or model risks.

Measurement System Reports

Many measurement systems are capable of providing summary reports detailing key model assumptions. Examiners should review a copy of these reports when analyzing a measurement system.

Most asset/liability management systems offer an array of summary reports (such as a chart of accounts and account attribute reports) that aid management in reviewing measurement system assumptions. These reports may also provide information regarding the contractual terms and parameters that have been entered into the system for various account types and financial instruments.

If an institution is unable to provide assumption summaries, examiners should determine whether the absence of the report is due to measurement system limitations or bank personnel's lack of familiarity with system capabilities. Typically, measurement system user manuals will provide a list of reports that may be generated by the system.

Assumption summary reports are an important tool that management and examiners can use to ensure that reasonable assumptions have been entered into the measurement system. The reports can also be useful to examiners when management does not maintain adequate documentation of current assumptions. For example, when assumption summary reports are regularly produced and retained, examiners can compare current assumptions against historical assumption reports.

To ensure proper controls over significant assumption changes, management should establish procedures for reviewing the reasonableness of assumption changes and for approving those changes before they occur.

Measurement System Results

After data and assumptions have been input, the IRR measurement system performs calculations. The calculations measure the IRR in the bank's assets, liabilities, and off-balance sheet items. The measurement system should generate summary reports that highlight the bank's sensitivity to changes in market rates given various interest rate scenarios. These reports typically indicate the change in net income or net interest income and/or economic value of equity. Some systems may also provide a gap report highlighting asset/liability mismatches over various time horizons. More detailed reports may be available on some systems that can be used to test the reasonableness, consistency, and accuracy of the output. They may also assist the examiner in identifying or verifying the system's underlying assumptions.

Management should have formalized procedures in place for reviewing measurement system results and reporting to the board or a board committee. Reports provided to the board and senior management should be clear, concise, timely, and informative in order to assist the board and senior management in making decisions. The results of the measurement system should also highlight deviations from board-approved IRR exposure limits. Examiners should review follow-up actions and communication relevant to any material breaches in board-approved limits. Examiners should also review the presentations or analyses provided to senior management, board members, and the ALCO, as well as any relevant meeting minutes.

Variance Analysis

Variance analysis (also known as back-testing) can provide valuable insights into the accuracy and reasonableness of IRR models and is an integral part of the control process for IRR management. Variance analysis involves identifying material differences between actual and forecasted income statement and balance sheet amounts and ascertaining the causes of the differences. Variances can be readily identified by direct comparison of the financial statements for a particular forecast period, or by using key financial indicators, such as net interest margin, cost of funds, or asset-yield comparisons.

Variance analysis can help management understand the primary reasons for material differences between projected and actual results. It can also provide a means to improve the precision of the IRR measurement system. Periodic variance analysis helps assure management and the board that the system is accomplishing its primary goal of providing meaningful information on the level of IRR. Variance analysis provides an opportunity for a deeper understanding of both the system and its results.

Variance analysis should be done periodically and no less frequently than annually. Further, management should document their analysis, highlighting any material variances, the primary cause of identified variances, and any proposed or implemented corrective actions.

Variances resulting from errors can be broken down into three major components: input, modeling, or assumption errors. When conducting variance analysis, management should attempt to pinpoint the cause of all material variances. Mathematical flaws, while relatively rare in widely available purchased systems, can occur. Other types of modeling errors can be caused by inaccurate data input, user unfamiliarity with the model, over-aggregation of account types, or the use of a model with insufficient capabilities.

Data errors can be minimized by strong internal controls and may be identified through selective transaction testing. Many models can compare the results of historical IRR simulations with actual financial results. Significant variances can help management identify, and subsequently correct, identified issues with the model setup, such as inappropriate account aggregations or the failure to include key account characteristics.

Assumption Variance Analysis

All IRR measurement systems rely heavily on a series of assumptions, and assessing their reasonableness is critical to ensuring the integrity of the measurement system results. Just as actual financial results can be expected to vary from forecasts, the assumptions that form the basis of that forecast can be expected to vary from actual events.

Institutions should have formalized procedures for periodically identifying material differences between assumed and realized values. Formal procedures help identify the key reasons for variances. Even if material financial variances are absent, the model's significant assumptions should be compared to actual performance. Compensating differences may have masked important variances. For example, an institution with a large mortgage portfolio may find that actual prepayment speeds were significantly higher than projected, but new loan production replaced the run-off. In this case, there may only be an immaterial variance in the ending loan balance, but a significant variance in projected vs. actual prepayments.

Given the large number of assumptions inherent in most measurement systems, a thorough review of every assumption during each measurement cycle is unrealistic. However, key assumptions should be checked against actual behaviors on a regular basis. Key assumptions include those dealing with interest rate movements, driver rates, non-maturity deposits, prepayment speeds, and account aggregations. Variance analysis should be used to identify the differences attributable to rate assumptions and other factors in order to better understand how those factors influenced modeled results.

Driver rate variances occur when the expected correlation between a bank rate and its driver rate does not act as predicted. Variance analysis is used to determine the significance of the difference and should address whether the difference is due to an inaccurate correlation between the subject and driver rate, or due to inappropriate spreads or beta factors. Ideally, the relationship between subject and driver rates should be documented, and the relationship should factor in historical correlations and management's intentions regarding future movements.

Non-maturity deposit assumptions may cause significant variances. If the measurement system forecast an increasing net interest margin in a rising rate environment, while the actual margin declined, the cause may involve NMD assumptions. Many models treat NMD rates as very insensitive to yield curve changes, while actual practices are to manage the rates more actively. This can lead to model measurements that show the bank as asset sensitive or neutral, when past performance shows it to be liability sensitive. Periodic variance analysis may identify this discrepancy and allow management to more effectively use the IRR measurement tool. *Note:* Examiners should recognize that models are forward looking; therefore the usefulness of historical variance analysis may be limited.

Prepayment speed variances occur when actual prepayments do not mirror those projected. Variances are not uncommon as the cash flows are difficult to model and predict; however, management should monitor prepayments and revise related assumptions if material variances occur.

Inappropriate account aggregation can also lead to significant variances. For example, when comparing actual and modeled loan interest income, an institution may find that the model overestimated income in a falling rate environment because real estate loans with significantly different prepayment characteristics were aggregated together.

Many models measure static IRR, that is, what would happen to the current balance sheet if only interest rates changed. Other models incorporate management projections about asset and liability growth and changes in product mix. Variance analysis in the latter instance is complicated by the need to segregate variances due to balance sheet changes from those caused by rate movements.

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OTHER RISK FACTORS TO CONSIDER

Although IRR is the principal market risk taken by most financial institutions, other activities can significantly increase (or reduce) a bank's exposure and sensitivity to market risk.

Foreign exchange activities expose institutions to the price (exchange rate) risk that results from volatile currency markets. Exchange rates depend upon a variety of global and local factors that are difficult to predict, including interest rates, economic performance, central bank actions, and political developments.

Commodity activities involve using commodity contracts (including futures and options) to speculate or hedge. Commodity prices depend upon many factors and are very difficult to forecast.

Generally, institutions should only use foreign exchange or commodity activities to hedge or control specific market risks. Management, independent of the broker/dealer, should demonstrate expertise commensurate with the activities undertaken. In addition, management should produce documented analysis that clearly details the effectiveness of all foreign exchange and commodity hedging activities. The analysis should be prepared at least quarterly and presented to the board for its review. *Note:* Typical commodity hedging activities are significantly different from speculative commodity activities.

Equity trading and investing creates market risk exposure because changes in equity prices can adversely affect earnings and capital. The board and management have a responsibility to identify, measure, monitor, and control trading risks. Management should carefully monitor all equity investments, regularly evaluate the resulting market risk exposure, and provide timely reports to the board.

Foreign exchange, commodities, and equity trading requires a high level of technical and managerial expertise. The risk management and measurement systems needed to operate them effectively are likewise highly sophisticated and require rigorous monitoring and testing. Foreign exchange, commodity, or equity speculation, absent the necessary controls and sufficient capital, might be considered an unsuitable practice. When necessary, contact legal counsel or capital markets specialists in your region for additional guidance.

Interest Rate Risk Mitigation

Institutions can use several measures to mitigate IRR exposures. If risk measures fall outside approved tolerance guidelines and trigger corrective steps (which should be guided by approved policies), management might alter their balance sheet or engage in hedging activities. Hedging strategies often involve using complex derivative instruments and are not suitable for institutions lacking technical expertise. When any IRR mitigation strategy is considered, management should also consider other risks, such as credit, liquidity, and operational risks.

When implementing IRR mitigation techniques, the board and management should ensure that policies and approved strategies address:

- Analysis of market, liquidity, credit, and operating risks;
- Qualifications of personnel involved in implementing and monitoring hedging strategies;
- Permissible strategies and types of derivative contracts;
- Authority levels and titles of individuals approved to initiate hedging transactions and related authority limits;
- Risk limits for hedging activities such as position limits (gross and net), maturity parameters, and counterparty credit guidelines;
- Monitoring requirements for hedging activities, including ensuring activities fall within approved limits and management lines of authority; and
- Controls for ensuring management's compliance with technical accounting guidance that covers hedging activities.

Institutions should not use derivative instruments for hedging (whether or not hedge accounting is applied), unless the board and senior management fully understand the institution's strategy and the potential risks and benefits. Relying on outside consultants to assist with a hedging strategy does not absolve the board and senior management of their responsibility to understand and oversee the risks of the activities. Hedging strategies should be designed to limit downside earnings exposure or manage income or EVE volatility. Activities conducted solely to generate additional income should not be considered hedging.

Altering the balance sheet is the most common method institutions use to modify their IRR position. However, this strategy may take time to implement and often cannot quickly correct significant exposures. For example, if a bank is liability sensitive and therefore exposed to rising interest rates, management may decide to reduce their retention of 30-year fixed-rate mortgages. Strategies may include increased sales (possibly for securitization) of longer-term mortgage products or pricing longer-term mortgages above market rates in order to reduce the volume of new loan originations. While this strategy may reduce IRR over time, this method can be slow in correcting material IRR imbalances and may not effect a timely reduction in risk exposures.

Institutions may also attempt to address exposures to rising interest rates by increasing longer-term deposit or borrowing levels. However, several factors may hinder the success of such strategies. There may be significant competition or limited demand for longer-term time deposits, and access to longer-term wholesale funding may be limited or offered on unfavorable terms. Additionally, embedded options (e.g., calls and step-up dates) in wholesale funding sources can present measurement challenges, and the cost of such funding can make this approach prohibitive unless there is a clear productive use for the funds.

Cash flow matching and duration matching are two typical hedging strategies. The goal of these strategies is to change a bank's IRR exposure to meet specific cash flow or duration targets. These strategies can be accomplished by altering the balance sheet composition or through the use of derivatives.

Some institutions refer to cash flow matching as matched funding. The bank matches the terms (rate or maturity) of funding and assets so that cash flows will reprice or mature simultaneously and interest rate changes will not significantly influence net cash flow. Cash flow matching can be difficult for small institutions due to the wide range of cash flows in most financial assets.

With a duration matching strategy, management may attempt to match the duration of a pool of assets with the duration of a pool of liabilities. The use of interest rate derivatives or options might also be used to modify or offset the duration of an existing pool of assets or liabilities. The goal is to match the effective durations of the pools in order to limit the net changes in fair values of the pools, rather than matching the specific cash flows. Duration matching is not a perfect strategy and may result in imperfect hedging from a cash flow perspective and can cause exposure to different kinds of risk (such as yield curve and basis risk).

Derivative instruments are available to hedge IRR. These instruments include, but are not limited to, swaps, amortizing swaps, basis swaps, futures, forwards, caps, options, floor options, and collars. The most common derivatives used to hedge IRR are swaps and forwards. In a pay-fixed swap transaction, a stream of fixed interest payments from a commercial loan may be contractually exchanged for a stream of floating-rate payments. This swap effectively shortens the duration of the commercial loan portfolio by reducing the asset/liability mismatch and improves profitability in a rising-rate environment. Conversely, the bank could lengthen the effective duration of its floating-rate deposits by entering into a swap where a floating-rate stream of payments is exchanged for a fixed-rate payment stream.

Institutions that use hedging activities should understand the true impact of a hedge (whether it actually decreases risks), and understand its impact on earnings and capital. All derivatives require fair value accounting adjustments, which may result in earnings and capital volatility. While management may utilize hedges to reduce certain risks in their portfolio, analysis of the hedges should consider the impact of related accounting adjustments on earnings and capital.

Each institution using derivatives should establish an effective process for managing related risks. The level of formality in this process should be commensurate with the activities involved and the level of risk approved by senior management and the board.

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INTERNAL CONTROLS

Establishing and maintaining an effective system of internal controls and independent reviews is critical to the risk management process and the general safety and soundness of the bank. Institutions should have adequate internal controls to ensure the integrity of their IRR management process. These controls should promote reliable financial reporting and compliance with internal policies and relevant regulations. Internal control policies and procedures should address appropriate approval processes, adherence to exposure limits, reconciliations, reporting, reviews, and other mechanisms designed to provide a reasonable assurance that the bank's IRR management objectives are achieved. Internal control policies and procedures should clearly define management authorities and responsibilities and identify the individuals and committees responsible for managing sensitivity to market risk.

A sound control environment should also ensure adequate separation of duties in key elements of the risk management process to avoid potential conflicts of interest. Institutions should have clearly defined duties that are sufficiently independent from position-taking functions of the bank. Additionally, IRR exposures should be reported directly to senior management and the board of directors. The nature and scope of such safeguards should reflect the type and structure of the bank, the volume and complexity of IRR incurred by the bank, and the complexity of its transactions and commitments. More complex institutions should have an independent unit responsible for the design and administration of the bank's IRR measurement, monitoring, and control functions.

Independent Reviews

Regular independent reviews of its IRR management process are an important element of a bank's internal control system. Internal reviews of the IRR measurement system should include assessments of the assumptions, parameters, and methodologies used. Such reviews should seek to understand, test, and document the current measurement process, evaluate the system's accuracy, and recommend solutions to any identified weaknesses. The independent review should be tailored to the type and complexity of an institution's activities and encompass the standards and desirable scope discussed below. Regardless of the depth of the independent review, the findings of the review should be reported to the board no less frequently than annually, along with a summary of the bank's IRR measurement techniques and management practices.

Independent Review Standards

The purpose of an independent review is to ensure that the IRR measurement and management processes are sound. Regardless of whether the review is performed by internal staff or external entities, it is important these parties be independent of any operational responsibility for the measurement and management processes. They should not perform any of the routine internal control functions such as reconciling data inputs, developing assumptions, or performing variance analysis.

Independent reviews should be performed at least annually. The scope, responsibility, and authority for the reviews should be clearly documented and encompass all material aspects of the measurement process. The scope of the independent review should generally be defined by the internal audit staff and approved by the audit committee. However, subject to board approval, it is acceptable for another department of the bank, separate from the group that measures IRR, to define, perform, and document the independent review. A bank's review processes should meet the following minimum standards:

- Independence - Parties performing the independent review should not be involved in the day-to-day IRR measurement/management process. Institutions may use internal staff, an outsourcing arrangement, or a combination of the two to independently review the measurement system. Management may find that the internal audit department, or other staff independent of the measurement system, has the knowledge and skills to perform certain aspects of the review while using external resources for other areas. When the assessment of the measurement system is outsourced, senior management and the board should ensure that the procedures used meet the same standards required of a satisfactory internal review.
- Skills and Knowledge - Senior management and the board must ensure that individuals performing the independent review have the knowledge and skills to competently assess the measurement system and its control environment.
- Transparency - The procedures used in the independent review of the measurement system should be clearly documented, and work papers should be available to management, auditors, and examiners for review. Senior management should ensure that they have access to work papers even when external parties perform the review.
- Communication of Results - Procedures should be established for reporting independent review findings at least annually to the board or board-delegated committee.

Scope of Independent Review

Independent reviews provide a way to assess the adequacy of a bank's IRR measurement system. The level and depth of the independent reviews should be commensurate with the bank's risks and activities. More complex institutions should have a more rigorous independent review process. Less complex institutions may rely upon less formal reviews. At a minimum, each institution should have procedures in place to independently review the input process, assumptions used, and system output reports.

System-input reviews should evaluate the adequacy and appropriateness of:

- The knowledge and skills of individuals responsible for input to the measurement system;
- The reconciliation of the measurement system's data

to the bank's general ledger;
- The rules and methods of account aggregation used in the measurement system;
- The accuracy of contractual terms captured within the measurement system; and
- The source, completeness, accuracy, and procedures for external data feeds.

Assumption reviews should evaluate the following issues:

- The process of developing assumptions for all material asset, liability, and off-balance sheet exposures;
- The process for reviewing and approving key assumptions;
- The periodic review of assumptions for relevance, applicability, and reasonableness; and
- The completeness of assumption analysis and its supporting documentation.

System output and reporting assessments should include coverage of the following:

- Inclusion of a sufficiently broad range of potential rate scenarios,
- Accuracy of the IRR measurement and assurance that all material exposures are captured,
- Timeliness and frequency of reporting to management and the board,
- Compliance with operating policies and approved risk limits,
- Performance and documentation of variance analyses (back-testing), and
- Translation of model output into understandable management reports that support decision making.

Theoretical and Mathematical Validations

The degree to which calculations in an IRR model should be validated depends on the complexity of an institution's activities and IRR model. The complexity of many measurement systems demands specialized knowledge and skills to verify the mathematical equations. Less complex institutions using simpler, vendor-supplied IRR models can satisfy some, but not all, validation requirements with independent attestation reports from the vendor.

Management should periodically discuss with vendors what validation and internal control process assessments have been conducted. The vendor should provide documentation showing a credible, independent third party has performed such assessments. Vendors should be able to provide appropriate testing results to show their product works as expected. They should also clearly indicate the model's limitations, assumptions, and where the product's use may be problematic. Such disclosures, exclusive of confidential or proprietary information, should contain useful insights regarding a model's functionality and outputs. However, a certification or validation report from a vendor is only one component of a bank's independent review and should not be used as a substitute for an overall validation review. Management is still responsible for any aspect of the process under their control, such as data input, assumption changes, etc.

As part of the validation process, management should ensure that the software and mathematics of the IRR model function as intended. Many community institutions use largely standardized, vendor-provided models. In such cases, the validations provided by vendors can be used to support the accuracy of the model. For models that are customized to an individual institution or in situations where vendors are unable or unwilling to provide appropriate certifications or validations, management is responsible for validating the accuracy of the model's mathematics and soundness of the software.

Additionally, vendor models may be customized by an institution for its particular circumstances. Management should document and justify the institution's customization choices as part of the validation process. If vendors provide input data or assumptions, their relevance to the bank's situation should be evaluated and approved. Institutions should obtain information regarding the data (e.g., vendor-derived assumptions) used to develop the model and assess whether the data is representative of the institution's situation.

Complex institutions or those with significant IRR exposures may need to perform more in-depth validation procedures of the underlying mathematics. Validation practices could include constructing a similar model to test assumptions and outcomes or using an existing, well-validated benchmark model, which is often a less costly alternative. The benchmark model should have theoretical underpinnings, methodologies, and inputs that are very close to those used in the model being validated. More complex institutions have used benchmarking effectively to identify model errors that could distort IRR measurements. The depth and extent of the validation process should be consistent with the degree of risk exposures.

Model certifications and validations commissioned by vendors can be a useful part of an institution's efforts to evaluate the model's development and conceptual soundness. Although many vendors offer services for process verification, benchmarking, or back-testing, the services are usually separate engagements. Each institution should ensure these engagements meet its internal policy requirements for validations and independent reviews.

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EVALUATING SENSITIVITY TO MARKET RISK

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

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

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

- The sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchanges rates, commodity prices, or equity prices.·
- The ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile.
- The nature and complexity of interest rate risk exposure arising from nontrading positions.
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

Ratings

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

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

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

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

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

Examination Standards and Goals

The following documents provide additional guidance for managing IRR:

- Joint Agency Policy Statement on Interest Rate Risk,
- Interagency Advisory on Interest Rate Risk Management, and
- Interagency Advisory on Interest Rate Risk Management Frequently Asked Questions.

Interagency Policy Statement on Interest Rate Risk

In 1996, the FDIC and the other Federal banking regulators adopted the Sensitivity to Market Risk component of the Uniform Financial Institutions Rating System and issued a Joint Agency Policy Statement on IRR (Policy Statement). The Policy Statement identifies the key elements of sound IRR management and describes prudent principles and practices for each of these elements. It emphasizes the importance of adequate oversight by a bank's board of directors and senior management as well as the importance of comprehensive risk management processes. The Policy Statement also describes the critical IRR-related factors that affect the Agencies' evaluation of an institution's capital adequacy

Interagency Advisory-Interest Rate Risk Management

In January 2010, the Agencies issued updated guidance to clarify supervisory expectations for IRR management set forth in the 1996 Policy Statement. The Interagency Advisory on Interest Rate Risk Management (Advisory) re-emphasizes the importance of effective corporate governance, policies and procedures, risk measurement and monitoring systems, stress testing, and internal controls related to IRR exposures. The Advisory indicates financial institutions should manage IRR commensurate with their complexity, risk profile, business model, and scope of operations. Additionally, the Advisory highlights that effective IRR management involves not only the identification and measurement of IRR, but also appropriate risk mitigation strategies that may be used to control IRR if exposure levels warrant corrective steps.

In January 2012, the agencies published supplemental guidance addressing Frequently Asked Questions (FAQs) on the 2010 Advisory. The FAQs provides additional clarification on topics such as determining model appropriateness; defining meaningful stress scenarios; analyzing yield curve, basis, and option risk, as well as using no-growth measurement scenarios. The FAQs also describe effective procedures for model validations and calculation of non-maturity deposit decay assumptions.

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EXAMINATION PROCESS

FDIC examination procedures follow a risk-focused framework that incorporates the guidelines outlined in the 1996 Policy Statement and the 2010 Advisory (including the FAQs guidance) to efficiently allocate examination resources. The scope of an examination should consider a bank's IRR exposure relative to earnings and capital, the complexity of on- and off-balance sheet exposures, and the strength of risk management processes.

Examiners can identify material exposures and risks by reviewing the following items (most of which are available during off-site analysis):

- Prior examination findings,
- Interest Rate Risk Standard Analysis (IRRSA),
- Net interest margin and net operating income trends,
- Board or committee minutes,
- Bank IRR analysis,
- Independent review or audit findings,
- Related bank policies and procedures,
- Balance sheet and account data,
- Strategic and business plans,
- Product pricing guidelines, and
- Derivatives activities.

Citing Examination Deficiencies

Material weaknesses in risk management processes, or high levels of IRR exposure relative to capital, require corrective action. Such actions may include recommendations or directives to:

- Raise additional capital;
- Reduce levels of IRR exposure;
- Strengthen IRR management expertise;
- Improve IRR management information and measurement systems; or
- Take other measures or combination of actions, depending on the facts and circumstances of the individual bank.

If an examiner determines that IRR weaknesses warrant the listing of a contravention of regulatory guidance in the Report of Examination, the 1996 Policy Statement should be cited as the source guidance. Examiners may reference the Advisory or the FAQs document in supporting comments. A contravention of the interagency guidelines detailed in Appendix A of Part 364 may also be warranted for institutions with seriously deficient IRR programs.

Pursuant to Appendix A (II.E.) of Part 364, an institution should:

- Manage interest rate risk in a manner that is appropriate to the size of the institution and the complexity of its assets and liabilities; and
- Provide for periodic reporting to management and the board of directors regarding interest rate risk with adequate information for management and the board of directors to assess the level of risk.

Note: Accepting a reasonable degree of IRR is a fundamental part of banking that significantly affects profitability and shareholder values. Although risks must be properly managed, exceptions to established IRR policies and limits occasionally occur. Examiners should not automatically criticize relatively minor exceptions to established policies or internal limits if an institution has appropriate, formal processes for monitoring, reviewing, and approving exceptions.

Additionally, examiners are reminded that, if weaknesses in a model or its assumptions are identified that render its results unreliable, report comments supporting the assigned rating should not rely on (or, at a minimum, should qualify any use of) the resulting data.

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MARKET RISK GLOSSARY

Deterministic Rate Scenarios

Deterministic modeling techniques allow management to specify the direction, amount, and timing of future interest rates in order to measure the potential impact the changes may have on earnings and capital. The following items are examples of commonly used deterministic interest rate scenarios:

- **Rate Shock Scenario** – In this scenario, rate changes are immediate and sustained. For example, in a plus 300 basis point scenario, the full effect of the rate increase would be administered in the first period measured and remain in effect for all periods.
- **Rate Ramp Scenario** – In this scenario, rate changes are applied gradually over the measured period. For example, when measuring the effects of a 300 basis point rate increase during a 12-month period, rates would be increased 25 basis points each month.
- **Stair Step Scenario** – In this scenario, rate changes are administered at less frequent intervals over the measured period. For instance, in a 300 basis point increasing rate environment measured over a two-year time period, rates may be increased 50 basis points each quarter of the first year and 25 basis points each quarter of the second year.

Non-parallel Yield Curve Shifts

A shift in the yield curve in which yields do not change by the same number of basis points for every maturity. When running various interest rate scenarios, management may set non-parallel shifts in a manner similar to deterministic rate scenarios (rate shock, rate ramp, or stair step). The scenarios often have a pivot point on the yield curve from which longer-term and shorter-term rates change in different amounts.

Static Models

Static simulation models are based on current exposures and assume a constant, no-growth balance sheet. In order to simulate no growth in balance sheet accounts, some static models assume that all principal cash flows from a particular account are reinvested back into that same account. This assumption is sometimes referred to as replacement growth.

Dynamic Models

Dynamic simulation models rely on detailed assumptions regarding changes in existing business lines, new business, and changes in management and customer behavior. The assumptions change the existing balance sheet to reflect expected business changes.

Stochastic Models

Stochastic modeling consists of the modeling of an uncertain variable over time using a random selection process. It recognizes that market variables, such as interest rates, exhibit a general trend (drift) and some degree of volatility around that trend. Stochastic models provide a framework for the evaluation of the impact of embedded options in financial instruments.

Constraints are usually imposed so that the model is representative of current market conditions. For example, if Treasury securities are priced using interest rate paths, a constraint may be imposed so that the average present value derived from all the paths must equal the observed market price of the Treasury securities. In such a case, the model can also be classified as a Stochastic No Arbitrage Model.

Monte Carlo Simulation

A Monte Carlo simulation randomly generates a large sample set of values from a reasonable population of variables such as an interest rate. The stochastic model provides a framework for the evolution of the variable, and a Monte Carlo simulation is an application of that stochastic model. The randomness in games of chance is similar to how Monte Carlo simulation selects values at random to simulate a model. When you turn a roulette wheel, you know that one number within a range of numbers will come up, but you do not know which number will come up for any particular turn. The same concept applies with a Monte Carlo simulation where the variables (e.g., interest rates, security prices) have a known range of values but an uncertain value for any particular time. Monte Carlo simulations can take into account returns, volatility, correlations, and other factors. Monte Carlo programs can generate millions of different scenarios by randomly changing a component for each run or iteration. Monte Carlo simulation allows the banker to simulate thousands of market-like scenarios and learn the probability of a particular outcome or a range of outcomes. Assume that the investment portfolio is run through 20,000 simulations, projecting 20,000 separate scenarios over a two-year period, and acceptable results occur 16,000 times. This means that there is an 80 percent probability that the portfolio will perform at an acceptable level. Like any financial model, the results are sensitive to underlying assumptions. The number of runs or simulations is also important. For example, a Monte Carlo model with only 500 iterations captures fewer possible scenarios than one that runs 50,000 iterations.

Spread Types

- **Static Spread –** Basis points, that when added to a set of implied forward rates, discounts the cash flows of an instrument back to its observed market value. For an instrument without embedded optionality, the static spread is the best measure of return in excess of the risk-free rates provided by that instrument. For instruments with embedded optionality, it may be useful to calculate a static spread only as a starting point for comparison with a more appropriate mark-to-market spread measure, such as the option adjusted spread.
- **Option Adjusted Spread (OAS) –** Basis points, that when added to a set of interest rates discounts the cash flows of an instrument back to its observed market value. This measure only applies to instruments with embedded optionality. The static spread applies to instruments without embedded optionality. For example, consider a mortgage-backed security, which typically contains an embedded prepayment option. Assume the static spread is 75 basis points. The OAS would be less than the static spread of 75 basis points because the volatility of interest rates reflected in an OAS framework assigns more value to the borrower's prepayment option, thus reducing the value to the MBS investor.
- **OAS Process –** In a stochastic valuation model, the average value generated by all the interest rate paths must equal the currently observed price of the security. The initial computation in the model is based on an assumed spread. The security value derived is compared to the observed.

Duration Calculations

Macaulay duration calculates the weighted average term to maturity of a security's cash flows. Assume a bond with three years remaining to maturity, bearing a 5 percent coupon rate paid annually, when a 10 percent yield is required.

Macaulay Duration Calculation
3 year bond, 5% coupon, 10% yield

Year	Payment	PV x	T	PVxT
1	$50	$45.5 x	1 =	$45.5
2	$50	$41.3 x	2 =	$82.6
3	$1,050	$788.9 x	3 =	$2,366.7
Total		$875.7		$2,494.8

T = Time period payment is received

Macaulay Duration: 2,494.8 / 875.7 = 2.85 years

Modified duration, calculated from Macaulay duration, estimates price sensitivity for small interest rate changes.

Modified Duration Calculation
3 year bond, 5% coupon, 10% yield
Macaulay Duration = 2.85 years

$$\frac{\text{Macaulay Duration}}{1 + (\text{Yield} / n)}$$
$$= 2.85 / 1.10$$

n = coupons per year

Modified Duration = 2.59%

The following formula can be used to estimate the percentage change in a bond's price:

$$\Delta\ \% = -\text{Modified Duration x } \Delta \text{ Yield x } 100$$

Note: The minus sign recognizes the inverse relationship of price and yield.

For a 100 basis point change in rates, the estimated change in price is equal to the modified duration. In other words, using a modified duration of 2.59 percent, the price of a bond would change approximately 2.6 percent for every 100 basis point change in rates. If rates changed by only 50 basis points, the bond would change approximately 1.3 percent.

$$\Delta\% = \text{Modified Duration x } \Delta \text{ Yield x } 100$$
$$= 2.59\% \text{ x } 50\text{bp x } 100$$
$$= 2.59\% \text{ x } .5$$
$$= 1.295\%$$

The following formula can be used to estimate the dollar change in price:

$$\Delta\$ = \text{minus Price x Modified Duration x } \Delta \text{ Yield x } 100$$

If the price of the bond had been $875.66, then its approximate change in value (price), if rates changed by 50bp, would be ($875.66) x 1.295% = ($11.34).

If rates fell, the estimated value would be $887.00, while if rates rose the estimated value would fall to $864.32.

Duration-based price forecasts are generally precise when used with small rate changes (1 to 5 basis points). However, the accuracy of the forecasts decline when larger rates changes (especially 100 basis points or more) are involved. The reason for the declining accuracy of price forecasts relates to the non-linear relationship between prices and yields (a.k.a., convexity).

Convexity

Option-free financial instruments display positive convexity. When rates decline, a positively convexed instrument's price increases at an increasing rate. When rates rise, a positively convexed instrument's price decreases at a decreasing rate.

Negative convexity causes the duration of a security to lengthen when rates rise and shorten when rates fall. Instruments that contain embedded options demonstrate negative convexity. When rates decline, a negatively convexed instrument's price increases at a decreasing rate. When rates rise, the price of a negatively convexed instrument will decline at an increasing rate.

For example, the value of the treasury security changes relatively less in value in comparison to the sample mortgage security, which declines more significantly. However, as yields decrease, the treasury security gains value at an increasing rate, while the mortgage security gains only modestly. As interest rates decline, the likelihood increases that borrowers will refinance (exercise prepayment option). Therefore, the value of a mortgage security does not increase at the same rate or magnitude as a decline in interest rates.

Effective Duration and Effective Convexity

Effective duration and effective convexity are used to calculate the price sensitivity of bonds with embedded options. The calculations provide an approximate price change of a bond given a parallel yield curve shift. Measures of modified duration and convexity do not provide accurate calculations of price sensitivity for bonds with embedded options. Effective duration and convexity provide a more accurate view of price sensitivity since the measures allow for cash flows to change due to a change in yield. Formula:

Effective Duration = $(V_- - V_+)/(2V_0 \times \Delta Y)$
Effective Convexity = $(V_+ + V_- - 2V_0)/(2V_0 \times \Delta Y)^2$

Where, ΔY = Change in market interest rate used to calculate new values:

V_+ = Price if yield is increased by Change Y
V_- = Price if yield is decreased by Change Y
V_0 = Initial price per \$100 of par value

Assume: a three-year callable bond's current market value is \$98.60 (V_0); that interest rates are projected to change by 100 basis points (Y); that the price of this bond given a 100 basis point increase in rates is \$96.75 (V_+); and that the price of this bond given a 100 basis point decrease in rates is \$99.98 (V_-).

To calculate effective duration and convexity:

Effective Duration =
$(99.98 – 96.75)/(2(98.60)(.01)) = 1.64$
Effective Convexity =
$96.75 + 99.98 – 2(98.60)\div(2(98.60)(.01))^2 = -23.83$

If we assume interest rates increase 100 basis points, the approximate price change due to effective duration is the following:

Percentage Price Change = -Effective Duration x Yield Change
Percentage Change in Price = -1.64 x .01 = -1.64%

The approximate price change due to effective convexity is the following:

½ x Effective Convexity x $(\text{Yield Change})^2$
½ x -23.83 x $(0.01)^2$ x 100 = -0.12%

Thus this bond's price would be expected to decrease by about 1.76 percent given a 100 bps rise in rates:

Effective Duration	=	-1.64%
Effective Convexity	=	-0.12%
		-1.76%

INTRODUCTION TO THE BANK SECRECY ACT

The Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act of 1970 (31 U.S.C. 5311 et seq.) is referred to as the Bank Secrecy Act (BSA). The purpose of the BSA is to require United States (U.S.) financial institutions to maintain appropriate records and file certain reports involving currency transactions and a financial institution's customer relationships. Currency Transaction Reports (CTRs) and Suspicious Activity Reports (SARs) are the primary means used by banks to satisfy the requirements of the BSA. The recordkeeping regulations also include the requirement that a financial institution's records be sufficient to enable transactions and activity in customer accounts to be reconstructed if necessary. In doing so, a paper and audit trail is maintained. These records and reports have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.

The BSA consists of two parts: Title I Financial Recordkeeping and Title II Reports of Currency and Foreign Transactions. Title I authorizes the Secretary of the Department of the Treasury (Treasury) to issue regulations, which require insured financial institutions to maintain certain records. Title II directed the Treasury to prescribe regulations governing the reporting of certain transactions by and through financial institutions in excess of $10,000 into, out of, and within the U.S. The Treasury's implementing regulations under the BSA, issued within the provisions of 31 CFR Part 103, are included in the FDIC's Rules and Regulations and on the FDIC website.

The implementing regulations under the BSA were originally intended to aid investigations into an array of criminal activities, from income tax evasion to money laundering. In recent years, the reports and records prescribed by the BSA have also been utilized as tools for investigating individuals suspected of engaging in illegal drug and terrorist financing activities. Law enforcement agencies have found CTRs to be extremely valuable in tracking the huge amounts of cash generated by individuals and entities for illicit purposes. SARs, used by financial institutions to report identified or suspected illicit or unusual activities, are likewise extremely valuable to law enforcement agencies.

Several acts and regulations expanding and strengthening the scope and enforcement of the BSA, anti-money laundering (AML) measures, and counter-terrorist financing measures have been signed into law and issued, respectively, over the past several decades. Several of these acts include:

- Money Laundering Control Act of 1986,
- Annuzio-Wylie Anti-Money Laundering Act of 1992,
- Money Laundering Suppression Act of 1994, and
- Money Laundering and Financial Crimes Strategy Act of 1998.

Most recently, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (more commonly known as the USA PATRIOT Act) was swiftly enacted by Congress in October 2001, primarily in response to the September 11, 2001 terrorist attacks on the U.S. The USA PATRIOT Act established a host of new measures to prevent, detect, and prosecute those involved in money laundering and terrorist financing.

FINANCIAL CRIMES ENFORCEMENT NETWORK REPORTING AND RECORDKEEPING REQUIREMENTS

Currency Transaction Reports and Exemptions

U.S. financial institutions must file a CTR, Financial Crimes Enforcement Network (FinCEN) Form 104 (formerly known as Internal Revenue Service [IRS] Form 4789), for each currency transaction over $10,000. A currency transaction is any transaction involving the physical transfer of currency from one person to another and covers deposits, withdrawals, exchanges, or transfers of currency or other payments. Currency is defined as currency and coin of the U.S. or any other country as long as it is customarily accepted as money in the country of issue.

Multiple currency transactions shall be treated as a single transaction if the financial institution has knowledge that the transactions are by, or on behalf of, any person and result in either cash in or cash out totaling more than $10,000 during any one business day. Transactions at all branches of a financial institution should be aggregated when determining reportable multiple transactions.

CTR Filing Requirements

Customer and Transaction Information

All CTRs required by 31 CFR 103.22 of the Financial Recordkeeping and Reporting of Currency and Foreign

Transactions regulations must be filed with the IRS. Financial institutions are required to provide all requested information on the CTR, including the following for the person conducting the transaction:

- Name,
- Street address (a post office box number is not acceptable),
- Social security number (SSN) or taxpayer identification number (TIN) (for non-U.S. residents), and
- Date of birth.

The documentation used to verify the identity of the individual conducting the transaction should be specified. Signature cards may be relied upon; however, the specific documentation used to establish the person's identity should be noted. A mere notation that the customer is "known to the financial institution" is insufficient. Additional requested information includes the following:

- Account number,
- Social security number or taxpayer identification number of the person or entity for whose account the transaction is being conducted (should reflect all account holders for joint accounts), and
- Amount and kind of transaction (transactions involving foreign currency should identify the country of origin and report the U.S. dollar equivalent of the foreign currency on the day of the transaction).

The financial institution must provide a contact person, and the CTR must be signed by the preparer and an approving official. Financial institutions can also file amendments on previously filed CTRs by using a new CTR form and checking the box that indicates an amendment.

CTR Filing Deadlines

CTRs filed with the IRS are maintained in the FinCEN database, which is made available to Federal Banking Agencies[1] and law enforcement. Paper forms are to be filed within 15 days following the date of the reportable transaction. If CTRs are filed using magnetic media, pursuant to an agreement between a financial institution and the IRS, a financial institution must file a CTR within 25 calendar days of the date of the reportable transaction. A third option is to file CTRs using the Patriot Act Communication System (PACS), which also allows up to 25 calendar days to file the CTR following the reportable transaction. PACS was launched in October 2002 and permits secure filing of CTRs over the Internet using encryption technology. Financial institutions can access PACS after applying for and receiving a digital certificate.

Examiners reviewing filed CTRs should inquire with financial institution management regarding the manner in which CTRs are filed before evaluating the timeliness of such filings. If for any reason a financial institution should withdraw from the magnetic tape program or the PACS program, or for any other reason file paper CTRs, those CTRs must be filed within the standard 15 day period following the reportable transaction.

Exemptions from CTR Filing Requirements

Certain "persons" who routinely use currency may be eligible for exemption from CTR filings. Exemptions were implemented to reduce the reporting burden and permit more efficient use of the filed records. Financial institutions are not required to exempt customers, but are encouraged to do so. There are two types of exemptions, referred to as "Phase I" and "Phase II" exemptions.

"Phase I" exemptions may be granted for the following "exempt persons":

- A bank[2], to the extent of its domestic operations;
- A Federal, State, or local government agency or department;
- Any entity exercising governmental authority within the U.S. (U.S. includes District of Columbia, Territories, and Indian tribal lands);
- Any listed entity other than a bank whose common stock or analogous equity interests are listed on the New York, American, or NASDAQ stock exchanges (with some exceptions);
- Any U.S. domestic subsidiary (other than a bank) of any "listed entity" that is organized under U.S. law and at least 51 percent of the subsidiary's common stock is owned by the listed entity.

"Phase II" exemptions may be granted for the following:

- A "non-listed business," which includes commercial enterprises that do not have more than 50% of the business gross revenues derived from certain ineligible businesses. Gross revenue has been interpreted to reflect what a business actually earns from an activity conducted by the business, rather than the sales volume of such activity. "Non-listed businesses" must

[1] Federal Banking Agencies consist of the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), and the FDIC.

[2] Bank is defined in The U.S. Department of the Treasury (Treasury) Regulation 31 CFR 103.11.

also be incorporated or organized under U.S. laws and be eligible to do business in the U.S. and may only be exempted to the extent of its domestic operations.

- A "payroll customer," which includes any other person not covered under the "exempt person" definition that operates a firm that regularly withdraws more than $10,000 in order to pay its U.S. employees in currency. "Payroll customers" must also be incorporated and eligible to do business in the U.S. "Payroll customers" may only be exempted on their withdrawals for payroll purposes from existing transaction accounts.

Commercial transaction accounts of sole proprietorships can qualify for "non-listed business" or "payroll customer" exemption.

Exemption of Franchisees

Franchisees of listed corporations (or of their subsidiaries) are not included within the definition of an "exempt person" under "Phase I" unless such franchisees are independently exempt as listed corporations or listed corporation subsidiaries. For example, a local corporation that holds an ABC Corporation franchise is not a "Phase I" "exempt person" simply because ABC Corporation is a listed corporation; however, it is possible that the local corporation may qualify for "Phase II" exemption as a "non-listed business," assuming it meets all other exemption qualification requirements. An ABC Corporation outlet owned by ABC Corporation directly, on the other hand, would be a "Phase I" "exempt person" because ABC Corporation's common stock is listed on the New York Stock Exchange.

Ineligible Businesses

There are several higher-risk businesses that may not be exempted from CTR filings. The nature of these businesses increases the likelihood that they can be used to facilitate money laundering and other illicit activities. Ineligible businesses include:

- Non-bank financial institutions or agents thereof (this definition includes telegraph companies, and money services businesses [currency exchange, check casher, or issuer of monetary instruments in an amount greater than $1,000 to any person in one day]);
- Purchasers or sellers of motor vehicles, vessels, aircraft, farm equipment, or mobile homes;
- Those engaged in the practice of law, medicine, or accountancy;
- Investment advisors or investment bankers;
- Real estate brokerage, closing, or title insurance firms;
- Pawn brokers;
- Businesses that charter ships, aircraft, or buses;
- Auction services;
- Entities involved in gaming of any kind (excluding licensed para mutual betting at race tracks);
- Trade union activities; and
- Any other activities as specified by FinCEN.

Additional Qualification Criteria for Phase II Exemptions

Both "non-listed businesses" and "payroll customers" must meet the following additional criteria to be eligible for "Phase II" exemption:

- The entity has maintained a transaction account with the financial institution for at least twelve consecutive months;
- The entity engages in frequent currency transactions that exceed $10,000 (or in the case of a "payroll customer," regularly makes withdrawals of over $10,000 to pay U.S. employees in currency); and
- The entity is incorporated or organized under the laws of the U.S. or a state, or registered as, and eligible to do business in the U.S. or state.

The financial institution may treat all of the customer's transaction accounts at that financial institution as a single account to qualify for exemption. There may be exceptions to this rule if certain accounts are exclusively used for non-exempt portions of the business. (For example, a small grocery with wire transfer services has a separate account just for its wire business).

Accounts of multiple businesses owned by the same individual(s) are generally not eligible to be treated as a single account. However, it may be necessary to treat such accounts as a single account if the financial institution has evidence that the corporate veil has been pierced. Such evidence may include, but is not limited to:

- Businesses are operated out of the same location and/or utilize the same phone number;
- Businesses are operated by the same daily management and/or board of directors;
- Cash deposits or other banking transactions are completed by the same individual at the same time for the different businesses;
- Funds are frequently intermingled between accounts or there are unexplained transfers from one account to the other; or
- Business activities of the entities cannot be differentiated.

More than one of these factors must typically be present in order to provide sufficient evidence that the corporate veil has been pierced.

Transactions conducted by an "exempt person" as agent or on behalf of another person are not eligible to be exempted based on being transacted by an "exempt person."

Exemption Qualification Documentation Requirements

Decisions to exempt any entity should be based on the financial institution taking reasonable and prudent steps to document the identification of the entity. The specific methodology for performing this assessment is largely at the financial institution's discretion; however, results of the review must be documented. For example, it is acceptable to document that a stock is listed on a stock market by relying on a listing of exchange stock published in a newspaper or by using publicly available information through the Securities and Exchange Commission (SEC). To document the subsidiary of a listed entity, a financial institution may rely on authenticated corporate officer's certificates or annual reports filed with the SEC. Annually, management should also ensure that "Phase I" exempt persons remain eligible for exemption (for example, entities remain listed on National exchanges.)

For "non-listed businesses" and "payroll customers," the financial institution will need to document that the entity meets the qualifying criteria both at the time of the initial exemption and annually thereafter. To perform the annual reviews, the financial institution can verify and update the information that it has in its files to document continued eligibility for exemption. The financial institution must also indicate that it has a system for monitoring the transactions in the account for suspicious activity as it continues to be obligated to file Suspicious Activity Reports on activities of "exempt persons," when appropriate. SARs are discussed in detail within the "Suspicious Activity Reporting" section of this chapter.

Designation of Exempt Person Filings and Renewals

Both "Phase I" and "Phase II" exemptions are filed with FinCEN using Form TD F 90-22.53 - Designation of Exempt Person. This form is available on the Internet at FinCEN's website. The designation must be made separately by each financial institution that treats the person in question as an exempt customer. This designation requirement applies whether or not the designee has previously been treated as exempt from the CTR reporting requirements within 31 CFR 103. Again, the exemption applies only to transactions involving the "exempt person's" own funds. A transaction carried out by an "exempt person" as an agent for another person, who is the beneficial owner of the funds involved in a transaction in currency can not be exempted.

Exemption forms for "Phase I" persons need to be filed only once. A financial institution that wants to exempt another financial institution from which it buys or sells currency must be designated exempt by the close of the 30 day period beginning after the day of the first reportable transaction in currency with the other financial institution. Federal Reserve Banks are excluded from this requirement.

Exemption forms for "Phase II" persons need to be renewed and filed every two years, assuming that the "exempt person" continues to meet all exemption criteria, as verified and documented in the required annual review process discussed above. The filing must be made by March 15th of the second calendar year following the year in which the initial exemption was granted, and by every other March 15th thereafter. When filing a biennial renewal of the exemption for these customers, the financial institution will need to indicate any change in ownership of the business. Initial exemption of a "non-listed business" or "payroll customer" must be made within 30 days after the day of the first reportable transaction in currency that the financial institution wishes to include under the exemption. Form TD F 90-22.53 can be also used to revoke or amend an exemption.

CTR Backfiling

Examiners may determine that a financial institution has failed to file CTRs in accordance with 31 CFR 103, or has improperly exempted customers from CTR filings. In situations where an institution has failed to file a number of CTRs on reportable transactions for any reason, examiners should instruct management to promptly contact the IRS Detroit Computing Center (IRS DCC), Compliance Review Group for instructions and guidance concerning the possible requirement to backfile CTRs for those affected transactions. The IRS DCC will provide an initial determination on whether CTRs should be backfiled in those cases. Cases that involve substantial noncompliance with CTR filing requirements are referred to FinCEN for review. Upon review, FinCEN may correspond directly with the institution to discuss the program deficiencies that resulted in the institution's failure to appropriately file a CTR and the corrective action that management has implemented to prevent further infractions.

When a backfiling request is necessary, examiners should direct financial institutions to write a letter to the IRS at the IRS Detroit Computing Center, Compliance Review Group Attn: Backfiling, P.O. Box 32063, Detroit, Michigan, 48232-0063 that explains why CTRs were not filed. Examiners should also provide the financial institution a copy of the "Check List for CTR Filing Determination" form available on the FDIC's website. The financial institution will need to complete this form and include it with the letter to the IRS.

Once an institution has been instructed to contact IRS DCC for a backfiling determination, examiners should notify both their Regional Special Activities Case Manager (SACM) or other designees and the Special Activities Section (SAS) in Washington, D.C. Specific contacts are listed on the FDIC's Intranet website. Requisite information should be forwarded electronically via e-mail to these contacts.

Currency and Banking Retrieval System

The Currency and Banking Retrieval System (CBRS) is a database of CTRs, SARs, and CTR Exemptions filed with the IRS. It is maintained at the IRS Detroit Computing Center. The SAS, as well as each Region's SACM and other designees, has on-line access to the CBRS. Refer to your Regional Office for a full listing of those individuals with access to the FinCEN database.

Examiners should routinely receive volume and trend information on CTRs and SARs from their Regional SACM or other designees for each examination or visitation prior to the pre-planning process. In addition, the database information may be used to verify CTR, SAR and/or CTR Exemption filings. Detailed FinCEN database information may be used for expanded BSA reviews or in any unusual circumstances where examiners suspect certain forms have not been filed by the financial institution, or where suspicious activity by individuals has been detected.

Examiners should provide all of the following items they have available for each search request:

- The name of the subject of the search (financial institution and/or individual/entity);
- The subject's nine-digit TIN/SSN (in Part III of the CTR form if seeking information on the financial institution and/or Part I of the CTR form if seeking information on the individual/entity); and
- The date range for which the information is requested.

When requesting a download or listing of CTR and SAR information, examiners should take into consideration the volume of CTRs and SARs filed by the financial institution under examination when determining the date range requested. Except under unusual circumstances, the date range for full listings should be no greater than one year. For financial institutions with a large volume of records, three months or less may be more appropriate.

Since variations in spellings of an individual's name are possible, accuracy of the TIN/SSN is essential in ensuring accuracy of the information received from the FinCEN database. To this end, examiners should also identify any situations where a financial institution is using more than one tax identification number to file their CTRs and/or SARs. To reduce the possibility of error in communicating CTR and SAR information/verification requests, examiners are requested to e-mail or fax the request to their Regional SACM or other designee.

Other FinCEN Reports

Report of International Transportation of Currency or Monetary Instruments

Treasury regulation 31 CFR 103.23 requires the filing of FinCEN Form 105, formerly Form 4790, to comply with other Treasury regulations and U.S. Customs disclosure requirements involving physical transport, mailing or shipping of currency or monetary instruments greater than $10,000 at one time out of or into the U.S. The report is to be completed by or on behalf of the person requesting the transfer of the funds and filed within 15 days. However, financial institutions are not required to report these items if they are mailed or shipped through the postal service or by common carrier. Also excluded from reporting are those items that are shipped to or received from the account of an established customer who maintains a deposit relationship with the bank, provided the item amounts are commensurate with the customary conduct of business of the customer concerned.

In situations where the quantity, dollar volume, and frequency of the currency and/or monetary instruments are not commensurate with the customary conduct of the customer, financial institution management will need to conduct further documented research on the customer's transactions and determine whether a SAR should be filed with FinCEN. Please refer to the discussion on "Customer Due Diligence" and "Suspicious Activity Reporting" within this chapter for detailed guidance.

Reports of Foreign Bank Accounts

Within 31 CFR 103.24, the Treasury requires each person who has a financial interest in or signature authority, or other authority over any financial accounts, including bank, securities, or other types of financial accounts, maintained in a foreign country to report those relationships to the IRS annually if the aggregate value of the accounts exceeds

$10,000 at any point during the calendar year. The report should be filed by June 30 of the succeeding calendar year, using Form TD F 90-22.1 available on the FinCEN website. By definition, a foreign country includes all locations outside the United States, Guam, Puerto Rico, the Virgin Islands, the Northern Mariana Islands, American Samoa, and Trust Territory of the Pacific Islands. U.S. military banking facilities are excluded. Foreign assets including securities issued by foreign corporations that are held directly by a U.S. person, or through an account maintained with a U.S. office of a bank or other institution are not subject to the BSA foreign account reporting requirements. The bank is also not required to report international interbank transfer accounts (“nostro accounts”) held by domestic banks. Also excluded are accounts held in a foreign financial institution in the name of, or on behalf of, a particular customer of the financial institution, or that are used solely for the transactions of a particular customer. Finally, an officer or employee of a federally-insured depository institution branch, or agency office within the U.S. of a foreign bank that is subject to the supervision of a Federal bank regulatory agency need not report that he or she has signature or other authority over a foreign bank, securities or other financial account maintained by such entities unless he or she has a personal financial interest in the account.

FinCEN Recordkeeping Requirements

Required Records for Sales of Monetary Instruments for Cash

Treasury regulation 31 CFR 103.29 prohibits financial institutions from issuing or selling monetary instruments purchased with cash in amounts of $3,000 to $10,000, inclusive, unless it obtains and records certain identifying information on the purchaser and specific transaction information. Monetary instruments include bank checks, bank drafts, cashier’s checks, money orders, and traveler’s checks. Furthermore, the identifying information of all purchasers must be verified. The following information must be obtained from a purchaser who has a deposit account at the financial institution:

- Purchaser’s name;
- Date of purchase;
- Type(s) of instrument(s) purchased;
- Serial number(s) of each of the instrument(s) purchased; and
- Amounts in dollars of each of the instrument(s) purchased.

If the purchaser does not have a deposit account at the financial institution, the following additional information must be obtained:

- Address of the purchaser (a post office box number is not acceptable);
- Social security number (or alien identification number) of the purchaser;
- Date of birth of the purchaser; and
- Verification of the name and address with an acceptable document (i.e. driver’s license).

The regulation requires that multiple purchases during one business day be aggregated and treated as one purchase. Purchases of different types of instruments at the same time are treated as one purchase and the amounts should be aggregated to determine if the total is $3,000 or more. In addition, the financial institution should have procedures in place to identify multiple purchases of monetary instruments during one business day, and to aggregate this information from all of the bank branch offices.

If a customer first deposits the cash in a bank account, then purchases a monetary instrument(s), the transaction is still subject to this regulatory requirement. The financial institution is not required to maintain a log for these transactions, but should have procedures in place to recreate the transactions.

The information required to be obtained under 31 CFR 103.29 must be retained for a period of five years.

Funds Transfer and Travel Rule Requirements

Treasury regulation 31 CFR Section 103.33 prescribes information that must be obtained for funds transfers in the amount of $3,000 or more. There is a detailed discussion of the recordkeeping requirements and risks associated with wire transfers within the “Banking Services and Activities with Greater Potential for Money Laundering and Terrorist Financing Vulnerabilities” discussion within this chapter.

Records to be Made and Retained by Financial Institutions

Treasury regulation 31 CFR 103.33 states that each financial institution must retain either the original or a microfilm or other copy/reproduction of each of the following:

- A record of each extension of credit in an amount in excess of $10,000, except an extension of credit secured by an interest in real property. The record

must contain the name and address of the borrower, the loan amount, the nature or purpose of the loan, and the date the loan was made. The stated purpose can be very general such as a passbook loan, personal loan, or business loan. However, financial institutions should be encouraged to be as specific as possible when stating the loan purpose. Additionally, the purpose of a renewal, refinancing, or consolidation is not required as long as the original purpose has not changed and the original statement of purpose is retained for a period of five years after the renewal, refinancing or consolidation has been paid out.
- A record of each advice, request, or instruction received or given regarding any transaction resulting in the transfer of currency or other monetary instruments, funds, checks, investment securities, or credit, of more than $10,000 to or from any person, account, or place outside the U.S. This requirement also applies to transactions later canceled if such a record is normally made.

Required Records for Deposit Accounts

Treasury regulation 31 CFR 103.34 requires banking institutions to obtain and retain a social security number or taxpayer identification number for each deposit account opened after June 30, 1972, and before October 1, 2003. The same information must be obtained for each certificate of deposit sold or redeemed after May 31, 1978, and before October 1, 2003. The banking institution must make a reasonable effort to obtain the identification number within 30 days after opening the account, but will not be held in violation of the regulation if it maintains a list of the names, addresses, and account numbers of those customers from whom it has been unable to secure an identification number. Where a person is a nonresident alien, the banking institution shall also record the person's passport number or a description of some other government document used to verify his/her identity.

Furthermore, 31 CFR 103.34 generally requires banks to maintain records of items needed to reconstruct transaction accounts and other receipts or remittances of funds through a bank. Specific details of these requirements are in the regulation.

Record Retention Period and Nature of Records

All records required by the regulation shall be retained for five years. Records may be kept in paper or electronic form. Microfilm, microfiche or other commonly accepted forms of records are acceptable as long as they are accessible within a reasonable period of time. The record should be able to show both the front and back of each document. If no record is made in the ordinary course of business of any transaction with respect to which records are required to be retained, then such a record shall be prepared in writing by the financial institution.

CUSTOMER IDENTIFICATION PROGRAM

Section 326 of the USA PATRIOT Act, which is implemented by 31 CFR 103.121, requires banks, savings associations, credit unions, and certain non-federally regulated banks to implement a written Customer Identification Program (CIP) appropriate for its size and type of business. For Section 326, the definition of **financial institution** encompasses a variety of entities, including **banks**, agencies and branches of foreign banks in the U.S., thrifts, credit unions, private banks, trust companies, investment companies, brokers and dealers in securities, futures commission merchants, insurance companies, travel agents, pawnbrokers, dealers in precious metals, check cashers, casinos, and telegraph companies, among many others identified at 31 USC 5312(a)(2) and (c)(1)(A). As of October 1, 2003, all institutions and their operating subsidiaries must have in place a CIP pursuant to Treasury regulation 31 CFR 103.121.

The CIP rules do not apply to a **financial institution**’s foreign subsidiaries. However, **financial institutions** are encouraged to implement an effective CIP throughout their operations, including their foreign offices, except to the extent that the requirements of the rule would conflict with local law.

Applicability of CIP Regulation

The CIP rules apply to **banks**, as defined in 31 CFR 103.11 that are subject to regulation by a Federal Banking Agency and to any non-Federally-insured credit union, private bank or trust company that does not have a Federal functional regulator. Entities that are regulated by the U.S. Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) are subject to separate rulemakings. It is intended that the effect of all of these rules be uniform throughout the financial services industry.

CIP Requirements

31 CFR 103.121 requires a **bank** to develop and implement a written, board-approved CIP, appropriate for its size and type of business that includes, at a minimum, procedures for:

- Verifying a customer's true identity to the extent reasonable and practicable and defining the methodologies to be used in the verification process;
- Collecting specific identifying information from each customer when opening an account;
- Responding to circumstances and defining actions to be taken when a customer's true identity cannot be appropriately verified with "reasonable belief;"
- Maintaining appropriate records during the collection and verification of a customer's identity;
- Verifying a customer's name against specified terrorist lists; and
- Providing customers with adequate notice that the **bank** is requesting identification to verify their identities.

While not required, a **bank** may also include procedures for:

- Specifying when it will rely on another **financial institution** (including an affiliate) to perform some or all of the elements of the CIP.

Additionally, 31 CFR 103.121 provides that a **bank** with a Federal functional regulator must formally incorporate its CIP into its written board-approved anti-money laundering program. The FDIC expanded Section 326.8 of its Rules and Regulations to require each **FDIC-supervised institution** to implement a CIP that complies with 31 CFR 103.121 and incorporate such CIP into a bank's written board-approved BSA compliance program (with evidence of such approval noted in the board meeting minutes). Consequently, a **bank** must specifically provide:

- Internal policies, procedures, and controls;
- Designation of a compliance officer;
- Ongoing employee training programs; and
- An independent audit function to test program.

The slight difference in wording between the Treasury's and FDIC's regulations regarding incorporation of a bank's CIP within its anti-money laundering program and BSA compliance program, respectively, was not intended to create duplicative requirements. Therefore, an FDIC-regulated **bank** must include its CIP within its anti-money laundering program and the latter included under the "umbrella" of its overall BSA/AML program.

CIP Definitions

As discussed above, both Section 326 of the USA PATRIOT Act and 31 CFR 103.121 specifically define the terms **financial institution** and **bank**. Similarly, specific definitions are provided for the terms **person**, **customer**, and **account**. Both bank management and examiners must properly understand these terms in order to effectively implement and assess compliance with CIP regulations, respectively.

Person

A **person** is generally an individual or other legal entity (such as registered corporations, partnerships, and trusts).

Customer

A **customer** is generally defined as any of the following:

- A **person** that opens a new **account** (**account** is defined further within the discussion of CIP definitions);
- An individual acting with "power of attorney"(POA)[3] who opens a new **account** to be owned by or for the benefit of a **person** lacking legal capacity, such as a minor;
- An individual who opens an **account** for an entity that is not a legal person, such as a civic club or sports boosters;
- An individual added to an existing **account** or one who assumes an existing debt at the **bank;** or
- A deposit broker who brings new customers to the bank (as discussed in detail later within this section).

The definition of **customer** excludes:

- A financial institution regulated by a Federal Banking Agency or a bank regulated by a State bank regulator[4];
- A department or agency of the U.S. Government, of any state, or of any political subdivision of any state;
- Any entity established under the laws of the U.S., of any state, or of any political subdivision of any state, or under an interstate compact between two or more states, that exercises governmental authority on behalf of the U.S. or any such state or political subdivision (U.S. includes District of Columbia and Indian tribal lands and governments); or

[3] If a POA individual opens an account for another individual with legal capacity or for a legal entity, then the **customer** is still the account holder. In this case, the POA is an agent acting on behalf of the **person** that opens the account and the CIP must still cover the account holder (unless the person lacks legal capacity).

[4] The IRS is not a Federal functional regulator. Consequently, money service businesses, such as check cashers and wire transmitters that are regulated by the IRS are not exempted from the definition of customer for CIP purposes.

- Any entity, other than a bank, whose common stock or analogous equity interests are listed on the New York or American Stock Exchanges or whose common stock or analogous equity interests have been designated as a NASDAQ National Market Security listed on the NASDAQ Stock Market (except stock or interests listed under the separate "NASDAQ Small-Cap Issues" heading). A listed company is exempted from the definition of **customer** only for its domestic operations.

The definition of **customer** also excludes a **person** who has an existing account with a bank, provided that the bank has a "reasonable belief" that it knows the true identity of the **person**. So, if the **person** were to open an additional account, or renew or roll over an existing account, CIP procedures would not be required. A bank can demonstrate that is has a "reasonable belief" that it knows the identity of an existing customer by:

- Demonstrating that it had similar procedures in place to verify the identity of **persons** prior to the effective date of the CIP rule. (An "affidavit of identity" by a bank officer is not acceptable for demonstrating "reasonable belief.")
- Providing a history of **account** statements sent to the **person.**
- **Maintaining account** information sent to the IRS regarding the **person's accounts** accompanied by IRS replies that contain no negative comments.
- Providing evidence of loans made and repaid, or other services performed for the **person** over a period of time.

These actions may not be sufficient for existing account holders deemed to be high risk. For example, in the situation of an import/export business where the identifying information on file only includes a number from a passport marked as a duplicate with no additional business information on file, the bank should follow all of the CIP requirements provided in 31 CFR 103.121 since it does not have sufficient information to show a "reasonable belief" of the true identity of the existing account holder.

Account

An **account** is defined as a formal, ongoing banking relationship established to provide or engage in services, dealings, or other financial transactions including:

- Deposit accounts;
- Transaction or asset accounts ;
- Credit accounts, or any other extension of credit;
- Safety deposit box or other safekeeping services;
- Cash management, custodian, and trust services; or
- Any other type of formal, ongoing banking relationship.

The definition of **account** specifically excludes the following:

- Product or service where a formal banking relationship is NOT established with a **person**. Thus CIP is not intended for infrequent transactions and activities (already covered under other recordkeeping requirements within 31 CFR 103) such as:
  - Check cashing,
  - Wire transfers,
  - Sales of checks,
  - Sales of money orders;
- Accounts acquired through an acquisition, merger, purchase of assets, or assumption of liabilities (as these "new" accounts were not initiated by customers);[5] and
- Accounts opened for the purpose of participating in an employee benefit plan established under the Employee Retirement Income Security Act of 1974 (ERISA).

Furthermore, the CIP requirements do not apply to a **person** who does not receive banking services, such as a **person** who applies for a loan but has his/her application denied. The **account** in this circumstance is only opened when the bank enters into an enforceable agreement to provide a loan to the **person** (who therefore also simultaneously becomes a **customer**).

Collecting Required Customer Identifying Information

The CIP must contain account opening procedures that specify the identifying information obtained from each customer prior to opening the account. The minimum required information includes:

- Name.
- Date of birth, for an individual.

[5] Accounts acquired by purchase of assets from a third party are excluded from the CIP regulations, provided the purchase was not made under an agency in place or exclusive sale arrangement, where the bank has final approval of the credit. If under an agency arrangement, the bank may rely on the agent third party to perform the bank's CIP, but it must ensure that the agent is performing the bank's CIP program. For example, a pool of auto loans purchased from an auto dealer after the loans have already been made would not be subject to the CIP regulations. However, if the bank is directly extending credit to the borrower and is using the car dealer as its agent to gather information, then the bank must ensure that the dealer is performing the bank's CIP.

- Physical address[6], which shall be:
  - for an individual, a residential or business street address (An individual who does not have a physical address may provide an Army Post Office [APO] or a Fleet Post Office [FPO] box number, or the residential or business street address of next of kin or of another contact individual. Using the box number on a rural route is acceptable description of the physical location requirement.)
  - for a person other than an individual (such as corporations, partnerships, and trusts), a principal place of business, local office, or other physical location.
- Identification number including a SSN, TIN, Individual Tax Identification Number (ITIN), or Employer Identification Number (EIN).

For non-U.S. persons, the bank must obtain one or more of the following identification numbers:

- Customer's TIN,
- Passport number and country of issuance,
- Alien identification card number, and
- Number and country of issuance of any other (foreign) government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

When opening an account for a foreign business or enterprise that does not have an identification number, the bank must request alternative government-issued documentation certifying the existence of the business or enterprise.

Exceptions to Required Customer Identifying Information

The bank may develop, include, and follow CIP procedures for a customer who at the time of account opening, has applied for, but has not yet received, a TIN. However, the CIP must include procedures to confirm that the application was filed before the customer opens the account and procedures to obtain the TIN within a reasonable period of time after the account is opened.

There is also an exception to the requirement that a bank obtain the above-listed identifying information <u>from the customer</u> prior to opening an account in the case of credit card accounts. A bank may obtain identifying information (such as TIN) <u>from a third-party source</u> prior to extending credit to the customer.

Verifying Customer Identity Information

The CIP should rely on a **risk-focused** approach when developing procedures for verifying the identity of each customer to the extent reasonable and practicable. A bank need not establish the accuracy of every element of identifying information obtained in the account opening process, but must do so for enough information to form a "reasonable belief" that it knows the true identity of each customer. At a minimum, the **risk-focused** procedures must be based on, but not limited to, the following factors:

- Risks presented by the various types of accounts offered by the bank;
- Various methods of opening accounts provided by the bank;
- Various sources and types of identifying information available; and
- The bank's size, location, and customer base.

Furthermore, a bank's CIP procedures must describe when the bank will use **documentary verification methods**, **non-documentary verification methods**, or a **combination of both methods**.

<u>Documentary Verification</u>

The CIP must contain procedures that set forth the specific documents that the bank will use. For an individual, the documents may include:

- Unexpired government-issued identification evidencing nationality or residence, and bearing a photograph or similar safeguard, such as a driver's license or passport.

For a person other than an individual (such as a corporation, partnership, or trust), the documents may include:

- Documents showing the existence of the entity, such as certified articles of incorporation, a government-issued business license, a partnership agreement, trust instrument, a certificate of good standing, or a business resolution.

<u>Non-Documentary Verification</u>

[6] The bank MUST obtain a physical address: a P.O. Box alone is NOT acceptable. Collection of a P.O. Box address and/or alternate mailing address is optional and potentially very useful as part of the bank's Customer Due Diligence (CDD) program.

Banks are not required to use non-documentary methods to verify a customer's identity. However, if a bank chooses to do so, a description of the approved non-documentary methods must be incorporated in the CIP. Such methods may include:

- Contacting the customer,
- Checking references with other financial institution,
- Obtaining a financial statement, and
- Independently verifying the customer's identity through the comparison of information provided by the customer with information obtained from consumer reporting agencies (for example, Experian, Equifax, TransUnion, Chexsystems), public databases (for example, Lexis, Dunn and Bradstreet), or other sources (for example, utility bills, phone books, voter registration bills).

The bank's non-documentary procedures must address situations such as:

- The inability of a customer to present an unexpired government-issued identification document that bears a photograph or similar safeguard;
- Unfamiliarity on the bank's part with the documents presented;
- Accounts opened without obtaining documents;
- Accounts opened without the customer appearing in person at the bank (for example, accounts opened through the mail or over the Internet); and
- Circumstances increasing the risk that the bank will be unable to verify the true identity of a customer through documents.

Many of the risks presented by these situations can be mitigated. A bank that accepts items that are considered secondary forms of identification, such as utility bills and college ID cards, is encouraged to review more than a single document to ensure that it has formed a "reasonable belief" of the customer's true identity. Furthermore, in instances when an account is opened over the Internet, a bank may be able to obtain an electronic credential, such as a digital certificate, as one of the methods it uses to verify a customer's identity.

Additional Verification Procedures for Customers (Non-Individuals)

The CIP must address situations where, based on a risk assessment of a new account that is opened by a customer that is not an individual, the bank will obtain information about individuals with authority or control over such accounts, in order to verify the customer's identity. These individuals could include such parties as signatories, beneficiaries, principals, and guarantors. As previously stated, a risk-focused approach should be applied to verify customer accounts. For example, in the case of a well-known firm, company information and verification could be sufficient without obtaining and verifying identity information for all signatories. However, in the case of a relatively new or unknown firm, it would be in the bank's best interest to obtain and verify a greater volume of information on signatories and other individuals with control or authority over the firm's account.

Inability to Verify Customer Identity Information

The CIP must include procedures for responding to circumstances in which the bank cannot form a reasonable belief that it knows the true identity of a customer. These procedures should describe, at a minimum, the following:

- Circumstances when the bank should not open an account;
- The terms or limits under which a customer may use an account while the bank attempts to verify the customer's identity (for example, minimal or no funding on credit cards, holds on deposits, limits on wire transfers);
- Situations when an account should be closed after attempts to verify a customer's identity have failed; and
- Conditions for filing a SAR in accordance with applicable laws and regulations.

Recordkeeping Requirements

The bank's CIP must include recordkeeping procedures for:

- Any document that was relied upon to verify identity noting the type of document, the identification number, the place of issuance, and, if any, the dates of issuance and expiration;
- The method and results of any measures undertaken to perform non-documentary verification procedures; and
- The results of any substantive discrepancy discovered when verifying the identifying information obtained.

Banks are not required to make and retain photocopies of any documents used in the verification process. However, if a bank does choose to do so, it must ensure that these photocopies are physically secured to adequately protect against possible identity theft. In addition, such photocopies should not be maintained with files and documentation relating to credit decisions in order to avoid any potential problems with consumer compliance regulations.

Required Retention Period

All required customer identifying information obtained in the account opening process must be retained for five years after the account is closed, or in the case of credit card accounts, five years after the account is closed or becomes dormant. The other "required records" (descriptions of documentary and non-documentary verification procedures and any descriptions of substantive discrepancy resolution) must be retained for five years after the record is made. If several accounts are opened at a bank for a customer simultaneously, all of the required customer identifying information obtained in the account opening process must be retained for five years after the last account is closed, or in the case of credit card accounts, five years after the last account is closed or becomes dormant. As in the case of a single account, all other "required records" must be kept for five years after the records are made.

Comparison with Government Lists of Known or Suspected Terrorists

The CIP must include procedures for determining whether the customer appears on any list of known or suspected terrorists or terrorist organizations issued by any Federal government agency and designated as such by the Treasury in consultation with the other Federal functional regulators.

The comparison procedures must be performed and a determination made within a reasonable period of time after the account is opened, or earlier, as required and directed by the issuing agency. Since the USA PATRIOT Act Section 314(a) Requests, discussed in detail under the heading entitled "Special Information Sharing Procedures to Deter Money Laundering and Terrorist Activities," are one-time only searches, they are not applicable to the CIP.

Adequate Customer Notice

The CIP must include procedures for providing customers with adequate notice that the bank is requesting information to verify their identities. This notice must indicate that the institution is collecting, verifying, and recording the customer identity information as outlined in the CIP regulations. Furthermore, the customer notice must be provided prior to account opening, with the general belief that it will be clearly read and understood. This notice may be posted on a lobby sign, included on the bank's website, provided orally, or disclosed in writing (for example, account application or separate disclosure form). The regulation provides sample language that may be used for providing adequate customer notice. In the case of joint accounts, the notice must be provided to all joint owners; however, this may be accomplished by providing notice to one owner for delivery to the other owners.

Reliance on Another Financial Institution's CIP

A bank may develop and implement procedures for relying on another financial institution for the performance of CIP procedures, yet the CIPs at both entities do not have to be identical. The reliance can be used with respect to any bank customer that is opening or has opened an account or similar formal relationship with the relied-upon financial institution. Additionally, the following requirements must be met:

- Reliance is reasonable, under the circumstances;
- The relied-upon financial institution (including an affiliate) is subject to the same anti-money laundering program requirements as a bank, and is regulated by a Federal functional regulator (as previously defined); and
- A signed contract exists between the two entities that requires the relied-upon financial institution to certify annually that it has implemented its anti-money laundering program, and that it will perform (or its agent will perform) the specified requirements of the bank's CIP.

To strengthen such an arrangement, the signed contract should include a provision permitting the bank to have access to the relied-upon institution's annual independent review of its CIP.

Deposit Broker Activity

The use of deposit brokers is a common funding mechanism for many financial institutions. This activity is considered higher risk because each deposit broker operates under its own operating guidelines to bring customers to a bank. Consequently, the deposit broker may not be performing sufficient Customer Due Diligence (CDD), Office of Foreign Assets Control (OFAC) screening (refer to the detailed OFAC discussion provided elsewhere within this chapter), or CIP procedures. The bank accepting brokered deposits relies upon the deposit broker to have sufficiently performed all required account opening procedures and to have followed all BSA and AML program requirements.

Deposit Broker is Customer

Regulations contained in 31 CFR 103.121 specifically defines the term customer as a person (individual, registered corporation, partnership, or trust). Therefore, according to this definition, if a deposit broker opens an account(s), the customer is the deposit broker NOT the deposit broker's clients.

Deposit Broker's CIP

Deposit brokers must follow their own CIP requirements for their customers. If the deposit broker is registered with the SEC, then it is required to follow the same general CIP requirements as banking institutions and is periodically examined by the SEC for compliance. However, if the deposit broker does not come under the SEC's jurisdiction, they may not be following any due diligence laws or guidelines.

As such, banks accepting deposit broker accounts should establish policies and procedures regarding the brokered deposits. Policies should establish minimum due diligence procedures for all deposit brokers providing business to the bank. The level of due diligence a bank performs should be commensurate with its knowledge of the deposit broker and the broker's known business practices.

Banks should conduct **enhanced** due diligence on unknown and/or unregulated deposit brokers. For protection, the bank should determine that the:

- Deposit broker is legitimate;
- Deposit broker is following appropriate guidance and/or regulations;
- Deposit broker's policies and procedures are sufficient;
- Deposit broker has adequate CIP verification procedures;
- Deposit broker screens clients for OFAC matches;
- BSA/OFAC audit reviews are adequate and show compliance with requirements; and
- Bank management is aware of the deposit broker's anticipated volume and transaction type.

Special care should be taken with deposit brokers who:

- Are previously unknown to the bank;
- Conduct business or obtain deposits primarily in another country;
- Use unknown or hard-to-contact businesses and banks for references;
- Provide other services which may be suspect, such as creating shell corporations for foreign clients;
- Advertise their own deposit rates, which vary widely from those offered by banking institutions; and
- Refuse to provide requested due diligence information or use methods to get deposits placed before providing information.

Banks doing business with deposit brokers are encouraged to include contractual requirements for the deposit broker to establish and conduct procedures for minimum CIP, CDD, and OFAC screening.

Finally, the bank should monitor brokered deposit activity for unusual activity, including cash transactions, structuring, and funds transfer activity. Monitoring procedures should identify any "red flags" suggesting that the deposit broker's customers (the ultimate customers) are trying to conceal their true identities and/or their source of wealth and funds.

Additional Guidance on CIP Regulations

Comprehensive guidance regarding CIP regulations and related examination procedures can be found within FDIC FIL 90-2004, Guidance on Customer Identification Programs. On January 9, 2004, the Treasury, FinCEN, and the Federal Financial Institutions Examination Council (FFIEC) regulatory agencies issued joint interpretive guidance addressing frequently asked questions (FAQs) relating to CIP requirements in FIL-4-2004. Additional information regarding CIP can be found on the FinCEN website.

SPECIAL INFORMATION SHARING PROCEDURES TO DETER MONEY LAUNDERING AND TERRORIST ACTIVITIES

Section 314 of the USA PATRIOT Act covers special information sharing procedures to deter money laundering and terrorist activities. These are the only two categories that apply under Section 314 information sharing; no information concerning other suspicious or criminal activities can be shared under the provisions of Section 314 of the USA PATRIOT Act. Final regulations of the following two rules issued on March 4, 2002, became effective on September 26, 2002:

- Section 314(a), codified into 31 CFR 103.100, requires **mandatory** information sharing between the U.S. Government (FinCEN, Federal law enforcement agencies, and Federal Banking Agencies) and financial institutions.
- Section 314(b), codified into 31 CFR 103.110, encourages **voluntary** information sharing between financial institutions and/or associations of financial institutions.

Section 314(a) – Mandatory Information Sharing Between the U.S. Government and Financial Institutions

A Federal law enforcement agency investigating terrorist activity or money laundering may request that FinCEN solicit, on its behalf, certain information from a financial institution or a group of financial institutions on certain individuals or entities. The law enforcement agency must provide a written certification to FinCEN attesting that credible evidence of money laundering or terrorist activity exists. It must also provide specific identifiers such as date of birth, address, and social security number of the individual(s) under investigation that would permit a financial institution to differentiate among customers with common or similar names.

Section 314(a) Requests

Upon receiving an adequate written certification from a law enforcement agency, FinCEN may require financial institutions to perform a search of their records to determine whether they maintain or have maintained accounts for, or have engaged in transactions with, any specified individual, entity, or organization. This process involves providing a Section 314(a) Request to the financial institutions. Such lists are issued to financial institutions every two weeks by FinCEN.

Each Section 314(a) request has a unique tracking number. The general instructions for a Section 314(a) Request require financial institutions to complete a **one-time** search of their records and respond to FinCEN, if necessary, within **two weeks**. However, individual requests can have different deadline dates. Any specific guidelines on the request supercede the general guidelines.

<u>Designated Point-of-Contact for Section 314(a) Requests</u>

All financial institutions shall designate at least one point-of-contact for Section 314(a) requests and similar information requests from FinCEN. FDIC-supervised financial institutions must promptly notify the FDIC of any changes to the point-of-contact, which is reported on each Call Report.

Financial Institution Records Required to be Searched

The records that must be searched for a Section 314(a) Request are specified in the request itself. Using the identifying information contained in the 314(a) request, financial institutions are required to conduct a **one-time** search of the following records, **whether or not they are kept electronically (subject to the limitations below)**:

- Deposit account records;
- Funds transfer records;
- Sales of monetary instruments (purchaser only);
- Loan records;
- Trust department records;
- Securities records (purchases, sales, safekeeping, etc.);
- Commodities, options, and derivatives; and
- Safe deposit box records (but only if searchable electronically).

According to the general instructions to Section 314(a), financial institutions are NOT required to research the following documents for matches:

- Checks processed through an account for a payee,
- Monetary instruments for a payee,
- Signature cards, and
- CTRs and SARs previously filed.

The general guidelines specify that the record search need only encompass current accounts and accounts maintained by a named subject during the preceding twelve (12) months, and transactions not linked to an account conducted by a named subject during the preceding six (6) months. Any record described above that is not maintained in electronic form need only be searched if it is required to be kept under federal law or regulation.

Again, if the specific guidelines or the timeframe of records to be searched on a Section 314(a) Request differ from the general guidelines, they should be followed to the extent possible. For example, if a particular Section 314(a) Request asks financial institutions to search their records back eight years, the financial institutions should honor such requests to the extent possible, even though BSA recordkeeping requirements generally do not require records to be retained beyond five years.

Reporting of "Matches"

Financial institutions typically have a two-week window to complete the one-time search and respond, if necessary to FinCEN. If a financial institution identifies an account or transaction by or on behalf of an individual appearing on a Section 314(a) Request, it must report back to FinCEN that it has a "positive match," unless directed otherwise. When reporting this information to FinCEN, no additional details, unless otherwise instructed, should be provided other than the fact that a "positive match" has been identified. In situations where a financial institution is unsure of a match, it may contact the law enforcement agency specified in the Section 314(a) Request. Negative responses to Section 314(a) Requests are not required; the financial institution does not need to respond to FinCEN on a Section 314(a) Request if there are no matches to the institution's records. Financial institutions are to be reminded that unless a name is repeated on a subsequent Section 314(a) Request, that name does not need to be searched again.

The financial institution **must not** notify a customer that he/she has been included on a Section 314(a) Request. Furthermore, the financial institution must not tell the customer that he/she is under investigation or that he/she is suspected of criminal activity.

Restrictions on Use of Section 314(a) Requests

A financial institution may only use the information identified in the records search to report "positive matches" to FinCEN and to file, when appropriate, SARs. If the financial institution has a "positive match," account activity with that customer or entity is not prohibited; it is acceptable for the financial institution to open new accounts or maintain current accounts with Section 314(a) Request subjects; the closing of accounts is not required. However, the Section 314(a) Requests may be useful as a determining factor for such decisions if the financial institution so chooses. Unlike OFAC lists, Section 314(a) Requests are not permanent "watch lists." In fact, Section 314(a) Requests are not updated or corrected if an investigation is dropped, a prosecution is declined, or a subject is exonerated, as they are point-in-time inquiries. Furthermore, the names provided on Section 314(a) Requests do not necessarily correspond to convicted or indicted persons; rather, a Section 314(a) Request subject need only be "reasonably suspected," based on credible evidence of engaging in terrorist acts or money laundering to appear on the list.

<u>SAR Filings</u>

If a financial institution has a positive match within its records, it is not required to automatically file a SAR on the identified subject. In other words, the subject's presence on the Section 314(a) Request should not be the sole factor in determining whether to file a SAR. However, prudent BSA compliance practices should ensure that the subject's accounts and transactions be scrutinized for suspicious or unusual activity. If, after such a review is performed, the financial institution's management has determined that the subject's activity is suspicious, unusual, or inconsistent with the customer's profile, then the timely filing of an SAR would be warranted.

Confidentiality of Section 314(a) Requests

Financial institutions must protect the security of the Section 314(a) Requests, as they are confidential. As stated previously, a financial institution must not tip off a customer that he/she is the subject of a Section 314(a) Request. Similarly, a financial institution cannot disclose to any person or entity, other than to FinCEN, its primary Federal functional regulator, or the Federal law enforcement agency on whose behalf FinCEN is requesting information, the fact that FinCEN has requested or obtained information from a Section 314(a) Request.

FinCEN has stated that an affiliated group of financial institutions may establish one point-of-contact to distribute the Section 314(a) Requests for the purpose of responding to requests. However, the Section 314(a) Requests should not be shared with foreign affiliates or foreign subsidiaries (unless the request specifically states otherwise), and the lists cannot be shared with affiliates or subsidiaries of bank holding companies that are not financial institutions.

Notwithstanding the above restrictions, a financial institution is authorized to share information concerning an individual, entity, or organization named in a Section 314(a) Request from FinCEN with other financial institutions and/or financial institution associations in accordance with the certification and procedural requirements of Section 314(b) of the USA PATRIOT Act discussed below. However, such sharing shall not disclose the fact that FinCEN has requested information on the subjects or the fact that they were included within a Section 314(a) Request.

<u>Internal Financial Institution Measures for Protecting Section 314(a) Requests</u>

In order to protect the confidentiality of the Section 314(a) Requests, these documents should only be provided to financial institution personnel who need the information to conduct the search and should not be left in an unprotected or unsecured area. A financial institution may provide the Section 314(a) Request to third-party information technology service providers or vendors to perform/facilitate the record searches so long as it takes the necessary steps to ensure that the third party appropriately safeguards the information. It is important to remember that the financial institution remains ultimately responsible for the performance of the required searches and to protect the security and confidentiality of the Section 314(a) Requests.

Each financial institution must maintain adequate procedures to protect the security and confidentiality of requests from FinCEN. The procedures to ensure confidentiality will be considered adequate if the financial institution applies procedures similar to those it has established to comply with Section 501 of the Gramm-Leach-Bliley Act (15 USC 6801) with regard to the protection of its customers' non-public personal information.

Financial institutions should keep a log of all Section 314(a) Requests received and any "positive matches" identified and reported to FinCEN. Additionally, documentation that all required searches were performed is essential. The financial institution should not need to keep copies of the Section 314(a) Requests, noting the unique tracking number will suffice. Some financial institutions may choose to destroy the Section 314(a) Requests after searches are performed. If a financial institution chooses to keep the Section 314(a) Requests for audit/internal review purposes, it should not be criticized for doing so, as long as it appropriately secures them and protects their confidentiality.

FinCEN has provided financial institutions with general instructions, FAQs, and additional guidance relating to the Section 314(a) Request process. These documents are revised periodically and may be found on FinCEN's Web site.

Section 314(b) - Voluntary Information Sharing

Section 314(b) of the USA PATRIOT Act encourages financial institutions and financial institution associations (for example, bank trade groups and associations) to share information on individuals, entities, organizations, and countries suspected of engaging in possible terrorist activity or money laundering. Section 314(b) limits the definition of "financial institutions" used within Section 314(a) of USA PATRIOT Act to include only those institutions that are required to establish and maintain an anti-money laundering program; this definition includes, but is not limited to, banking entities regulated by the Federal Banking Agencies. The definition specifically excludes any institution or class of institutions that FinCEN has designated as ineligible to share information. Section 314(b) also describes the safe harbor from civil liability that is provided to financial institutions that appropriately share information within the limitations and requirements specified in the regulation.

Restrictions on Use of Shared Information

Information shared on a subject from a financial institution or financial institution association pursuant to Section 314(b) cannot be used for any purpose other than the following:

- Identifying and, where appropriate, reporting on money laundering or terrorist activities;
- Determining whether to establish or maintain an account, or to engage in a transaction; or
- Assisting in the purposes of complying with this section.

Annual Certification Requirements

In order to avail itself to the statutory safe harbor protection, a financial institution or financial institution association must annually certify with FinCEN stating its intent to engage in information sharing with other similarly-certified entities. It must further state that it has established and will maintain adequate procedures to protect the security and confidentiality of the information, as if the information were included in one of its own SAR filings. The annual certification process involves completing and submitting a "Notice for Purposes of Subsection 314(b) of the USA PATRIOT Act and 31 CFR 103.110." The notice can be completed and electronically submitted to FinCEN via their website. Alternatively, the notice can be mailed to the following address: FinCEN, P.O. Box 39, Mail Stop 100, Vienna, VA 22183. It is important to mention that if a financial institution or financial institution association improperly uses its Section 314(b) permissions, its certification can be revoked by either FinCEN or by its Federal Banking Agency.

Failure to follow the Section 314(b) annual certification requirements will result in the loss of the financial institution or financial institution association's statutory safe harbor and could result in a violation of privacy laws or other laws and regulations.

Verification Requirements

A financial institution must take reasonable steps to verify that the other financial institution(s) or financial institution association(s) with which it intends to share information has also performed the annual certification process discussed above. Such verification can be performed by reviewing the lists of other 314(b) participants that are periodically provided by FinCEN. Alternatively, the financial institution or financial institution association can confirm directly with the other party that the certification process has been completed.

Other Important Requirements and Restrictions

Section 314(b) requires virtually the same care and safeguarding of sensitive information as Section 314(a), whether the bank is the "provider" or "receiver" of information. Refer to the discussions provided above and within "Section 314(a) – Mandatory Information Sharing Between the U.S. Government and Financial Institutions" for detailed guidance on:

- SAR Filings and
- Confidentiality of Section 314(a) Requests (including the embedded discussion entitled "Internal Financial Institution Measures for Protecting Section 314(a) Requests").

Actions taken pursuant to shared information do not affect a financial institution's obligations to comply with all BSA and OFAC rules and regulations. For example, a financial institution is still obligated to immediately contact law enforcement and its Federal regulatory agency, by telephone, when a significant reportable violation requiring immediate attention (such as one that involves the financing of terrorist activity or is of an ongoing nature) is being conducted; thereafter, a timely SAR filing is still required.

FinCEN has provided financial institutions with general instructions, registration forms, FAQs, and additional guidance relating to the Section 314(b) information sharing process. These documents are revised periodically and may be found on FinCEN's website.

CUSTOMER DUE DILIGENCE (CDD)

The cornerstone of strong BSA/AML programs is the adoption and implementation of comprehensive CDD policies, procedures, and controls for all customers, particularly those that present a higher risk for money laundering and terrorist financing. The concept of CDD incorporates and builds upon the CIP regulatory requirements for identifying and verifying a customer's identity.

The goal of a CDD program is to develop and maintain an awareness of the unique financial details of the institution's customers and the ability to relatively predict the type and frequency of transactions in which its customers are likely to engage. In doing so, institutions can better identify, research, and report suspicious activity as required by BSA regulations. Although not required by statute or regulation, an effective CDD program provides the critical framework that enables the institution to comply with regulatory requirements.

Benefits of an Effective CDD Program

An effective CDD program protects the reputation of the institution by:

- Preventing unusual or suspicious transactions in a timely manner that potentially exposes the institution to financial loss or increased expenses;
- Avoiding criminal exposure from individuals who use the institution's resources and services for illicit purposes; and
- Ensuring compliance with BSA regulations and adhering to sound and recognized banking practices.

CDD Program Guidance

CDD programs should be tailored to each institution's BSA/AML risk profile; consequently, the scope of CDD programs will vary. While smaller institutions may have more frequent and direct contact with customers than their counterparts in larger institutions, all institutions should adopt and follow an appropriate CDD program.

An effective CDD program should:

- Be commensurate with the institution's BSA/AML risk profile, paying particular attention to higher risk customers,
- Contain a clear statement of management's overall expectations and establish specific staff responsibilities, and
- Establish monitoring systems and procedures for identifying transactions or activities inconsistent with a customer's normal or expected banking activity.

Customer Risk

As part of an institution's BSA/AML risk assessment, many institutions evaluate and apply a BSA/AML risk rating to its customers. Under this approach, the institution will obtain information at account opening sufficient to develop a "customer transaction profile" that incorporates an understanding of normal and expected activity for the customer's occupation or business operations. While this practice may not be appropriate for all institutions, management of all institutions should have a thorough understanding of the money laundering or terrorist financing risks of its customer base and develop and implement the means to adequately mitigate these risks.

Due Diligence for Higher Risk Customers

Customers that pose higher money laundering or terrorist financing risks present increased exposure to institutions. Due diligence for higher risk customers is especially critical in understanding their anticipated transactions and implementing a suspicious activity monitoring system that reduces the institution's reputation, compliance, and transaction risks. Higher risk customers and their transactions should be reviewed more closely at account opening and more frequently throughout the term of the relationship with the institution.

The USA PATRIOT Act requires special due diligence at account opening for certain foreign accounts, such as foreign correspondent accounts and accounts for senior foreign political figures. An institution's CDD program should include policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts that are established or maintained for non-U.S. persons. Guidance regarding special due diligence requirements is provided in the next section entitled "Banking Services and Activities with Greater Potential for Money Laundering and Enhanced Due Diligence Procedures."

BANKING SERVICES AND ACTIVITIES WITH GREATER POTENTIAL FOR MONEY LAUNDERING AND ENHANCED DUE DILIGENCE PROCEDURES

Certain financial services and activities are more vulnerable to being exploited in money laundering and terrorist financing activities. These conduits are often utilized because each typically presents an opportunity to move large amounts of funds embedded within a large number of similar transactions. Most activities discussed in this section also offer access to international banking and financial systems. The ability of U.S. financial institutions to conduct the appropriate level of due diligence on customers of foreign banks, offshore and shell banks, and foreign branches is often severely limited by the laws and banking practices of other countries.

While international AML and Counter-Terrorist Financing (CTF) standards are improving through efforts of several international groups, U.S. financial institutions will still need effective systems in their AML and CTF programs to understand the quality of supervision and assess the integrity and effectiveness of controls in other countries. Higher risk areas discussed in this section include:

- Non-bank financial institutions (NBFIs), including money service businesses (MSBs);
- Foreign correspondent banking relationships;
- Payable-through accounts;
- Private banking activities;
- Numbered accounts;
- Pouch activities;
- Special use accounts;
- Wire transfer activities; and
- Electronic banking.

Financial institutions offering these higher risk products and services must enhance their AML and CDD procedures to ensure adequate scrutiny of these activities and the customers conducting them.

Non-Bank Financial Institutions and Money Service Businesses

Non-bank financial institutions (NBFIs) are broadly defined as institutions that offer financial services. Traditional financial institutions ("banks" for this discussion) that maintain account relationships with NBFIs are exposed to a higher risk for potential money laundering activities because these entities are less regulated and may have limited or no documentation on their customers. Additionally, banks may likewise be exposed to possible OFAC violations for unknowingly engaging in or facilitating prohibited transactions through a NBFI account relationship.

NBFIs include, but are not limited to:

- Casinos or card clubs;
- Securities brokers/dealers; and
- Money Service Businesses (MSBs)
    - currency dealers or exchangers;
    - check cashers;
    - issuers, sellers, or redeemers of traveler's checks, money orders, or stored value cards;
    - money transmitters; and
    - U.S. Post Offices (money orders).

Money Service Businesses

As indicated above, MSBs are a subset of NBFIs. Regulations for MSBs are included within 31 CFR 103.41. All MSBs were required to register with FinCEN using Form TD F 90-22.55 by December 31, 2001, or within 180 days after the business begins operations. Thereafter, each MSB must renew its registration every two years.

MSBs are a major industry, and typically operate as independent businesses. Relatively few MSBs are chains that operate in multiple states. MSBs can be sole-purpose entities but are frequently tied to another business such as a liquor store, bar, grocery store, gas station, or other multi-purpose entity. As a result, many MSBs are frequently unaware of their legal and regulatory requirements and have been historically difficult to detect. A bank may find it necessary to inform MSB customers about the appropriate MSB regulations and requirements.

Most legitimate MSBs should not refuse to follow regulations once they have been informed of the requirements. If they do, the bank should closely scrutinize the MSBs activities and transactions for possible suspicious activity.

MSBs typically do not establish on-going customer relationships, and this is one of the reasons that MSB customers are considered higher risk. Since MSBs do not have continuous relationships with their clients, they generally do not obtain key due diligence documentation, making customer identification and suspicious transaction identification more difficult.

Banks with MSB customers also have a risk in processing third-party transactions through their payment and other banking systems. MSB transactions carry an inherent potential for the facilitation of layering. MSBs can be conduits for illicit cash and monetary instrument transactions, check kiting, concealing the ultimate beneficiary of the funds, and facilitating the processing of forged or fraudulent items such as treasury checks, money orders, traveler's checks, and personal checks.

MSB Agents

MSBs that are agents of such commonly known entities as Moneygram or Western Union should be aware of their legal requirements. Agents of such money transmitters, unless they offer another type of MSB activity, do NOT have to independently register with FinCEN, but are maintained on an agency list by the "actual" MSB (such as Western Union). However, this "actual" MSB is responsible for providing general training and information requirements to their agents and for aggregating transactions on a nationwide basis, as appropriate.

Check Cashers

FinCEN defines a check casher as a business that will cash checks and/or sell monetary or other instruments over $1,000 per customer on any given day. If a company, such as a local mini-market, will cash only personal checks up to $100 per day AND it provides no other financial services or instruments (such as money orders or money transmittals), then that company would NOT be considered a check casher for regulatory purposes or have to register as an MSB.

Exemptions from CTR Filing Requirements

MSBs are subject to BSA regulations and OFAC sanctions and, as such, should be filing CTRs, screening customers for OFAC matches, and filing SARs, as appropriate. MSBs cannot exempt their customers from CTR filing requirements like banks can, and banks may not exempt MSB customers from CTR filing, unless the "50 Percent Rule" applies.

The "50 Percent Rule" states that if a MSB derives less than 50 percent of its gross cash receipts from money service activities, then it can be exempted. If the bank exempts a MSB customer under the "50 Percent Rule," it should have documentation evidencing the types of business conducted, receipt volume, and estimations of MSB versus non-MSB activity.

Policies and Procedures for Opening and Monitoring NBFI and MSB Relationships

Banks that maintain account relationships with NBFIs or MSBs should perform greater due diligence for these customers given their higher risk profile. Management should implement the following due diligence procedures for MSBs:

- Identify all NBFI/MSB accounts;
- Determine that the business has met local licensing requirements;
- Ascertain if the MSB has registered or re-registered with FinCEN and obtain a copy of the filing or verify the filing on FinCEN's website;
- Determine if the MSB has procedures to comply with BSA regulations and OFAC monitoring;
- Establish the types and amounts of currencies/instruments handled, and any additional services provided;
- Note the targeted customer base;
- Determine if the business sends or receives international wires and the nature of the activity;
- Determine if the MSB has procedures to monitor and report suspicious activity; and
- Obtain a copy of the MSBs independent BSA review, if available.

Management should document in writing the responses to the items above and update MSB customer files at least annually. In addition, management should continue to monitor these higher risk accounts for suspicious activity. The FDIC does not expect the bank to perform an examination of the MSB; however, the bank should take reasonable steps to document that MSB customers are aware of and are complying with appropriate regulations.

For additional information, examiners should instruct bank management to consult the FinCEN website developed specifically for MSBs. This website contains guidance, registration forms, and other materials useful for MSBs to understand and comply with BSA regulations. Bank customers who are uncertain if they are covered by the definition of MSBs can also visit this site to determine if their business activities qualify.

Foreign Correspondent Banking Relationships

Correspondent accounts are accounts that financial institutions maintain with each other to handle transactions for themselves or for their customers. Correspondent accounts between a foreign bank and U.S. financial institutions are much needed, as they facilitate international trade and investment. However, these relationships may pose a higher risk for money laundering.

Transactions through foreign correspondent accounts are typically large and would permit movement of a high volume of funds relatively quickly. These correspondent accounts also provide foreign entities with ready access to the U.S. financial system. These banks and other financial institutions may be located in countries with unknown AML regulations and controls ranging from strong to weak, corrupt, or nonexistent.

The USA PATRIOT Act establishes reporting and documentation requirements for certain high-risk areas, including:

- Special due diligence requirements for correspondent accounts and private banking accounts which are addressed in 31 CFR 103.181.
- Verification procedures for foreign correspondent account relationships which are included in 31 CFR 103.185.
- Foreign banks with correspondent accounts at U.S. financial institutions must produce bank records, including information on ownership, when requested by regulators and law enforcement, as detailed in Section 319 of the USA PATRIOT Act and codified at 31 CFR 103.185.

The foreign correspondent records detailed above are to be provided within seven days of a law enforcement request and within 120 hours of a Federal regulatory request. Failure to provide such records in a timely manner may result in the U.S. financial institution's required termination of the foreign correspondent account. Such foreign correspondent relationships need only be terminated upon the U.S. financial institution's written receipt of such instruction from either the Secretary of the Treasury or the U.S. Attorney General. If the U.S. financial institution fails to terminate relationships after receiving notification, the U.S. institution may face civil money penalties.

The Treasury was also granted broad authority by the USA PATRIOT Act (codified in 31 USC 5318[A]), allowing it to establish special measures. Such special measures can be established which require U.S. financial institutions to perform additional recordkeeping and/or reporting or require a complete prohibition of accounts and transactions with certain countries and/or specified foreign financial institutions. The Treasury may impose such special measures by regulation or order, in consultation with other regulatory agencies, as appropriate.

Shell Banks

Sections 313 and 319 of the USA PATRIOT Act implemented (by 31 CFR 103.177 and 103.185, respectively) a new provision of the BSA that relates to foreign correspondent accounts. Covered financial institutions (CFI) are prohibited from establishing, maintaining, administering, or managing a correspondent account in the U.S. for or on behalf of a foreign shell bank.

A correspondent account, under this regulation, is defined as an account established by a CFI for a foreign bank to receive deposits from, to make payments or other disbursements on behalf of a foreign financial institution, or to handle other financial transactions related to the foreign bank. An account is further defined as any formal banking or business relationship established to provide:

- Regular services,
- Dealings, and
- Other financial transactions,

and may include:

- Demand deposits,
- Savings deposits,
- Any other transaction or asset account,
- Credit account, or
- Any other extension of credit.

A foreign shell bank is defined as a foreign bank without a physical presence in any country. Physical presence means a place of business that:

- Is maintained by a foreign bank;
- Is located at a fixed address (other than solely an electronic address or a post-office box) in a country in which the foreign bank is authorized to conduct banking activities;
- Provides at that fixed address:
    - One or more full-time employees,
    - Operating records related to its banking activities; and
- Is subject to inspection by the banking authority that licensed the foreign bank to conduct banking activities.

There is one exception to the shell bank prohibition. This exception allows a CFI to maintain a correspondent account with a foreign shell bank if it is a regulated affiliate. As a regulated affiliate, the shell bank must meet the following requirements:

- The shell bank must be affiliated with a depository institution (bank or credit union, either U.S. or foreign) in the U.S. or another foreign jurisdiction.
- The shell bank must be subject to supervision by the banking authority that regulates the affiliated entity.

Furthermore, in any foreign correspondent relationship, the CFI must take reasonable steps to ensure that such an account is not being used indirectly to provide banking services to other foreign shell banks. If the CFI discovers that a foreign correspondent account is providing indirect services in this manner, then it must either prohibit the indirect services to the foreign shell bank or close down the foreign correspondent account. This activity is referred to as "nested" correspondent banking and is discussed in greater detail below under "Foreign Correspondent Banking Money Laundering Risks."

Required Recordkeeping on Correspondent Banking Accounts

As mentioned previously, a CFI that maintains a foreign correspondent account must also maintain records identifying the owners of each foreign bank. To minimize recordkeeping burdens, ownership information is not required for:

- Foreign banks that file form FR-7 with the Federal Reserve, or
- Publicly traded foreign banks.

A CFI must also record the name and street address of a person who resides in the U.S. and who is willing to accept service of legal process on behalf of the foreign institution. In other words, the CFI must collect information so that law enforcement can serve a subpoena or other legal document upon the foreign correspondent bank.

Certification Process

To facilitate information collection, the Treasury, in coordination with the banking industry, Federal regulators and law enforcement agencies, developed a certification process using special forms to standardize information collection. The use of these forms is not required; however, the information must be collected regardless. The CFI must update, or re-certify, the foreign correspondent information at least once every three years.

For new accounts, this certification information must be obtained within 30 calendar days after the opening date. If the CFI is unable to obtain the required information, it must close all correspondent accounts with that foreign bank within a commercially reasonable time. The CFI should review certifications to verify their accuracy. The review should look for potential problems that may warrant further research or information. Should a CFI know, suspect, or have reason to suspect that any certification information is no longer correct, the CFI must request the foreign bank to verify or correct such information within 90 days. If the information is not corrected within that time, the CFI must close all correspondent accounts with that institution within a commercially reasonable time.

Foreign Correspondent Banking Money Laundering Risks

Foreign correspondent accounts provide clearing access to foreign financial institutions and their customers, which may include other foreign banks. Many U.S. financial institutions fail to ascertain the extent to which the foreign banks will allow other foreign banks to use their U.S. accounts. Many high-risk foreign financial institutions have gained access to the U.S. financial system by operating through U.S. correspondent accounts belonging to other foreign banks. These are commonly referred to as "nested" correspondent banks.

Such nested correspondent bank relationships result in the U.S. financial institution's inability to identify the ultimate customer who is passing a transaction through the foreign correspondent's U.S. account. These nested relationships may prevent the U.S. financial institution from effectively complying with BSA regulations, suspicious activity reporting, and OFAC monitoring and sanctions.

If a U.S. financial institution's due diligence or monitoring system identifies the use of such nested accounts, the U.S.

financial institution should do one or more of the following:

- Perform due diligence on the nested users of the foreign correspondent account, to determine and verify critical information including, but not limited to, the following:
  - Ownership information,
  - Service of legal process contact,
  - Country of origin,
  - AML policies and procedures,
  - Shell bank and licensing status,
  - Purpose and expected volume and type of transactions;
- Restrict business through the foreign correspondent's accounts to limited transactions and/or purposes; and
- Terminate the initial foreign correspondent account relationship.

Necessary Due Diligence on Foreign Correspondent Accounts

Because of the heightened risk related to foreign correspondent banking, the U.S. financial institution needs to assess the money laundering risks associated with each of its correspondent accounts. The U.S. financial institution should understand the nature of each account holder's business and the purpose of the account. In addition, the U.S. financial institution should have an expected volume and type of transaction anticipated for each foreign bank customer.

When a new relationship is established, the U.S. financial institution should assess the management and financial condition of the foreign bank, as well as its AML programs and the home country's money laundering regulations and supervisory oversight. These due diligence measures are in addition to the minimum regulation requirements.

Each U.S. financial institution maintaining foreign correspondent accounts must establish appropriate, specific, and, where necessary, enhanced due diligence policies, procedures, and controls as required by 31 CFR 103.181. The U.S. financial institution's AML policies and programs should enable it to reasonably detect and report instances of money laundering occurring through the use of foreign correspondent accounts.

The regulations specify that additional due diligence must be completed if the foreign bank is:

- Operating under an offshore license;
- Operating under a license granted by a jurisdiction designated by the Treasury or an intergovernmental agency (such as the Financial Action Task Force [FATF]) as being a primary money laundering concern; or
- Located in a bank secrecy or money laundering haven.

Internal financial institution policies should focus compliance efforts on those accounts that represent a higher risk of money laundering. U.S. financial institutions may use their own risk assessment or incorporate the best practices developed by industry and regulatory recommendations.

Offshore Banks

An offshore bank is one which does not transact business with the citizens of the country that licenses the bank. For example, a bank is licensed as an offshore bank in Spain. This institution may do business with anyone in the world except for the citizens of Spain. Offshore banks are typically a revenue generator for the host country and may not be as closely regulated as banks that provide financial services to the host country's citizens. The host country may also have lax AML standards, controls, and enforcement. As such, offshore licenses can be appealing to those wishing to launder illegally obtained funds.

The FATF designates Non-Cooperative Countries and Territories (NCCTs). These countries have been so designated because they have not applied the recommended international anti-money laundering standards and procedures to their financial systems. The money laundering standards established by FATF are known as the Forty Recommendations. Further discussion of the Forty Recommendations and NCCTs can be found at the FATF website.

Payable Through Accounts

A payable through account (PTA) is a demand deposit account through which banking agencies located in the U.S. extend check writing privileges to the customers of other domestic or foreign institutions. PTAs have long been used in the U.S. by credit unions (for example, for checking account services) and investment companies (for example, for checking account services associated with money market management accounts) to offer customers the full range of banking services that only a commercial bank has the ability to provide.

International PTA Use

Under an international PTA arrangement, a U.S. financial institution, Edge corporation, or the U.S. branch or agency of a foreign bank (U.S. banking entity) opens a master checking account in the name of a foreign bank operating outside the U.S. The master account is subsequently divided by the foreign bank into "sub-accounts" each in the name of one of the foreign bank's customers. Each sub-account holder becomes a signatory on the foreign bank's account at the U.S. banking entity and may conduct banking activities through the account.

Financial institution regulators have become aware of the increasing use of international PTAs. These accounts are being marketed by U.S. financial institutions to foreign banks that otherwise would not have the ability to offer their customers direct access to the U.S. banking system. While PTAs provide legitimate business benefits, the operational aspects of the account make it particularly vulnerable to abuse as a mechanism to launder money. In addition, PTAs present unique safety and soundness risks to banking entities in the U.S.

Sub-account holders of the PTA master accounts at the U.S. banking entity may include other foreign banks, rather than just individuals or corporate accounts. These second-tier foreign banks then solicit individuals as customers. This may result in thousands of individuals having signatory authority over a single account at a U.S. banking entity. The PTA mechanism permits the foreign bank operating outside the U.S. to offer its customers, the sub-account holders, U.S. denominated checks and ancillary services, such as the ability to receive wire transfers to and from sub-accounts and to cash checks. Checks are encoded with the foreign bank's account number along with a numeric code to identify the sub-account.

Deposits into the U.S. master account may flow through the foreign bank, which pools them for daily transfer to the U.S. banking entity. Funds may also flow directly to the U.S. banking entity for credit to the master account, with further credit to the sub-account.

Benefits Associated with Payable Through Accounts

While the objectives of U.S. financial institutions marketing PTAs and the foreign banks which subscribe to the PTA service may vary, essentially three benefits currently drive provider and user interest:

- PTAs permit U.S. financial institutions to attract dollar deposits from the home market of foreign banks without jeopardizing the foreign bank's relationship with its clients.
- PTAs provide fee income potential for both the U.S. PTA provider and the foreign bank.
- Foreign banks can offer their customers efficient and low-cost access to the U.S. banking system.

Risks Associated with Payable Through Accounts

The PTA arrangement between a U.S. banking entity and a foreign bank may be subject to the following risks:

- *Money Laundering risk* – the risk of possible illegal or improper conduct flowing through the PTAs.
- *OFAC risk* – the risk that the U.S. banking entity does not know the ultimate PTA customers which could facilitate the completion of sanctioned or blocked transactions.
- *Credit risk* - the risk the foreign bank will fail to perform according to the terms and conditions of the PTA agreement, either due to bankruptcy or other financial difficulties.
- *Settlement risk* - the risk that arises when the U.S. banking entity pays out funds before it can be certain that it will receive the corresponding deposit from the foreign bank.
- *Country risk* - the risk the foreign bank will be unable to fulfill its international obligations due to domestic strife, revolution, or political disturbances.
- *Regulatory risk* - the risk that deposit and withdrawal transactions through the PTA may violate State and/or Federal laws and regulations.

Unless a U.S. banking entity is able to identify adequately, and understand the transactions of the ultimate users of the foreign bank's account maintained at the U.S. banking entity, there is a potential for serious illegal conduct.

Because of the possibility of illicit activities being conducted through PTAs at U.S. banking entities, financial institution regulators believe it is inconsistent with the principles of safe and sound banking for U.S. banking entities to offer PTA services without developing and maintaining policies and procedures designed to guard against the possible improper or illegal use of PTA facilities.

Policy Recommendations

Policies and procedures must be fashioned to enable each U.S. banking entity offering PTA services to foreign banks to:

- Identify sufficiently the ultimate users of its foreign bank PTAs, including obtaining (or having the ability to obtain) substantially the same type of information on the ultimate users as the U.S. banking entity obtains for its domestic customers.
- Review the foreign bank's own procedures for identifying and monitoring sub-account holders, as

well as the relevant statutory and regulatory requirements placed on the foreign bank to identify and monitor the transactions of its own customers by its home country supervisory authorities.
- Monitor account activities conducted in the PTAs with foreign banks and report suspicious or unusual activity in accordance with Federal regulations.

Termination of PTAs

It is recommended the U.S. banking entity terminate a PTA with a foreign bank as expeditiously as possible in the following situations:

- Adequate information about the ultimate users of the PTAs cannot be obtained.
- The U.S. banking entity cannot adequately rely on the home country supervisor to require the foreign bank to identify and monitor the transactions of its own customers.
- The U.S. banking entity is unable to ensure that its PTAs are not being used for money laundering or other illicit purposes.
- The U.S. banking entity identifies ongoing suspicious and unusual activities dominating the PTA transactions.

Private Banking Activities

Private banking has proven to be a profitable operation and is a fast-growing business in U.S. financial institutions. Although the financial service industry does not use a standard definition for private banking, it is generally held that private banking services include an array of all-inclusive deposit account, lending, investment, trust, and cash management services offered to high net worth customers and their business interests. Not all financial institutions operate private banking departments, but they typically offer special attention to their best customers and ensure greater privacy concerning the transactions and activities of these customers. Smaller institutions may offer similar services to certain customers while not specifically referring to this activity as private banking.

Confidentiality is a vital element in administering private banking relationships. Although customers may choose private banking services to manage their assets, they may also seek confidential ownership of their assets or a safe, legal haven for their capital. When acting as a fiduciary, financial institutions may have statutory, contractual, or ethical obligations to uphold customer confidentiality.

Typically, a private banking department will service a financial institution's wealthy foreign customers, as these customers may be conducting more complex transactions and using services that facilitate international transactions. Because of these attributes, private banking also appeals to money launderers.

Examiners should evaluate the financial institution management's ability to measure and control the risk of money laundering in the private banking area and determine if adequate AML policies, procedures, and oversight are in place to ensure compliance with laws and regulations and adequate identification of suspicious activities.

Policy Recommendations

At a minimum, the financial institution's private banking policies and procedures should address:

- Acceptance and approval of private banking clients;
- Desired or targeted client base;
- Products and services that will be offered;
- Effective account opening procedures and documentation requirements; and
- Account review upon opening and ongoing thereafter.

In addition, the financial institution must:

- Document the identity and source of wealth on all customers requesting custody or private banking services;
- Understand each customer's net worth, account needs, as well as level and type of expected activity;
- Verify the source and accuracy of private banking referrals;
- Verify the origins of the assets or funds when transactions are received from other financial service providers;
- Review employment and business information, income levels, financial statements, net worth, and credit reports; and
- Monitor the account relationship by:
    - Reviewing activity against customer profile expectations,
    - Investigating extraordinary transactions,
    - Maintaining an administrative file documenting the customer's profile and activity levels,
    - Maintaining documentation that details personal observations of the customer's business and/or personal life, and
    - Ensuring that account reviews are completed periodically by someone other than the private banking officer.

Financial institutions should ensure, through independent review, that private banking account officers have adequate documentation for accepting new private banking account funds and are performing the responsibilities detailed above.

Enhanced Due Diligence for Non-U.S. Persons Maintaining Private Banking Accounts

Section 312 of the USA PATRIOT Act, implemented by 31 CFR 103.181, requires U.S. financial institutions that maintain private banking accounts for non-U.S. persons to establish enhanced due diligence policies, procedures, and controls that are designed to detect and report money laundering.

Private banking accounts subject to requirements under Section 312 of the USA PATRIOT Act include:

- Accounts, or any combination of accounts with a minimum deposit of funds or other assets of at least $1 million;
- Accounts established for one or more individuals (beneficial owners) that are neither U.S. citizens, nor lawful permanent residents of the U.S.; or
- Accounts assigned to or managed by an officer, employee, or agent of a financial institution acting as a liaison between the financial institution and the direct or beneficial owner of the account.

Regulations for private banking accounts specify that enhanced due diligence procedures and controls should be established where appropriate and necessary with respect to the applicable accounts and relationships. The financial institution must be able to show it is able to reasonably detect suspicious and reportable money laundering transactions and activities.

A due diligence program is considered reasonable if it focuses compliance efforts on those accounts that represent a high risk of money laundering. Private banking accounts of foreign customers inherently indicate higher risk than many U.S. accounts; however, it is incumbent upon the financial institution to establish a reasonable level of monitoring and review relative to the risk of the account and/or department.

A financial institution may use its own risk assessment or incorporate industry best practices into its due diligence program. Specific due diligence procedures required by Section 312 of USA PATRIOT Act include:

- Verification of the identity of the nominal and beneficial owners of an account;
- Documentation showing the source of funds; and
- Enhanced scrutiny of accounts and transactions of senior foreign political figures, also known as “politically exposed persons” (PEPs).

<u>Identity Verification</u>

The financial institution is expected to take reasonable steps to verify the identity of both the nominal and the beneficial owners of private banking accounts. Often, private banking departments maintain customer information in a central confidential file or use code names in order to protect the customer’s privacy. Because of the nature of the account relationship with the bank liaison and the focus on a customer’s privacy, customer profile information has not always been well documented.

Other methods used to maintain customer privacy include:

- Private Investment Corporation (PIC),
- Offshore Trusts, and
- Token Name Accounts.

PICs are established to hold a customer’s personal assets in a separate legal entity. PICs offer confidentiality of ownership, hold assets centrally, and provide intermediaries between private banking customers and the potential beneficiaries of the PICs or trusts. A PIC may also be a trust asset. PICs are incorporated frequently in countries that impose low or no taxes on company assets and operations, or are bank secrecy havens. They are sometimes established by the financial institution for customers through their international affiliates – some high profile or political customers have a legitimate need for a higher degree of financial privacy. However, financial institutions should exercise extra care when dealing with beneficial owners of PICs and associated trusts because they can be misused to conceal illegal activities. Since PICs issue bearer shares, anonymous relationships in which the financial institution does not know and document the beneficial owner should not be permitted.

Offshore trusts can operate similarly to PICs and can even include PICs as assets. Beneficial owners may be numerous; regardless, the financial institution must have records demonstrating reasonable knowledge and due diligence of beneficiary identities. Offshore trusts should identify grantors of the trusts and sources of the grantors’ wealth.

Furthermore, OFAC screening may be difficult or impossible when transactions are conducted through PICs, offshore trusts, or token name accounts that shield true identities. Management must ensure that accounts maintained in a name other than that of the beneficial owner are subject to the same level of filtering for OFAC as other accounts. That is, the OFAC screening process must include the account's beneficial ownership as well as the official account name.

Documentation of Source of Funds

Documentation of the source of funds deposited into a private banking account is also required by Section 312 of the USA PATRIOT Act. Customers will frequently transfer large sums in single transactions and the financial institution must document initial and ongoing monetary flows in order to effectively identify and report suspicious activity. Understanding how high net worth customers' cash flows, operational income, and expenses flow through a private banking relationship is an integral part of understanding the customer's wealth picture. Due diligence will often necessitate that the financial institution thoroughly investigate the customer's expected transactions.

Enhanced Scrutiny of Politically Exposed Persons

Enhanced scrutiny of accounts and transactions involving senior foreign political figures, their families and associates is required by law in order to guard against laundering the proceeds of foreign corruption.

Illegal activities related to foreign corruption were brought under the definition of money laundering by Section 315 of USA PATRIOT Act. Abuses and corruption by political officials not only negatively impacts their home country's finances, but can also undermine international government and working group efforts against money laundering. A financial institution doing business with corrupt PEPs can be exposed to significant reputational risk, which could result in adverse financial impact through news articles, loss of customers, and even civil money penalties (CMPs). Furthermore, a financial institution, its directors, officers, and employees can be exposed to criminal charges if they did know or should have known (willful blindness) that funds stemmed from corruption or serious crimes.

As such, PEP accounts can present a higher risk. Enhanced scrutiny is appropriate in the following situations:

- Customer asserts a need to have the foreign political figure or related persons remain secret.
- Transactions are requested to be performed that are not expected given the customer's account profile.
- Amounts and transactions do not make sense in relation to the PEP's known income sources and uses.
- Transactions exceed reasonable amounts in relation to the PEP's known net worth.
- Transactions are large in relation to the PEP's home country financial condition.
- PEP's home country is economically depressed, yet the PEP's home country transactions funding the account remain high.
- Customer refuses to disclose the nominal or beneficial owner of the account or provides false or misleading information.
- Net worth and/or source of funds for the PEP are unidentified.

Additional discussion of due diligence procedures for these accounts can be found in interagency guidance issued in FDIC FIL-6-2001, dated in January 2001, "Guidance on Enhanced Scrutiny for Transactions That May Involve the Proceeds of Foreign Official Corruption."

Fiduciary and Custody Services within the Private Banking Department

Although fiduciary and agency activities are circumscribed by formal trust laws, private banking clients may delegate varying degrees of authority (discretionary versus nondiscretionary) over assets under management to the financial institution. In all cases, the terms under which the assets are managed are fully described in a formal agreement, also known as the "governing instrument" between the customer and the financial institution.

Even though the level of authority may encompass a wide range of products and services, examiners should determine the level of discretionary authority delegated to private banking department personnel in the management of these activities and the documentation required from customers to execute transactions on their behalf**.** Private banking department personnel should not be able to execute transactions on behalf of their clients without proper documentation from clients or independent verification of client instructions**.**

Concerning investments, fiduciaries are also required to exercise prudent investment standards, so the financial institution must ensure that if it is co-trustee or under direction of the customer who retains investment discretion, that the investments meet prudent standards and are in the best interest of the beneficiaries of the trust accounts.

Trust agreements may also be structured to permit the grantor/customer to continue to add to the corpus of the trust account. This provides another avenue to place funds into the banking system and may be used by money launderers for that purpose.

Investment management services have many similar characteristics to trust accounts. The accounts may be discretionary or nondiscretionary. Transactions from clients through a private banking department relationship manager should be properly documented and able to be independently verified. The portfolio manager should also document the investment objectives.

Custodial services offered to private banking customers include securities safekeeping, receipts and disbursements of dividends and interest, recordkeeping, and accounting. Custody relationships can be established in many ways, including referrals from other departments in the financial institution or from outside investment advisors. The customer, or designated financial advisor, retains full control of the investment management of the property subject to the custodianship. Sales and purchases of assets are made by instruction from the customer, and cash disbursements are prearranged or as instructed, again by the customer. In this case, it is important for the financial institution to know the customer. Procedures for proper administration should be established and reviewed frequently.

Numbered Accounts

A numbered account, also known as a pseudonym account, is opened not under an individual or corporate name, but under an assigned number or pseudonym. These types of numbered accounts are typically services offered in the private banking department or the trust department, but they can be offered anywhere in the institution.

Numbered accounts present some distinct customer advantages when it comes to privacy. First, all of the computerized information is recorded using the number or pseudonym, not the customer's real name. This means that tellers, wire personnel, and various employees do not know the true identity of the customer. Furthermore, it protects the customer against identity theft. If electronic financial records are stolen, the number or pseudonym will not provide personal information. Statements and any documentation would simply show the number, not the customer's true name or social security number.

However, numbered accounts offered by U.S. financial institutions must still meet the requirements of the BSA and specific customer identification and minimum due diligence documentation should be obtained. Account opening personnel must adequately document the customer due diligence performed, and access to this information must be provided to employees reviewing transactions for suspicious activity.

If the financial institution chooses to use numbered accounts, they must ensure that proper procedures are in place. Here are some minimum standards for numbered or pseudonym accounts:

- The BSA Officer should ensure that all required CIP information is obtained and well documented. The documentation should be readily available to regulators upon request.
- Management should ensure that adequate suspicious activity review procedures are in place. These accounts are considered to be high risk, and, as such, should have enhanced scrutiny. In order to properly monitor for unusual or suspicious activities, the person(s) responsible for monitoring these accounts must have the identity of the customer revealed to them. <u>All transactions for these accounts should be reviewed at least once a month or more frequently.</u>
- The financial institution's system for performing OFAC reviews, Section 314(a) Requests, or any other inquiries on its customer databases, must be able to check the actual names and relevant information of these individuals. Typically the software will screen just the account name on the trial balance. Consequently, if the name is not on the trial balance, then it could be overlooked in this process. Management should thoroughly document how it will handle such situations, as well as each review that is performed.

Examiners should include the fact that the financial institution's policy allows for numbered accounts on the "Confidential – Supervisory Section" page of the Report of Examination. Given the high risk nature of this account type, examiners should review them at every examination to ensure that management is adequately handling these accounts.

Pouch Activities

Pouch activities involve the use of a common carrier to transport currency, monetary instruments, and other documents usually from outside the U.S. to a domestic bank account. Pouches can originate from an individual or another financial institution and can contain any kind of document, including all forms of bank transactions such as demand deposits and loan payments. The contents of the pouch are not always subject to search while in transport, and considerable reliance is placed on the financial institution's internal control systems designed to account for the contents and their transfer into the institution's accounts.

Vulnerabilities in pouch systems can be exploited by those looking for an avenue to move illegally-gained funds into the U.S. Law enforcement has uncovered money laundering schemes where pouches were used to transfer:

- Bulk currency, both U.S. and foreign, and
- Sequentially numbered monetary instruments, such as traveler's checks and money orders.

Once these illegal funds are deposited into the U.S. financial institution, they can be moved – typically through use of a wire transfer – anywhere in the world. As such, pouches are used by those looking to legitimize proceeds and obscure the true source of the funds.

Financial institutions establish pouch activities primarily to provide a service. The risks associated with a night deposit drop box (one example of pouch activity) are very different from financial institutions that provide document and currency transport from their international offices to banking offices in the U.S.

A prime benefit of having pouch services is the speed with which international transactions can be placed in the U.S. domestic banking system by avoiding clearing a transaction through several international banks in order to move the funds into the U.S. This benefit is particularly advantageous for customers in countries that do not do direct business with the U.S., including those countries that:

- May require little or no customer identification,
- Are well-known secrecy havens, or
- Are considered NCCTs.

Examination Guidance

Examiners should ascertain if a financial institution offers pouch services. If it does provide these services, examiners must verify that all pouch activity is included in AML programs and is thoroughly monitored for suspicious activity.

Examiners are strongly encouraged to be present during one or more pouch openings during the examination. By reviewing the procedures for opening and documenting items in the pouches, along with records maintained of pouch activities, examiners should be able to ascertain or confirm the degree of risk undertaken and the sufficiency of AML program in relation to the institution's pouch activity.

Special Use Accounts

Special use accounts are in-house accounts established to handle the processing of multiple customer transactions within the financial institution. These accounts are also known as concentration accounts, omnibus, or suspense accounts and serve as settlement accounts. They are used in many areas of a financial institution, including private banking departments and in the wire transfer function. They present heightened money laundering risks because controls may be lax and an audit trail of customer information may not be easy to follow since transactions do not always maintain the customer identifying information with the transaction amount. In addition, many financial institution employees may have access to the account and have the ability to make numerous entries into and out of the account. Balancing of the special use account is also not always the responsibility of one individual, although items posted in the account are usually expected to be processed or resolved and settled in one day.

Financial institutions that use special use accounts should implement risk-based procedures and controls covering access to and operation of these accounts. Procedures and controls should ensure that the audit trail provides for association of the identity of transactor, customer and/or direct or beneficial owner with the actual movement of the funds. As such, financial institutions must maintain complete records of all customer transactions passing through these special use accounts. At a minimum, such records should contain the following information:

- Customer name,
- Customer address,
- Account number,
- Dollar value of the transaction, and
- Dates the account was affected.

Wire Transfer Activities

The established wire transfer systems permit quick movement of funds throughout the U.S. banking system and internationally. Wire transfers are commonly used to move funds in various money laundering schemes. Successive wire transfers allow the originator and the ultimate beneficiary of the funds to:

- Obtain relative anonymity,
- Obfuscate the money trail,
- Easily aggregate funds from a large geographic area,
- Move funds out of or into the U.S., and
- "Legitimize" illegal proceeds.

Financial institutions use two wire transfer systems in the U.S., the Fedwire and the Clearing House Interbank Payments System (CHIPS). A telecommunications network, the Society for Worldwide Interbank Financial Telecommunications (SWIFT), is often used to send messages with international wire transfers.

Fedwire transactions are governed by the Uniform Commercial Code Article 4a and the Federal Reserve Board's Regulation J. These laws primarily facilitate business conduct for electronic funds transfers; however, financial institutions must ensure they are using procedures for identification and reporting of suspicious and unusual transactions.

Wire Transfer Money Laundering Risks

Although wire systems are used in many legitimate ways, most money launderers use wire transfers to aggregate funds from different sources and move them through accounts at different banks until their origin cannot be traced. Money laundering schemes uncovered by law enforcement agencies show that money launderers aggregate funds from multiple accounts at the same financial institution, wire those funds to accounts held at other U.S. financial institutions, consolidate funds from these larger accounts, and ultimately wire the funds to offshore accounts in countries where laws are designed to facilitate secrecy. In some cases the monies are then sent back into the U.S. with the appearance of being legitimate funds.

It can be challenging for financial institutions to identify suspicious transactions due to the:

- Large number of wire transactions that occur in any given day;
- Size of wire transactions;
- Speed at which transactions move and settle; and
- Weaknesses in identifying the customers (originators and/or beneficiaries) of such transactions at the sending or receiving banks.

A money launderer will often try to make wire transfers appear to be for a legitimate purpose, or may use "shell companies" (corporations that exist only on paper, similar to shell banks discussed above in the section entitled "Foreign Correspondent Banking Relationships"), often chartered in another country. Money launderers usually look for legitimate businesses with high cash sales and high turnover to serve as a front company.

<u>Mitigation of Wire Transfer Money Laundering Risks</u>

Familiarity with the customer and type of business enables the financial institution to more accurately analyze transactions and thereby identify unusual wire transfer activity. With appropriate CDD policies and procedures, financial institutions should have some expectation of the type and volume of activity in accounts, especially if the account belongs to a high-risk entity or the customer uses higher-risk products or services. Consideration should be given to the following items in arriving at this expectation:

- Type and size of business;
- Customer's stated explanation for activity;
- Historical customer activity; and
- Activity of other customers in the same line of business.

Wire Transfer Recordkeeping Requirements

BSA recordkeeping rules require the retention of certain information for funds transfers and the transmittal of funds. Basic recordkeeping requirements are established in 31 CFR 103.33 and require the maintenance of the following records on all wire transfers originated over $3,000:

- Name and address of the originator,
- Amount of the payment order,
- Execution date of the payment order,
- Payment instructions received from the originator,
- Identity of the beneficiary's financial institution, and
- As many of the following items that are received with the transfer order:
    - Name and address of the beneficiary,
    - Account number of the beneficiary, and
    - Any other specific identifier of the beneficiary.

In addition, as either an intermediary bank or a beneficiary bank, the financial institution must retain a complete record of the payment order. Furthermore, the $3,000 minimum limit for retention of this information does not mean that wire transfers under this amount should not be reviewed or monitored for unusual activity.

Funds Transfer Record Keeping and Travel Rule Regulations

Along with the BSA recordkeeping rules, the Funds Transfer Recordkeeping and Travel Rule Regulations became effective in May of 1996. The regulations call for standard recordkeeping requirements to ensure all institutions are obtaining and maintaining the same information on all wire transfers of $3,000 or more. Like the BSA recordkeeping requirements, these additional recordkeeping requirements were put in place to create a paper trail for law enforcement to investigate money laundering schemes and other illegal activities.

Industry best practices dictate that domestic institutions should encourage all foreign countries to attach the identity of the originator to wire information as it travels to the U.S. and to other countries. Furthermore, the financial institution sending or receiving the wire cannot ensure adequate OFAC verification if they do not have all of the appropriate originator and beneficiary information on wire transfers.

Necessary Due Diligence on Wire Transfer Customers

To comply with these standards and regulations, a financial institution needs to know its customers. The ability to trace funds and identify suspicious and unusual transactions hinges on retaining information and a strong knowledge of the customer developed through comprehensive CDD procedures. Financial institution personnel must know the identity and business of the customer on whose behalf wire transfers are sent and received. Wire room personnel must be trained to identify suspicious or unusual wire activities and have a strong understanding of the bank's OFAC monitoring and reporting procedures.

Review and monitoring activity should also take place subsequent to sending or receiving wires to further aid in identification of suspicious transactions. Reviewers should look for:

- Unusual wire transfer activity patterns;
- Transfers to and from high-risk countries; or
- Any of the "red flags" relating to wire transfers (refer to the "Identification of Suspicious Transactions" discussion included within this chapter.)

Risks Associated with Wire Transfers Sent with "Pay Upon Proper Identification" Instructions

Financial institutions should also be particularly cautious of wire transfers sent or received with "Pay Upon Proper Identification" (PUPID) instructions. PUPID transactions allow the wire transfer originator to send funds to a financial institution location where an individual or business does not have an account relationship. Since the funds receiver does not have an account at the financial institution, he/she must show prior identification to pick up the funds, hence the term PUPID. These transactions can be legitimate, but pose a higher than normal money laundering risk.

Electronic Banking

Electronic banking (E-Banking) consists of electronic access (through direct personal computer connection, the Internet, or other means) to financial institution services, such as opening deposit accounts, applying for loans, and conducting transactions. E-banking risks are not as significant at financial institutions that have a stand-alone "information only" website with no transactional or application capabilities. Many financial institutions offer a variety of E-banking services and it is very common to obtain a credit card, car loan, or mortgage loan on the Internet without ever meeting face-to-face with a financial institution representative.

The financial institution should have established policies and procedures for authenticating new customers obtained through E-banking channels. Customer identification policies and procedures should meet the minimum requirements of the USA PATRIOT Act and be sufficient to cover the additional risks related to customers opening accounts electronically. New account applications submitted over the Internet increase the difficulty of verifying the application information. Many financial institutions choose to require the prospective customer to come into an office or branch to complete the account opening process, while others will not. If a financial institution completes the entire application process over the Internet, it should consider using third-party databases or vendors to provide:

- Positive verification, which ensures that material information provided by an applicant matches information from third-party sources;
- Negative verification, which ensures that information provided is not linked to previous fraudulent activity; and
- Logical verification, which ensures that the information is logically consistent.

In addition to initial verification, a financial institution must also authenticate the customer's identity each time an attempt is made to access his/her private information or to conduct a transaction over the Internet. The authentication methods involve confirming one or more of these three factors:

- Information only the user should know, such as a password or personal identification number (PIN);
- An object the user possesses, such as an automatic teller machine (ATM) card, smart card, or token; or
- Something physical of the user, such as a biometric characteristic like a fingerprint or iris pattern.

Automated Clearing House Transactions and Electronic Initiation Systems

Additionally, the National Automated Clearing House Association (NACHA) has provided standards which mandate the use of security measures for automated clearing house (ACH) transactions initiated through the Internet or electronically. These guidelines include ensuring secure access to the electronic and Internet systems in conjunction with procedures reasonably designed to identify the ACH originator.

Interagency guidance on authenticating users of technology and the identity of customers is further discussed in FDIC FIL-69-2001, "Authentication in an Electronic Environment." This FIL not only identifies the risk of access to systems and information, it also emphasizes the need to verify the identity of electronic and/or Internet customers, particularly those who request account opening and new services online.

MONITORING BANK SECRECY ACT COMPLIANCE

Section 8(s) of the Federal Deposit Insurance Act, which implements 12 U.S.C. 1818, requires the FDIC to:

- Develop regulations that require insured financial institutions to establish and maintain procedures reasonably designed to assure and monitor compliance with the BSA;
- Review such procedures during examinations; and
- Describe any problem with the procedures maintained by the insured depository institution within reports of examination.

To satisfy Section 8(s) requirements, at a minimum, examiners must review BSA at each regular safety and soundness examination. In addition, the FDIC must conduct its own BSA examination at any intervening Safety and Soundness examination conducted by a State banking authority if such authority does not review for compliance with the BSA. Section 326.8 of the FDIC's Rules and Regulations establishes the minimum BSA program requirements for all state nonmember banks, which are necessary to assure compliance with the financial recordkeeping and reporting requirements set forth within the provisions of the Treasury regulation 31 CFR 103.

Part 326.8 of the FDIC's Rules and Regulations

Minimum Requirements of the BSA Compliance Program

The BSA compliance program must be in writing and approved by the financial institution's board of directors, with approval noted in the Board minutes. Best practices dictate that Board should review and approve the policy annually. In addition, financial institutions are required to develop and implement a Customer Identification Program as part of their overall BSA compliance program. More specific guidance regarding the CIP program requirements can be found within the "Customer Identification Program" discussion within this section of the DSC Risk Management Manual of Examination Policies (DSC Manual).

A financial institution's BSA compliance program must meet four minimum requirements, as detailed in Section 326.8 of the FDIC's Rules and Regulations. The procedures necessary to establish an adequate program and assure reasonable compliance efforts designed to meet these minimum requirements are discussed in detail below:

1. *A system of internal controls.* At a minimum, the system must be designed to:

    a. Identify reportable transactions at a point where all of the information necessary to properly complete the required reporting forms can be obtained. The financial institution might accomplish this by sufficiently training tellers and personnel in other departments or by referring large currency transactions to a designated individual or department. If all pertinent information cannot be obtained from the customer, the financial institution should consider declining the transaction.
    b. Monitor, identify, and report possible money laundering or unusual and suspicious activity. Procedures should provide that high-risk accounts, services, and transactions are regularly reviewed for suspicious activity.
    c. Ensure that all required reports are completed accurately and properly filed within required timeframes. Financial institutions should consider centralizing the review and report filing functions within the banking organization.
    d. Ensure that customer exemptions are properly granted, recorded, and reviewed as appropriate, including biennial renewals of "Phase II" exemptions. Exempt accounts must be reviewed at least annually to ensure that the exemptions are still valid and to determine if any suspicious or unusual activity is occurring in the account. The

BSA compliance officer should review and initial all exemptions prior to granting and renewing them.

e. Ensure that all information sharing requests issued under Section 314(a) of the USA PATRIOT Act are checked in accordance with FinCEN guidelines and are fully completed within mandated time constraints.
f. Ensure that guidelines are established for the optional providing and sharing of information in accordance with 314(b) of the USA PATRIOT Act and the written employment verification regulations (as specified in Section 355 of the USA PATRIOT Act).
g. Ensure that the financial institution's CIP procedures comply with regulatory requirements.
h. Ensure that procedures provide for adequate customer due diligence in relation to the risk levels of customers and account types. Adequate monitoring for unusual or suspicious activities cannot be completed without a strong CDD program. The CDD program should assist management in predicting the types, dollar volume, and transaction volume the customer is likely to conduct, thereby providing a means to identify unusual or suspicious transactions for that customer.
i. Establish procedures for screening accounts and transactions for OFAC compliance that include guidelines for responding to identified matches and reporting those to OFAC.
j. Provide for adequate due diligence, monitoring, and reporting of private banking activities and foreign correspondent relationships. The level of due diligence and monitoring must be commensurate with the inherent account risk.
k. Provide for adequate supervision of employees who accept currency transactions, complete reports, grant exemptions, open new customer accounts, or engage in any other activity covered by the Financial Recordkeeping and Reporting of Currency and Foreign Transactions regulations at 31 CFR 103.
l. Establish dual controls and provide for separation of duties. Employees who complete the reporting forms should not be responsible for filing them or for granting customer exemptions.

2. *Independent testing for compliance with the BSA and Treasury's regulation 31 CFR Part 103*. Independent testing of the BSA compliance program should be conducted by the internal audit department, outside auditors, or qualified consultants. Testing must include procedures related to high-risk accounts and activities. Although not required by the regulation, this review should be conducted at least annually. Financial institutions that do not employ outside auditors or consultants or that do not operate internal audit departments can comply with this requirement by utilizing employees who are not involved in the currency transaction reporting or suspicious activity reporting functions to conduct the reviews. The BSA compliance officer, even if he/she does not participate in the daily BSA monitoring and reporting of BSA, can <u>never suffice</u> for an independent review.

The scope of the independent testing should be sufficient to verify compliance with the financial institution's anti-money laundering program. Additionally, all findings from the audit should be provided within a written report and promptly reported to the board of directors or appropriate committee thereof. Testing for compliance should include, at a minimum:

a. A test of the financial institution's internal procedures for monitoring compliance with the BSA, including interviews of employees who handle cash transactions and their supervisors. The scope should include all business lines, departments, branches, and a sufficient sampling of locations, including overseas offices.
b. A sampling of large currency transactions, followed by a review of CTR filings.
c. A test of the validity and reasonableness of the customer exemptions granted by the financial institution.
d. A test of procedures for identifying suspicious transactions and the filing of SARs. Such procedures should incorporate a review of reports used by management to identify unusual or suspicious activities.
e. A review of documentation on transactions that management initially identified as unusual or suspicious, but, after research, determined that SAR filings were not warranted.
f. A test of procedures and information systems to review compliance with the OFAC regulations. Such a test should include a review of the frequency of receipt of OFAC updates and interviews to determine personnel knowledge of OFAC procedures.
g. A test of the adequacy of the CDD program and the CIP. Testing procedures should ensure that established CIP standards are appropriate for the various account types, business lines, and departments. New accounts from various areas in the financial institution should be sampled to

ensure that CDD and CIP efforts meet policy requirements.

h. A review of management reporting of BSA-related activities and compliance efforts. Such a review should determine that reports provide necessary information for adequate BSA monitoring and that they capture the universe of transactions for that reporting area. (For example, the incoming wire transfer logs should contain all the incoming transfers for the time period being reviewed).

i. A test of the financial institution's recordkeeping system for compliance with the BSA.

j. Documentation of the scope of the testing procedures performed and the findings of the testing.

Independent Testing Workpaper Retention

Retention of workpapers from the independent testing or audit of BSA is expected and those workpapers must be made available to examiners for review upon request. It is essential that the scope and findings from any testing procedures be thoroughly documented. Procedures that are not adequately documented will not be accepted as being in compliance with the independent testing requirement.

3. *The designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance with BSA.* To meet the minimum requirement, each financial institution must designate a senior official within the organization to be responsible for overall BSA compliance. Other individuals in each office, department or regional headquarters should be given the responsibility for day-to-day compliance. The senior official in charge of BSA compliance should be in a position, and have the authority, to make and enforce policies. This is not intended to require that the BSA administrator be an "executive officer" under the Federal Reserve Board's Regulation O.

4. *Training for appropriate personnel.* At a minimum, the financial institution's training program must provide training for all operational personnel whose duties may require knowledge of the BSA, including, but not limited to, tellers, new accounts personnel, lending personnel, bookkeeping personnel, wire room personnel, international department personnel, and information technology personnel. In addition, an overview of the BSA requirements should be given to new employees and efforts should be made to keep executives and directors informed of changes and new developments in BSA regulations.Training should be comprehensive, conducted regularly, and clearly documented. The scope of the training should include:

    - The financial institution's BSA policies and procedures;
    - Identification of the three stages of money laundering (placement, layering, and integration);
    - "Red flags" to assist in the identification of money laundering (similar to those provided within the "Identification of Suspicious Transactions" discussion within this chapter);
    - Identification and examples of suspicious transactions;
    - The purpose and importance of a strong CDD program and CIP requirements;
    - Internal procedures for CTR and SAR filings;
    - Procedures for reporting BSA matters, including SAR filings to senior management and the board of directors;
    - Procedures for conveying any new BSA rules, regulations, or internal policy changes to all appropriate personnel in a timely manner; and
    - OFAC policies and procedures.

Depending on the financial institution's needs, training materials can be purchased from banking associations, trade groups, and outside vendors, or they can be internally developed by the financial institution itself. Copies of the training materials must be available in the financial institution for review by examiners.

BSA VIOLATIONS AND ENFORCEMENT

Procedures for Citing Apparent Violations in the Report of Examination

Apparent Violations of the U.S. Department of the Treasury's regulation 31 CFR 103 - Financial Recordkeeping and Reporting of Currency and Foreign Transactions

As stated previously, Treasury's regulation 31 CFR 103 establishes the minimum recordkeeping and reporting requirements for currency and foreign transactions by financial institutions. Failure to comply with the requirements of 31 CFR 103 may result in the examiner citing an apparent violation(s). Apparent violations of 31 CFR 103 are generally for specific issues such as:

- Failure to adequately identify and report large cash transactions in a timely manner;

- Failure to report Suspicious Activities, such as deposit layering or structuring cash transactions;
- Failure to reasonably identify and verify customer identity; and
- Failure to maintain adequate documentation of financial transactions, such as the purchase or sale of monetary instruments and originating or receiving wire transfers.

All apparent violations of the BSA should be reported in the Violations of Laws and Regulations pages of the Report of Examination. When preparing written comments related to apparent violations cited as a result of deficient BSA compliance practices, the following information should be included in each citation:

- Reference to the appropriate section of the regulation;
- Nature of the apparent violation;
- Date(s) and amount of the transaction(s);
- Name(s) of the parties to the transaction;
- Description of the transaction; and
- Management's response, including planned or taken corrective action.

In preparing written comments for apparent violations of the BSA, examiners should focus solely on statements of fact, and take precautions to ensure that subjective comments are omitted. Such statements would include an examiner attributing the infraction to a cause, such as management oversight or computer error. For all violations of 31 CFR 103, the Treasury reserves the authority to determine if civil penalties should be pursued. Examiner comments on the supposed causes of apparent violations may affect the Treasury's ability to pursue a case.

Random, isolated apparent violations do not require lengthy explanations or write-ups in the Report of Examination. In such cases, the section of the regulation violated, and identification of the transaction and/or instance will suffice. Examiners are also encouraged to group violations by type. When there are several exceptions to a particular section of the regulation, for example, late CTR filing, examiners should include a <u>minimum</u> of three examples in the Report of Examination citation. The remainder of the violations under that specific regulation can be listed as a total, without detailing all of the information. For example, detail three late CTR filings with customer information, dates, and amounts, but list a total in the apparent violation write-up for 55 instances identified during the examination.

If an examiner chooses not to include each example in the apparent violation citation, the examiners should provide bank management with a separate list so that they can identify and, if possible, correct the particular violation. A copy of the list must also be maintained in the BSA examination workpapers.

Additionally, deficient practices may violate more than one regulation. In such circumstances, the apparent violations can be grouped together. However, all of the sections of each violated regulation must be cited. Each apparent violation must be recorded on the BSA Data Entry sheet and submitted with the Report of Examination for review and transmittal.

Apparent Violations of Section 326.8 of the FDIC Rules and Regulations

In situations where deficiencies in the BSA compliance program are serious or systemic in nature, or apparent violations result from management's inability or unwillingness to develop and administer an effective BSA compliance program, examiners should cite an apparent violation(s) of the appropriate subsection(s) of Section 326.8, within the Report of Examination. Additionally, apparent violations of 31 CFR 103 that are repeated at two or more examinations, or dissimilar apparent violations that are <u>recurring</u> over several examinations, may <u>also point towards a seriously deficient compliance</u> program. When such deficiencies persist within the financial institution, it may be appropriate for examiners to consider the overall program to be deficient and cite an apparent violation of Section 326.8.

Specifically, an apparent violation of Section 326.8(b)(1) should be cited when the weaknesses and deficiencies identified in the BSA compliance program are significant, repeated, or pervasive. Citing a Section 326.8(b)(1) violation indicates that the program is inadequate or substantially ineffective. Furthermore, these deficiencies, if uncorrected, significantly impair the institution's ability to detect and prevent potential money laundering or terrorist financing activities.

An apparent violation of Section 326.8(b)(2) should be cited when weaknesses and deficiencies cited in the Customer Identification Program mitigate the institution's ability to reasonably establish, verify and record customer identity. An apparent violation of 326.8(b)(2) would generally be associated with specific weaknesses that would be reflected in apparent violations of 31 CFR 103.121, which establishes the minimum requirements for Customer Identification Programs.

An apparent violation of Section 326.8(c) should be cited for a specific program deficiency to the extent that deficiency is attributed to internal controls, independent testing, individual responsible for monitoring day-to-day compliance, or training. If an apparent violation of Section 326.8(c) is determined to be an isolated program weakness that does not significantly impair the effectiveness of the overall compliance program, then a Section 326.8(b) should **not** be cited. If one or more program violations are cited under Section 326.8(c), or are accompanied by notable infractions of Treasury's regulation 31 CFR 103, or management is unwilling or unable to correct the reported deficiencies, the aggregate citations would likely point toward an ineffective program and warrant the additional citing of a 326.8(b) program violation, in addition to the other program, and/or financial recordkeeping violations.

When preparing written comments related to apparent violations cited as a result of deficient BSA compliance program, as defined in Section 326.8, the following information should be included in each citation:

- Nature of the violation(s);
- Name(s) of the individual(s) responsible for coordinating and monitoring compliance with the BSA (BSA officer);
- Specific internal control deficiencies that contributed to the apparent violation(s); and
- Management's response, including planned or taken corrective action.

BSA Workpapers Evidencing Apparent Violations

BSA examination workpapers that support BSA/AML apparent violation citations, enforcement actions, SARs, and CMP referrals to the Treasury should be maintained for 5 years, since they may be needed to assist further investigation or other supervisory response. Examination workpapers should not generally be included as part of a SAR, enforcement action recommendation, or Treasury referral, but may be requested for additional supporting information during a law enforcement investigation.

Civil Money Penalties and Referrals to FinCEN

When significant apparent violations of the BSA, or cases of willful and deliberate violations of 31 CFR 103 or Section 326.8 of the FDIC's Rules and Regulations are identified at a state nonmember financial institution, examiners should determine if a recommendation for CMPs is appropriate. This assessment should be conducted in accordance with existing examiner guidance for consideration of CMPs, detailed within the DSC Manual.

Civil penalties for negligence and willful violations of BSA are detailed in 31 CFR 103.57. This section states that negligent violations of any regulations under 31 CFR 103 shall not exceed $500. Willful violations for any reporting requirement for financial institutions under 31 CFR 103 can be assessed a civil penalty up to $100,000 and no less than $25,000. CMPs may also be imposed by the FDIC for violations of final Cease and Desist Orders issued under our authority granted in Section 8(s) of the Federal Deposit Insurance Act (FDI Act). In these cases, the penalty is established by Section 8(i)(2) of the FDI Act at up to $5,000 per day for each day the violation continues. Recommendations for civil money penalties for violations of Cease and Desist Orders should be handled in accordance with outstanding FDIC Directives.

Furthermore, Section 363 of the USA PATRIOT Act increases the maximum civil and criminal penalties from $100,000 to up to $1,000,000 for violations of the following sections of the USA PATRIOT Act:

- Section 311: Special measures enacted by the Treasury for jurisdictions, financial institutions, or international transactions or accounts of primary money laundering concern;
- Section 312: Special due diligence for correspondent accounts and private banking accounts; and
- Section 313: Prohibitions on U.S. correspondent accounts with foreign shell banks.

Referring Significant Violations of the BSA to FinCEN

Financial institutions that are substantially noncompliant with the BSA should be reviewed by the FDIC for recommendation to FinCEN regarding the issuance of CMPs. FinCEN is the administrator of the BSA and has the authority to assess CMPs against any domestic financial institution, including any insured U.S. branch of a foreign bank, and any partner, director, officer, or employee of a domestic financial institution for violations of the BSA and implementing regulations. Criminal prosecution is also authorized, when warranted. However, referrals to FinCEN do not preclude the FDIC from using its authority to take formal administrative action.

Factors to consider for determining when a referral to FinCEN is warranted and the guidelines established for preparing and forwarding referral documentation are detailed in examiner guidance. When examiners identify serious BSA program weaknesses at an institution, including significant apparent violations, the examiner should consult with the Regional SACM before proceeding further.

Generally, a referral should be considered when the types and nature of apparent violations of the BSA result from a nonexistent or seriously deficient BSA and anti-money laundering compliance program; expose the financial institution to a heightened level of risk for potential money laundering activity; or demonstrate a willful or flagrant disregard for the requirements of the BSA. Normally, isolated incidences of noncompliance should not be referred for penalty consideration. Even if the type of violation was cited previously, referral would not be appropriate if the apparent violations involved are genuine misunderstandings of the BSA requirements or inadvertent violations, the deficiencies are correctable in the normal course of business and proper corrective action has been taken or committed to by management.

A referral may be warranted in the absence of previous violations if the nature of apparent violations identified at the current examination is serious. An example would be failing to file FinCEN Form 104, Currency Transaction Report, on nonexemptible businesses or businesses that, while exemptible, FinCEN, as a matter of policy will not authorize the financial institution to exempt. To illustrate, the failure to file CTRs on transactions involving an individual or automobile dealer (both nonexemptible) is of greater concern to FinCEN than a failure to file CTRs on a recently opened supermarket which has not yet been added to the bank's exempt list or a golf course where the financial institution believed that it qualified for a unilateral exemption as a sports arena. This doesn't mean that the failure to file CTRs on a supermarket should never be referred. Failure to file CTRs on a supermarket that is a front for organized crime, that has no customers yet has large receipts, or that has currency transaction activity that far exceeds its expected revenues would warrant referral.

Mitigating Factors to Consider

Other considerations in, deciding whether to recommend criminal/civil penalties include the financial institution's past history of compliance, and whether the current system of policies, procedures, systems, internal controls, and training are sufficient to ensure a satisfactory level in the future. Senior management's attitude and commitment toward compliance as evidenced by their involvement and devotion of resources to compliance programs should also be considered. Any mitigating factors should be given full consideration. Mitigating factors would include:

- The implementation of a comprehensive compliance program that ensures a high level of compliance including a system for aggregating currency transactions.
- Volunteer reporting by the institution of apparent violations discovered on its own during the course of internal audits. This does not apply to situations where examiners disclose apparent violations and the institution comes forward voluntarily to head off a possible referral.
- Positive efforts to assist law enforcement, including the reporting of suspicious transactions and the filing of Suspicious Activity Reports.

It should be noted that FinCEN does not categorize violations as substantive or technical. However, FinCEN does recognize the varying nature of violations and the fact that not all violations require a referral.

Content of a Well-Developed Referral

A well-developed referral is one that contains sufficient detail to permit FinCEN to ascertain: the number, nature and severity of apparent violations cited; the overall level of BSA compliance; the severity of any weaknesses in the financial institution's compliance program; and the financial institution's ability to achieve a satisfactory level of compliance in the future.

A summary memorandum detailing these issues should be prepared by the field examiner and submitted to the Regional Office for review. At a minimum, each referral should include a copy of this memorandum, the Report of Examination pages that discuss BSA findings, and a civil monetary penalty assessment. Documents contained in the referral package need to be conclusion-oriented and descriptive with facts supporting summary conclusions. It is not sufficient to say that the financial institution has written policies and procedures or that management provides training to employees. Referrals are much more useful when they discuss the specific deficiencies identified within the compliance programs, policies and procedures, systems, management involvement, and training.

Discussing the Referral Process with Financial Institution Management

Examiners should not advise the financial institution that a civil money penalty referral is being submitted to FinCEN. If an investigation by law enforcement is warranted, it may be compromised by disclosure of this information. It is permissible to tell management that FinCEN will be notified of all apparent violations of the BSA cited. However, examiners are not to provide any oral or written communication to the financial institution passing judgment on the willfulness of apparent violations.

Criminal Penalties

Treasury regulation 31 CFR 103.59 notifies institutions that they can be subject to criminal penalties if convicted for willful violations of the BSA of not more than $1,000 and/or one year in prison. If such a BSA violation is committed to further any other Federal law punishable by more than a year in prison (such as fraud, money laundering, theft, illegal narcotics sales, etc.) then harsher penalties can be imposed. In these cases, the perpetrator, upon conviction, can be fined not more than $10,000 and/or be imprisoned not more than 5 years.

In addition, criminal penalties may also be charged against any person who knowingly makes any false, fictitious, or fraudulent statement or representation in any BSA report. Upon conviction of such an act, the perpetrator may be fined not more than $10,000 and/or imprisoned for 5 years.

Certain violations of the BSA allow for the U.S. Government to seize the funds related to the crime. The USA PATRIOT Act amended the BSA to provide for funds forfeiture in cases dealing with foreign crimes, U.S. interbank accounts, and in connection with some currency transaction reporting violations. Furthermore, the U.S. Government can seize currency or other monetary instruments physically transported into or out of the U.S. when required BSA reports go unfiled or contain material omissions or misstatements.

Supervisory Actions

The FDIC has the authority to address less than adequate compliance with the BSA through various formal or informal administrative actions. If a specific violation of Section 326.8 or 31 CFR 103 is not corrected or the same provision of a regulation is cited from one examination to the next, Section 8(s) of the FDI Act requires the FDIC to consider formal enforcement action as described in Section 8(b) or 8(c) of the FDI Act. However, the FDIC has determined that informal enforcement action, such as a Board Resolution or a Memorandum of Understanding may be a more appropriate supervisory response, given related circumstances and events, which may serve as mitigating factors.

Violations of a technical and limited nature would not necessarily reflect an inadequate BSA program; as such, it is important to look at the type and number of violations before determining the appropriate administrative action. If the Regional Office reviews a case with significant violations, it should determine whether an enforcement action is necessary. Under such circumstances, if the Regional Office determines that a Cease and Desist action is **not** appropriate, then documentation supporting that decision should be maintained at the Regional Office and a copy of that documentation submitted to the Special Activities Section in Washington, D.C.

Memoranda of Understanding (MOU) and Board Resolutions (BBR)

In certain cases, the Regional Office may determine that a BBR or a MOU is an appropriate action to deal with an institution's BSA weaknesses. BBRs should only be used in circumstances where recommendations are minor and do not affect the overall adequacy of the institution's BSA compliance program. Unlike a BBR, a MOU is a bi-lateral agreement between the financial institution and the FDIC. When the Regional Office deems that a MOU is appropriate, the examiners, reviewer, the Regional SACM, and the Regional legal department may work together to formulate the provisions of the action and obtain appropriate approvals as soon as possible after the examination.

Cease and Desist Orders

Section 8(s) of the FDI Act grants the FDIC the power to issue Cease and Desist Orders solely for the purpose of correcting BSA issues at state nonmember banks. In situations where BSA/AML program weaknesses expose the institution to an elevated level of risk to potential money laundering activity, are repeatedly cited at consecutive examinations, or demonstrate willful noncompliance or negligence by management, a Section 8(b) Order to Cease and Desist should be considered by the Regional Office. Cases referred to FinCEN for civil money penalties should also be reviewed for **formal** supervisory action.

When a Cease and Desist Order is deemed to be appropriate, the examiners, reviewer, the Regional SACM, and the Regional legal department should work together to formulate the provisions of the action and obtain appropriate approvals as soon as possible after the examination. Specific details are contained in the Formal and Informal Actions Procedures (FIAP) Manual.

Removal/Prohibition Orders

If deficiencies or apparent violations of Section 326.8 or 31 CFR 103 involve negligent or egregious action or inaction by institution-affiliated parties (IAPs), other formal actions may be appropriate. In such situations where the IAP exposes the institution to an elevated risk of, or has facilitated or participated in actual transactions involving money laundering activity, utilization of Section

8(e) of the FDI Act, a removal/prohibition action, should be considered.

In cases where apparent violations of Section 326.8 and/or 31 CFR Section 103 have been committed by an IAP(s) and appear to involve criminal intent, examiners should contact the Regional SACM or other designees about filing a SAR on the IAP(s). If the involvement of the IAP(s) in the criminal activity warrants, the Regional Office should also consider contacting the Federal Bureau of Investigation (FBI) or other Federal law enforcement agency via phone or letter to provide them a referral of the SAR and indicate the FDIC's interest in pursuit of the case.

IDENTIFICATION OF SUSPICIOUS TRANSACTIONS

Effective BSA/AML compliance programs include controls and measures to identify and report suspicious transactions in a timely manner. An institution should have in place a CDD program sufficient to be able to make an informed decision about the suspicious nature of a particular transaction. This section highlights unusual or suspicious activities and transactions that may indicate potential money laundering through structured transactions, terrorist financing, and other schemes designed for illicit purposes. Often, individuals involved in suspicious activity will use a combination of several types of unusual transactions in an attempt to confuse or mislead anyone attempting to identify the true nature of their activities.

Structuring is the most common suspicious activity reported to FinCEN. Structuring is defined as breaking down a sum of currency that exceeds the $10,000 CTR reporting level per the regulation, into a series of transactions at or less than $10,000. The transactions do not need to occur on any single day in order to constitute structuring. Money launderers have developed many ways to structure large amounts of cash to evade the CTR reporting requirements. Examiners should be alert to multiple cash transactions that exceed $10,000, but may involve other monetary instruments, bank official checks, travelers' checks, savings bonds, loans and loan payments, or even securities transactions as the offsetting entry. The transactions could also involve the exchange of small bank notes for large ones, but in amounts less than $10,000. Structuring of cash transactions to evade CTR filing requirements is often the easiest of suspicious activities to identify. It is subject to criminal and civil violations of the BSA regulations as implemented within 31 CFR 130.63. This regulation states that any person who structures or assists in structuring a currency transaction at a financial institution for the purpose of evading CTR reporting, or causes or attempts to cause a financial institution to fail to file a CTR, or causes the financial institution to file a CTR that contains a material omission or misstatement of fact, is subject to the criminal and civil violations of the BSA regulations. Financial institutions are required by the BSA to have monitoring procedures in place to identify structured transactions.

Knowledge of the three stages of money laundering (discussed below) has multiple benefits for financial institutions. These benefits include, but are not limited to, the following:

- Identification and reporting of illicit activities to FinCEN,
- Prevention against losses stemming from fraud,
- Prevention against citation of apparent violations of BSA and SAR regulations, and
- Prevention against assessment of CMPs by FinCEN and/or the FDIC.

The following discussions and "red flag" lists, while not all-inclusive, identify various types of suspicious activity/transactions. These lists are intended to serve as a reference tool and should not be used to make immediate and definitive conclusions that a particular activity or series of transactions is illegal. They should be viewed as potentially suspicious warranting further review. The activity/transactions may not be suspicious if they are consistent with a customer's legitimate business.

The Three Stages of Money Laundering

There are three stages in typical money laundering schemes:

1. Placement,
2. Layering, and
3. Integration.

Placement

Placement, the first stage of money laundering, involves the placement of bulk cash into the financial system without the appearance of being connected to a criminal activity. There are many ways cash can be placed into the system. The simplest way is to deposit cash into a financial institution; however, this is also one of the riskier ways to get caught laundering money. To avoid notice, banking transactions involving cash are likely to be conducted in amounts under the CTR reporting thresholds; this activity is referred to as "structuring."

Furthermore, the use of false identities to conduct these transactions is common; banking officers should be vigilant in looking for false identification documents. In an attempt to conceal their activities, money launderers will often resort to "smurfing" activities to get illicit funds into a financial institution. "Smurfing" is the process of using several individuals to deposit illicit cash proceeds into many accounts at one or several financial institutions in a single day.

Furthermore, cash can be exchanged for traveler's checks, food stamps, or other monetary instruments, which can then also be deposited into financial institutions. Placement can also be done by purchasing goods or services, such as a travel/vacation package, insurance policies, jewelry, or other "high-ticket" items. These goods and services can then be returned to the place of purchase in exchange for a refund check, which can then be deposited at a financial institution with less likelihood of detection as being suspicious. Smuggling cash out of a country and depositing that cash into a foreign financial institution is also a form of placement. Illegally-obtained funds can also be funneled into a legitimate business as cash receipts and deposited without detection. This type of activity actually combines placement with the other two stages of money laundering, layering and integration, discussed below.

Layering

The second stage of money laundering is typically layering. This stage is the process of moving and manipulating funds to confuse their sources as well as complicating or partially eliminating the paper trail. Layering may involve moving funds in various forms through multiple accounts at numerous financial institutions, both domestic and international, in a complex series of transactions. Examples of layering transactions include:

- Transferring funds by check or monetary instrument;
- Exchanging cashier's checks and other monetary instruments for other cashier's checks, larger or smaller, possibly adding additional cash or other monetary instruments in the process;
- Performing intrabank transfers between accounts owned or controlled by common individuals (for example, telephone transfers);
- Performing wire transfers to accounts under various customer and business names at other financial institutions;
- Transferring funds outside and possibly back into the U.S. by various means such as wire transfers, particularly through "secrecy haven" countries;
- Obtaining certificate of deposit (CD) secured loans and depositing the loan disbursement check into an account (when the loan is defaulted on, there is no loss to the bank); and
- Depositing a refund check from a canceled vacation package or insurance policy.

Layering transactions may become very complex and involve several of these methods to hide the trail of funds.

Integration

The third stage of money laundering is integration, which typically follows the layering stage. However, as mentioned in the discussion of the placement stage, integration can be accomplished simultaneously with the placement of funds. After the funds have been placed into the financial system and insulated through the layering process, the integration phase is used to create the appearance of legality through additional transactions such as loans, or real estate deals. These transactions provide the criminal with a plausible explanation as to where the funds came from to purchase assets and shield the criminal from any type of recorded connection to the funds.

During the integration stage, the funds are returned in a usable format to the criminal source. This process can be achieved through various schemes, such as:

- Inflating business receipts,
- Overvaluing and undervaluing invoices,
- Creating false invoices and shipping documents,
- Establishing foreign trust accounts,
- Establishing a front company or phony charitable organization, and
- Using gold bullion schemes.

These schemes are just a few examples of the integration stage; the possibilities are not limited.

Money Laundering Red Flags

Some activities and transactions that are presented to a financial institution should raise the level of concern regarding the possibility of potential money laundering activity. Evidence of these "red flags" in an institution's accounts and transactions should prompt the institution, and examiners reviewing such activity, to consider the possibility of illicit activities. While these red flags are not evidence of illegal activity, these common indicators should be part of an expanded review of suspicious activities.

General

- **Refusal or reluctance to proceed with a transaction, or abruptly withdrawing a transaction.** A customer may be reluctant to proceed, or may even withdraw all or a portion of a transaction after being informed that a CTR will be filed, or that the purchase of a monetary instrument will be recorded. This action would be taken to avoid BSA reporting and recordkeeping requirements.

- **Customer refusal or reluctance to provide information or identification.** A customer may be reluctant, or even refuse to provide identifying information when opening an account, cashing a check, recording the purchase of a monetary instrument, or providing information necessary to file a CTR.

- **Structured or recurring, non-reportable transactions.** An individual or group may attempt to avoid BSA reporting and recordkeeping requirements by breaking up, or structuring a currency transaction or purchase of monetary instruments in amounts less than the reporting/recordkeeping thresholds. Transactions may also be conducted with multiple banks, branches, customer service representatives, accounts, and/or on different days in an attempt to avoid reporting requirements.

- **Multiple third parties conducting separate, but related, non-reportable transactions.** Two or more individuals may go to different tellers or branches and each conduct transactions just under the reporting/recordkeeping threshold. (This activity is often referred to as "smurfing.")

- **Even dollar amount transactions.** Numerous transactions are conducted in even dollar amounts.

- **Transactions structured to lose the paper trail.** The bank may be asked to process internal debits or credits containing little or no description of the transaction in an attempt to "separate" a transaction from its account.

- **Significant increases in the number or amount of transactions.** A large increase in the number or amount of transactions involving currency, the purchase of monetary instruments, wire transfers, etc., may indicate potential money laundering.

- **Transactions which are not consistent with the customer's business, occupation, or income level.** Transactions should be consistent with the customer's known business or income level.

- **Transactions by non-account holders.** A non-account holder conducts or attempts to conduct transactions such as currency exchanges, the purchase or redemption of monetary instruments, with no apparent legitimate reason.

<u>Cash Management: Branch and Vault Shipments</u>

- **Change in currency shipment patterns.** Significant changes in currency shipment patterns between vaults, branches and/or correspondent banks as noted on cash shipment records may indicate a potential money laundering scheme occurring in a particular location.

- **Large increase in the cash supply.** A large, sustained increase in the cash balance would normally cause some increase in the number of CTRs filed. Another example of a red flag in this area would be a rapid increase in the size and frequency of cash deposits with no corresponding increase in non-cash deposits.

- **Currency shipments to or from remote locations**. Unusually large transactions between a small, remote bank and a large metropolitan bank may also indicate potential money laundering.

- **Significant exchanges of small denomination bills for large denomination bills**. Significant increases resulting from the exchange of small denominations for large denominations may be reflected in the cash shipment records.

- **Significant requirement for large bills.** Branches whose large bill requirements are significantly greater than the average may be conducting large currency exchanges. Branches that suddenly stop shipping large bills may be using them for currency exchanges.

- **International cash shipments funded by multiple monetary instruments.** This involves the receipt of funds in the form of multiple official bank checks, cashier's checks, traveler's checks, or personal checks that are drawn on or issued by U.S. financial institutions. They may be made payable to the same individual or business, or related individuals or businesses, and may be in U.S. dollar amounts that are below the BSA reporting/recordkeeping threshold. Funds are then shipped or wired to a financial institution outside the U.S.

- **Other unusual domestic or international shipments.** A customer requests an outgoing shipment or is the beneficiary of a shipment of currency, and the instructions received appear inconsistent with normal cash shipment practices. For example, the customer directs the bank to ship the funds to a foreign country and advises the bank to expect same day return of funds from sources different than the beneficiary named, thereby changing the source of the funds.

- **Frequent cash shipments with no apparent business reason**. Frequent use of cash shipments that is not justified by the nature of the customer's business may be indicative of money laundering.

Currency Exchanges and Other Currency Transactions

- **Unusual exchange of denominations**. An individual or group seeks the exchange of small denomination bills (five, ten and twenty dollar bills) for large denomination bills (hundred dollar bills), without any apparent legitimate business reason.

- **Check cashing companies**. Large increases in the number and/or amount of cash transactions for check cashing companies.

- **Unusual exchange by a check cashing service.** No exchange or cash back for checks deposited by an individual who owns a check cashing service can indicate another source of cash.

- **Suspicious movement of funds.** Suspicious movement of funds out of one financial institution, into another financial institution, and back into the first financial institution can be indicative of the layering stage of money laundering.

Deposit Accounts

- **Minimal, vague or fictitious information provided**. An individual provides minimal, vague, or fictitious information that the financial institution cannot readily verify.

- **Lack of references or identification.** An individual attempts to open an account without references or identification, gives sketchy information, or refuses to provide the information needed by the financial institution.

- **Non-local address**. The individual does not have a local residential or business address and there is no apparent legitimate reason for opening an account with the bank.

- **Customers with multiple accounts.** A customer maintains multiple accounts at a bank or at different banks for no apparent legitimate reason. The accounts may be in the same names or in different names with different signature authorities. Routine inter-account transfers provide a strong indication of accounts under common control.

- **Frequent deposits or withdrawals with no apparent business source**. The customer frequently deposits or withdraws large amounts of currency with no apparent business source, or the business is of a type not known to generate substantial amounts of currency.

- **Multiple accounts with numerous deposits under $10,000**. An individual or group opens a number of accounts under one or more names, and makes numerous cash deposits just under $10,000, or deposits containing bank checks or traveler's checks, or a combination of all of these.

- **Numerous deposits under $10,000 in a short period of time**. A customer makes numerous deposits under $10,000 in an account in short periods of time, thereby avoiding the requirement to file a CTR. This includes deposits made at an ATM.

- **Accounts with a high volume of activity and low balances**. Accounts with a high volume of activity, which carry low balances, or are frequently overdrawn, may be indicative of money laundering or check kiting.

- **Large deposits and balances.** A customer makes large deposits and maintains large balances with little or no apparent justification.

- **Deposits and immediate requests for wire transfers or cash shipments**. A customer makes numerous deposits in an account and almost immediately requests wire transfers or a cash shipment from that account to another account, possibly in another country. These transactions are not consistent with the customer's legitimate business needs. Normally, only a nominal amount remains in the original account.

- **Numerous deposits of small incoming wires or monetary instruments, followed by a large outgoing wire**. Numerous small incoming wires and/or multiple monetary instruments are deposited into an account. The customer then requests a large outgoing wire to another institution or country.

- **Accounts used as a temporary repository for funds.** The customer appears to use an account as a temporary repository for funds that ultimately will be transferred out of the financial institution, sometimes to foreign-based accounts. There is little account activity.

- **Funds deposited into several accounts, transferred to another account, and then transferred outside of the U.S.** This involves the deposit of funds into several accounts, which are then combined into one account, and ultimately transferred outside the U.S. This activity is usually not consistent with the known legitimate business of the customer.

- **Disbursement of certificates of deposit by multiple bank checks.** A customer may request disbursement of the proceeds of a certificate of deposit or other investments in multiple bank checks, each at or under $10,000. The customer can then negotiate these checks elsewhere for currency. The customer avoids the CTR requirements and severs the paper trail.

- **Early redemption of certificates of deposits**. A customer may request early redemption of certificates of deposit or other investments within a relatively short period of time from the purchase date of the certificate of deposit or investment. The customer may be willing to lose interest and incur penalties as a result of the early redemption.

- **Sudden, unexplained increase in account activity or balance**. There may be a sudden, unexplained increase in account activity, both from cash and from non-cash items. An account may be opened with a nominal balance that subsequently increases rapidly and significantly.

- **Limited use of services.** Frequent large cash deposits are made by a corporate customer, who maintains high balances but does not use the financial institution's other services.

- **Inconsistent deposit and withdrawal activity.** Retail businesses may deposit numerous checks, but there will rarely be withdrawals for daily operations.

- **Strapped currency**. Frequent deposits of large amounts of currency, wrapped in currency straps that have been stamped by other financial institutions.

- **Client, trust and escrow accounts**. Substantial cash deposits by a professional customer into client accounts, or in-house company accounts, such as trust and escrow accounts.

- **Large amount of food stamps.** Unusually large deposits of food stamps, which may not be consistent with the customer's legitimate business.

<u>Lending</u>

- **Certificates of deposits used as collateral.** An individual buys certificates of deposit and uses them as loan collateral. Illegal funds can be involved in either the certificate of deposit purchase or utilization of loan proceeds.

- **Sudden/unexpected payment on loans**. A customer may suddenly pay down or pay off a large loan, with no evidence of refinancing or other explanation.

- **Reluctance to provide the purpose of the loan or the stated purpose is ambiguous**. A customer seeking a loan with no stated purpose may be trying to conceal the true nature of the loan. The BSA requires the bank to document the purpose of all loans over $10,000, with the exception of those secured by real property.

- **Inconsistent or inappropriate use of loan proceeds**. There may be cases of inappropriate disbursement of loan proceeds, or disbursements for purposes other than the stated loan purpose.

- **Overnight loans.** A customer may use "overnight" loans to create high balances in accounts.

- **Loan payments by third parties.** Loans that are paid by a third party could indicate that the assets securing the loan are really those of a third party, who may be attempting to conceal ownership of illegally, gained funds.

- **Loan proceeds used to purchase property in the name of a third party, or collateral pledged by a third party.** A customer may use loan proceeds to purchase, or may pledge as collateral, real property in the name of a trustee, shell corporation, etc.

- **Permanent mortgage financing with an unusually short maturity, particularly in the case of large mortgages.**

- **Structured down payments or escrow money transactions**. An attempt to "structure" a down payment or escrow money transaction may be made in order to conceal the true source of the funds used.

- **Attempt to sever the paper trail**. Attempts may be made by the customer or bank to sever any paper trail connecting a loan to the collateral.

- **Wire transfer of loan proceeds**. A customer may request that loan proceeds be wire transferred for no apparent legitimate reason.

- **Disbursement of loan proceeds by multiple bank checks**. A customer may request disbursement of loan proceeds in multiple bank checks, each under $10,000. The customer can then negotiate these checks elsewhere for currency. The customer avoids the currency transaction reporting requirements and severs the paper trail.

- **Loans to companies outside the U.S.** Unusual loans to offshore customers, and loans to companies incorporated in "secrecy havens" are higher risk activities.

- **Financial statement.** Financial statement composition of a business differs greatly from those of similar businesses.

Monetary Instruments

- **Structured purchases of monetary instruments.** An individual or group purchases monetary instruments with currency in amounts below the $3,000 BSA recordkeeping threshold.

- **Replacement of monetary instruments**. An individual uses one or more monetary instruments to purchase another monetary instrument(s).

- **Frequent purchase of monetary instruments without apparent legitimate reason**. A customer may repeatedly buy a number of official bank checks or traveler's checks with no apparent legitimate reason.

- **Deposit or use of multiple monetary instruments**. The deposit or use of numerous official bank checks or other monetary instruments, all purchased on the same date at different banks or different issuers of the instruments may indicate money laundering. These instruments may or may not be payable to the same individual or business.

- **Incomplete or fictitious information**. The customer may conduct transactions involving monetary instruments that are incomplete or contain fictitious payees, remitters, etc.

- **Large cash amounts.** The customer may purchase cashier's checks, money orders, etc., with large amounts of cash.

Safe Deposit Boxes

- **Frequent visits.** The customer may visit a safe deposit box on an unusually frequent basis.

- **Out-of-area customers.** Safe deposit boxes may be opened by individuals who do not reside or work in the banks service area.

- **Change in safe deposit box traffic pattern.** There may be traffic pattern changes in the safe deposit box area. For example, more people may enter or enter more frequently, or people carry bags or other containers that could conceal large amounts of cash.

- **Large amounts of cash maintained in a safe deposit box**. A customer may access the safe deposit box after completing a transaction involving a large withdrawal of cash, or may access the safe deposit box prior to making cash deposits which are just under $10,000.

- **Multiple safe deposit boxes**. A customer may rent multiple safe deposit boxes if storing large amounts of currency.

Wire Transfers

- **Wire transfers to countries widely considered "secrecy havens."** Transfers of funds to well known "secrecy havens."

- **Incoming/outgoing wire transfers with instructions to the receiving institution to pay upon proper identification**. The instructions to the receiving bank are to "pay upon proper identification." If paid for in cash, the amount may be just under $10,000 so no CTR is required. The purchase may be made with numerous official checks or other monetary instruments. The amount of the transfer may be large, or the funds may be sent to a foreign country.

- **Outgoing wire transfers requested by non-account holders.** If paid in cash, the amount may be just under $10,000 to avoid the CTR filing requirement.

Alternatively, the transfer may be paid with several official checks or other monetary instruments. The funds may be directed to a foreign country.

- **Frequent wire transfers with no apparent business reason**. A customer's frequent wire transfer activity is not justified by the nature of their business.

- **High volume of wire transfers with low account balances.** The customer requests a high volume of incoming and outgoing wire transfers but maintains low or overdrawn account balances.

- **Incoming and outgoing wires in similar dollar amounts**. There is a pattern of wire transfers of similar amounts both into and out of the customer's account, or related customer accounts, on the same day or next day. The customer may receive many small incoming wires, and then order a large outgoing wire transfer to another city or country.

- **Large wires by customers operating a cash business**. Could involve wire transfers by customers operating a mainly cash business. The customers may be depositing large amounts of currency.

- **Cash or bearer instruments used to fund wire transfers**. Use of cash or bearer instruments to fund wire transfers may indicate money laundering.

- **Unusual transaction by correspondent financial institutions.** Suspicious transactions may include: (1) wire transfer volumes that are extremely large in proportion to the asset size of the bank; (2) when the bank's business strategy and financial statements are inconsistent with a large volume of wire transfers, particularly outside the U.S.; or (3) a large volume of wire transfers of similar amounts in and out on the same or next day.

- **International funds transfer(s) which are not consistent with the customer's business**. International transfers, to or from the accounts of domestic customers, in amounts or with a frequency that is inconsistent with the nature of the customer's known legitimate business activities could indicate money laundering.

- **International transfers funded by multiple monetary instruments**. This involves the receipt of funds in the form of multiple official bank checks, traveler's checks, or personal checks that are drawn on or issued by U.S. financial institutions and made payable to the same individual or business, or related individuals or businesses, in U.S. dollar amounts that are below the BSA reporting threshold. The funds are then wired to a financial institution outside the U.S.

- **Other unusual domestic or international funds transfers.** The customer requests an outgoing wire or is the beneficiary of an incoming wire, and the instructions appear inconsistent with normal wire transfer practices. For example, the customer directs the bank to wire the funds to a foreign country and advises the bank to expect same day return of funds from sources different than the beneficiary named, thereby changing the source of the funds.

- **No change in form of currency.** Funds or proceeds of a cash deposit may be wired to another country without changing the form of currency.

<u>Other Activities Involving Customers and Bank Employees</u>

- **Questions or discussions on how to avoid reporting/recordkeeping**. This involves discussions by individuals about ways to bypass the filing of a CTR or recording the purchase of a monetary instrument.

- **Customer attempt to influence a bank employee not to file a report**. This would involve any attempt by an individual or group to threaten, bribe, or otherwise corruptly influence a bank employee to bypass the filing of a CTR, the recording of purchases of monetary instruments, or the filing of a SAR.

- **Lavish lifestyles of customers or bank employees**. Lavish lifestyles of customers or employees, which are not supported by their current salary, may indicate possible involvement in money laundering activities.

- **Short-term or no vacations.** A bank employee may be reluctant to take any vacation time or may only take short vacations (one or two days).

- **Circumvention of internal control procedures**. Overrides of internal controls, recurring exceptions, and out-of-balance conditions may indicate money laundering activities. For example, bank employees may circumvent wire transfer authorizations and approval policies, or could split wire transfers to avoid ceiling limitations.

- **Incorrect or incomplete CTRs**. Employees may frequently submit incorrect or incomplete CTRs.

Terrorist Financing Red Flags

Methods used by terrorists to generate funds can be both legal and illegal. In the U.S., it is irrelevant whether terrorist funding is obtained legally or illegally; any funds provided to support terrorist activity are considered to be laundered money. Funding from both legal and illegal sources must be laundered by the terrorist in order to obscure links between the terrorist group (or cell) and its funding sources and uses. Terrorists and their support organizations typically use the same methods that criminal groups use to launder funds. In particular, terrorists appear to favor:

- Cash smuggling, both by couriers or in bulk cash shipments;
- Structured deposits and/or withdrawals;
- Purchases of monetary instruments;
- Use of credit and/or debit cards; and
- Use of underground banking systems.

While it is not the primary function of an examiner to identify terrorist financing while examining an institution for BSA compliance, examiners and financial institution management should be cognizant of suspicious activities or unusual transactions that are common indicators of terrorist financing. Institutions are encouraged to incorporate procedures into their BSA/AML compliance programs that address notifying the proper Federal agencies when serious concerns of terrorist financing activities are encountered. At a minimum, these procedures should require the institution to contact FinCEN's Financial Institutions Hotline to report such activities.

SUSPICIOUS ACTIVITY REPORTING

Part 353 of the FDIC's Rules and Regulations requires insured state nonmember banks to report known or suspected criminal offenses to the Treasury. The SAR form to be used by financial institutions is Form TD F 90-22.47 and is available on the FinCEN website. FinCEN is the repository for these reports, but content is owned by the Federal Banking Agencies. The SAR form is used to report many types of suspected criminal violations. Details of the criminal violations can be found in the Criminal Violations section of this manual.

Suspicious Activities and Transactions Requiring SAR Filings

Among the suspicious activities required to be reported are any transactions aggregating $5,000 or more that involve potential money laundering, suspected terrorist financing activities, or violations of the BSA. However, if a financial institution insider is involved in the suspicious transaction(s), a SAR must be filed at any transaction amount. Other suspected criminal activity requires filing a SAR if the transactions aggregate $5,000 or more and a suspect can be identified. If the financial institution is unable to identify a suspect, but believes it was an actual or potential victim of a criminal violation, then a SAR must be filed for transactions aggregating $25,000 or more. Although these are the required transaction levels for filing a SAR, a financial institution may voluntarily file a SAR for suspicious transactions below these thresholds. SAR filings are not used for reporting robberies to local law enforcement, or for lost, counterfeit, or stolen securities that are reported pursuant to 17 CFR 240.17f-1.

If the suspicious transaction involves currency and exceeds $10,000, the financial institution will also need to file a CTR in addition to a SAR.

For suspected money laundering and violations of the BSA, a financial institution must file a SAR, if it knows, suspects, or has reason to suspect that:

- The transaction involves funds derived from illegal activities or is intended or conducted in order to conceal funds or assets derived from illegal activities (including without limitation, the ownership, nature, source, location, or control of such funds or assets), as part of a plan to violate or evade any Federal law or regulation or to avoid any transaction reporting requirement under Federal law;
- The transaction is designed to evade any regulation promulgated under the BSA; or
- The transaction has no business or apparent lawful purpose or is not the sort of transaction in which the particular customer would normally be expected to engage, and the financial institution knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

Preparation of the SAR Form

The SAR form requires the financial institution to complete detailed information about the suspect(s) of the transaction, the type of suspicious activity, the dollar amount involved, along with any loss to the financial institution, and information about the reporting financial institution. Part V of the SAR form requests a narrative description of the suspect violation and transactions and is used to document what supporting information and records the financial institution retains. This section is considered very critical in terms of explaining the apparent criminal activity to law enforcement and regulatory agencies. The information provided in this section should be complete, accurate, and well-organized. This section should contain additional information on suspects, describe instruments and methods of facilitating the transaction, and provide any follow-up action taken by the financial institution. Data inserts in the form of tables or graphics are discouraged as they are not compatible with the SAR database at FinCEN. Also, attachments to a SAR form will not be stored in the database because they do not conform to the database format. Consequently, a narrative in Part V that states only "see attached" will result in no meaningful description of the transaction, rendering the record in this field insufficient.

The financial institution is also encouraged to detail a listing of documentation available that supports the SAR filing in Part V of the SAR form. This notice will provide law enforcement the awareness necessary to ensure timely access to vital information, if further investigation results from the SAR filing. All documentation supporting the SAR must be stored by the financial institution for five years and is considered property of the U.S. Government.

FinCEN has provided ongoing guidance on how to prepare SAR forms in its publication, "SAR Activity Reviews," under a section on helpful hints, tips, and suggestions on SAR filing. These publications are available at the FinCEN website. Financial institution management should be encouraged to review current and past issues as an aid in properly completing SARs.

SAR Filing Deadlines

By regulation, SAR forms are required to be filed no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing a SAR. If no suspect was identified on the date of detection of the incident requiring the filing, a financial institution may delay filing a SAR for an additional 30 calendar days in order to identify a suspect. In no case shall reporting be delayed more than 60 days after the date of initial detection of a reportable transaction.

Customers Engaging in Ongoing Suspicious Activity

If a customer's suspicious activity continues to occur, FinCEN recommends the financial institution file an update on the activity and amounts every 90 days using the SAR form. In such instances, the financial institution should aggregate the dollar amount of previously reported activity and the dollar amount of the newer activity and put this amount in the box on the SAR requesting "total dollar amount involved in known or suspicious activity." Similarly, for the date range of suspicious activity, the financial institution should maintain the original "start" date and extend the "to" date to include the 90 day period in which the suspicious and reportable activity continued.

Failure to File SARs

If an examiner determines that a financial institution has failed to file a SAR when there is evidence to indicate a report should have been filed, the examiner should instruct the financial institution to immediately file the SAR. If the financial institution refuses, the examiner should complete the SAR and cite violations of Part 353 of the FDIC's Rules and Regulations, providing limited details of suspicious activity or the SAR in the Report of Examination. In instances involving a senior officer or director of the financial institution, examiners may prepare the SAR, rather than request the financial institution to do so in order to ensure that the SAR explains the suspicious activity accurately and completely. Each Regional Office is responsible for monitoring SARs filed within that region. Examiner-prepared SARs should be forwarded to their Regional Special Activities Case Manager to ensure timely and proper filing. Any examiner-prepared SARs and all supporting documents should be maintained in the field office files for five years.

SAR Filing Methods

SARs can be filed in paper form, by magnetic tape, or through the Patriot Act Communications System. Financial institutions may contact law enforcement and their Federal Banking Agency to notify them of the suspicious activity, and these contacts should be noted on the SAR form.

Notification to Board of Directors of SAR Filings

Section 353.3 of the FDIC's Rules and Regulations requires the financial institution's board of directors, or designated committee, be promptly notified of any SAR filed. However, if the subject of the SAR is a senior officer or member of the board of directors of the financial institution, notification to the board of directors should be handled differently in order to avoid violating Federal laws that prohibit notifying a suspect or person involved in the suspicious transaction that forms the basis of the SAR. In these situations, it is recommended that appropriate senior personnel not involved in the suspicious activity be advised of the SAR filing and this process be documented.

In cases of financial institutions that file a large volume of SARs, it is not necessary that the board of directors, or designated committee thereof, review each and every SAR document. It is acceptable for the BSA officer to prepare an internal tracking report that briefly discusses all of the SARs filed for a particular month. As long as this tracking report is meaningful in content, then the institution will still be meeting the requirements of Part 353 of the FDIC's Rules and Regulations. Such a report would identify the following information for each SAR filed:

- Customer's name and any additional suspects;
- Social Security Number or TIN;
- Account number (if a customer);
- The date range of suspicious activity;
- The dollar amount of suspicious activity;
- Very brief synopsis of reported activity (for example, "cash deposit structuring" or "wire transfer activity inconsistent with business/occupation"); and
- Indication of whether it is a first-time filing or repeat filing on the customer/suspects.

Such a tracking report promotes efficiency in review of multiple SAR filings. Nevertheless, there are still some SARs that the board of directors, or designated committee thereof, should review individually. Such "significant SARs" would include those that involve insiders (notwithstanding the guidance above regarding the handling of SARs involving board members and senior management), suspicious activity above an internally determined dollar threshold, those involving significant check kiting activity, etc. Financial institutions are encouraged to develop their own parameters for defining "significant SARs" necessitating full reviews; such guidance needs to be written and formalized within board approved BSA policies and procedures.

Safe Harbor for Institutions on SAR Filings

A financial institution that files a SAR is accorded safe harbor from civil liability for filing reports of suspected or known criminal violations and suspicious activities with appropriate authorities. Any financial institution that is subpoenaed or otherwise requested to disclose information contained in a SAR or the fact that a SAR was filed to others shall decline to produce the SAR or provide any information or statements that would disclose that a SAR has been prepared or filed. This prohibition does not preclude disclosure of facts that are the basis of the SAR, as long as the disclosure does not state or imply that a SAR has been filed on the underlying information.

Recently, the safe harbor protections were reiterated and expanded. Section 351 of the USA PATRIOT Act, amended Section 5318(g)(3) of 31 USC and included directors, officers, employees, and agents of the financial institutions who participate in preparing and reporting of SARs under safe harbor protections. Section 355 of the USA PATRIOT Act, implemented at Section 18(w) of the FDI Act, established a means by which financial institutions can share factual information of suspected involvement in criminal activity with each other in connection with references for employment. To comply, employment references must be written and the disclosure made without malicious intent. The financial institution still may not disclose that a SAR was filed. The sharing of employment information is voluntary and should be done under adequate procedures, which may include review by the institution's legal counsel to assess potential for claims of malicious intent.

Examination Guidance

Examiners should ensure that the financial institution has procedures in place to identify and report suspicious activity for all of the financial institution's departments and activities. The guidance may be contained in several policies and procedures; however, it may be advisable for the financial institution to centrally manage the reporting of suspicious activities to ensure that transactions are being reported, when appropriate. A single point of contact can also expedite law enforcement contacts and requests to review specific SARs and their supporting documentation.

As part of its BSA and anti-money laundering programs, the financial institution's policies should detail procedures for complying with suspicious activity reporting requirements. These procedures should define reportable suspicious activity. Financial institutions are encouraged to elaborate and clarify definitions using examples and discussion of the criminal violations. Parameters to filter transactions and review for customer suspicious activity should also be established. Typically, the criteria will be used to identify exceptions to expected customer and transaction activity patterns and identify high-risk customers, whose accounts and transactions should be subject to enhanced scrutiny. Procedures to facilitate accurate and timely filing of SARs, as well as to ensure proper maintenance of supporting documentation, should also be prescribed. Procedures to document decisions not to file a SAR should also be established. Reporting requirements, including reporting SAR filings to senior management and institution directors should be defined. Any additional actions, such as closer monitoring or closing of an involved account(s) that the financial institution may wish to take should be defined in the policy. Many institutions are concerned about facilitating money laundering by continuing to process these suspicious transactions. As there is no requirement to close an account, the institution should assess each situation and provide corresponding guidance on this area in its policy. If the financial institution does plan to close an account that is under investigation by law enforcement, then the institution should notify law enforcement of its intent to close the account.

SAR Database

If examiners need specific SAR filing information, they should contact their Regional SACM or other designees. These specially designated individuals have access to the FinCEN computer system and the database containing records of SAR filings. The database contains information from SARs filed by all federally insured financial institutions. The database is maintained according to the numbered reporting fields in the SAR form, so information can be searched, for example, by suspect, type of violation, or location.

Under current guidance, examiners should obtain a listing or copies of the SARs filed in the current and previous two years by a financial institution for pre-examination planning purposes. Additional searches may be requested as needed, such as to identify whether a SAR has been filed for suspicious activity discovered during the examination, or to obtain information about additional SAR filings on a particular suspect or group of transactions.

For additional guidance on obtaining SAR data, refer to the detailed instructions provided within the "Currency and Banking Retrieval System" discussion within the "Financial Crimes Enforcement Network Reporting and Recordkeeping Requirements" section of this chapter.

OFFICE OF FOREIGN ASSETS CONTROL

The Treasury's Office of Foreign Assets Control administers laws that impose economic and trade sanctions based on foreign policy and national security objectives. Sanctions have been established against various entities and individuals such as targeted foreign countries, terrorists, international narcotics traffickers, and those engaging in activities relating to the proliferation of weapons of mass destruction. Collectively, such individuals and companies are called Specially Designated Nationals (SDNs) and Blocked Persons.

OFAC acts under Presidential wartime and national emergency powers, in addition to authority granted by specific legislation. OFAC has powers to impose controls on transactions and to freeze foreign assets under U.S. jurisdiction. Sanctions can be specific to the interests of the U.S.; however, many sanctions are based on United Nations and other international mandates. Sanctions can include one or more of the following:

- Blocking of assets,
- Trade embargoes,
- Prohibition on unlicensed trade and/or financial transactions,
- Travel bans, and
- Other financial and commercial prohibitions.

A complete list of countries and other specially-designated targets that are currently subject to U.S. sanctions and a detailed description of each order can be found on the Treasury website.

OFAC Applicability

OFAC regulations apply to all U.S. persons and entities, including financial institutions. As such, all U.S. financial institutions, their branches and agencies, international banking facilities, and domestic and overseas branches, offices, and subsidiaries must comply with OFAC sanctions.

Blocking of Assets, Accounts, and Transactions

OFAC regulations require financial institutions to block accounts and other assets and prohibit unlicensed trade and financial transactions with specified countries. Assets and accounts must be blocked when that property is located in the U.S., or is held by, possessed by, or under the control of U.S. persons or entities. The definition of assets and property can include anything of direct, indirect, present, future, and contingent value. Since this definition is so broad, it can affect many types of products and services provided by financial institutions.

OFAC regulations also direct that prohibited accounts of and transactions with SDNs and Blocked Persons need to be blocked or rejected. Generally, U.S. financial institutions must block or freeze funds that are remitted by or on behalf of a blocked individual or entity, are remitted to or through a blocked entity, or are remitted in connection with a transaction in which a blocked entity has an interest. For example, a financial institution cannot send a wire transfer to a blocked entity; once a payment order has been received from a customer, those funds must be placed in an account on the blocked entity's behalf. The interest rate must be a commercially reasonable rate (i.e., at a rate currently offered to other depositors with similar deposit size and terms). Customers cannot cancel or amend payment orders on blocked funds after the U.S.

financial institution has received the order or the funds in question. Once these funds are blocked, they may be released only by specific authorization from the Treasury. Full guidelines for releasing blocked funds are available on the OFAC website. Essentially, either the financial institution or customer files an application with OFAC to obtain a license or authorization to release the blocked funds.

Rejected transactions are those that are to be stopped because the underlying action is prohibited and cannot be processed per the sanctions program. Rejected transactions are to be returned to the sending institution. Transactions include, but are not limited to, the following:

- Cash deposits;
- Personal, official, and traveler's checks;
- Drafts;
- Loans;
- Obligations;
- Letters of credit;
- Credit cards;
- Warehouse receipts;
- Bills of sale;
- Evidences of title;
- Negotiable instruments, such as money orders;
- Trade acceptances;
- Wire transfers;
- Contracts;
- Trust assets; and
- Investments.

OFAC Reporting Requirements

OFAC imposes reporting requirements for blocked property and blocked or rejected transactions. OFAC does not take control of blocked or rejected funds, but it does require financial institutions to report all blocked property to OFAC annually by September 30th. Additionally, financial institutions must notify OFAC of blocked or rejected transactions within 10 days of their occurrence.

When an institution identifies an entity that is an exact match, or has many similarities to a subject listed on the SDN and Blocked Persons List, the institution should contact OFAC Compliance at 1-800-540-6322 for verification. Unless a transaction involves an exact match, it is recommended that the institution contact OFAC Compliance before blocking assets.

Issuance of OFAC Lists

OFAC frequently publishes updates to its list of SDNs and Blocked Persons. This list identifies individuals and companies owned or controlled by, or acting for or on behalf of, targeted countries. It also includes those individuals, groups, and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific. OFAC adds and removes names as necessary and appropriate and posts those updates to its website. The Special Activities Section in Washington D.C. notifies FDIC-supervised institutions that updates to the SDN and Blocked Persons List are available through Financial Institution Letters.

Maintaining an updated SDN and Blocked Persons list is essential to an institution's compliance with OFAC regulations. It is important to remember that outstanding sanctions can and do change and names of individuals and entities are added to the list frequently. Financial institutions should establish procedures to ensure that its screening information is up-to-date to prevent accepting, processing, or facilitating illicit financial transactions and the potential civil liability that may result.

Financial Institution Responsibilities – OFAC Programs and Monitoring Systems

Financial institutions are subject to the prohibitions and reporting required by OFAC regulations; however, there are not any regulatory program requirements for compliance. Neither OFAC nor Federal financial institution regulators have established laws or regulations dictating what banking records must be screened for matches to the OFAC list, or how frequently reviews should be performed. A violation of law occurs only when the institution conducts a blocked or rejected transaction, <u>regardless</u> of whether the financial institution is aware of it. Additionally, institutions that fail to block and report a transfer (which is subsequently blocked by another bank) may be subject to adverse publicity, fines, and even criminal penalties.

OFAC has the authority to assess CMPs for any sanction violation, and these penalties can be severe. Over the past several years, OFAC has had to impose millions of dollars in CMPs involving U.S. financial institutions. The majority of these fines resulted from institution's failure to block illicit transfers when there was a reference to a targeted country or SDN. While the maximum penalties are established by law, OFAC will consider the Federal banking regulator's most recent assessment of the financial institution's OFAC compliance program as one of the mitigating factors for determining any penalty. In addition, OFAC can pursue criminal penalties if there is any evidence of criminal intent on the part of the financial institution or its employees. Criminal penalties provide for imprisonment up to 30 years and fines ranging up to $10 million.

Furthermore, financial institutions are not permitted to transfer responsibility for OFAC compliance to correspondent banks or a contracted third party, such as a data processing service provider. Each financial institution is responsible for every transaction occurring by or through its systems. If a sanctioned transaction transverses several U.S. financial institutions, all of these institutions will be subject to the same civil or criminal action, with the exception of the financial institution that blocked or rejected the transaction, as appropriate.

Examination Considerations

Financial institutions should establish and maintain effective OFAC programs and screening capabilities in order to facilitate safe and sound banking practices. It is not the examiner's primary duty to identify unreported accounts or transactions within an institution. Rather, examination procedures should focus on evaluating the adequacy of an institution's overall OFAC compliance program and procedures, including the systems and controls in place to reasonably assure accounts and transactions are blocked and rejected.

In reviewing an institution's OFAC compliance program, examiners should evaluate the operational risks the financial institution is willing to accept and determine if this exposure is reasonable in comparison with the business type, department or product, customer base, and cost of an effective screening program for that particular institution, based on its risk profile.

The FDIC strongly recommends that each financial institution adopt a risk-focused, written OFAC program designed to ensure compliance with OFAC regulations. An effective OFAC program should include the following:

- Written policies and procedures for screening transactions and new customers to identify possible OFAC matches;
- Qualified individual to monitor compliance and oversee blocked funds;
- OFAC risk-assessment for various products and departments within the financial institution;
- Guidelines and internal controls to ensure the periodic screening of all existing customer accounts;
- Procedures for obtaining and maintaining up-to-date OFAC lists of blocked countries, entities, and individuals;
- Methods for conveying timely OFAC updates throughout the financial institution, including offshore locations and subsidiaries;
- Procedures for handling and reporting prohibited OFAC transactions;
- Guidance for SAR filings on OFAC matches, if appropriate, such as when criminal intent or terrorist activity is involved;
- Internal review or audit of the OFAC processes in each affected department; and
- Training for all appropriate employees, including those in offshore locations and subsidiaries.

Departmental and product risk assessments are fundamental to a sound OFAC compliance program. These assessments allow institution management to ensure appropriate focus on high-risk areas, such as correspondent banking activities and electronic funds transfers. An effective program will filter as many transactions as possible through OFAC's SDN and Blocked Persons List, whether they are completed manually or through the use of a third party software program. However, when evaluating an institution's compliance program, examiners should consider matters such as the size and complexity of the institution. Adequate compliance procedures can and should be targeted to transactions that pose the greatest risk to an institution. Some transactions may be difficult to capture within a risk-focused compliance program. For example, a customer could write a personal check to a blocked entity; however, the only way the financial institution that the check is drawn upon could block those funds would be if it reviewed the payee on each personal check, assuming the information is provided and legible. Under current banking practices, this would be costly and time consuming. Most financial institutions do not have procedures for interdicting these transactions, and, yet, if such a transaction were to be processed by a U.S. financial institution, it is a violation of OFAC regulations and could result in CMPs against the bank.

However, if a financial institution only screens its wire transfers through the OFAC SDN and Blocked Persons List and never screens its customer database, that is a much higher and, likely, unacceptable risk for the financial institution to assume in relation to the time and expense to perform such a review. Particular risk areas that should be screened by all financial institutions include:

- Incoming and outgoing electronic transactions, such as ACH;
- Funds transfers, including message or instruction fields;
- Monetary instrument sales; and

- Account beneficiaries, signors, powers of attorney, and beneficial owners.

As mentioned previously, account and transaction screening may be done manually, or by utilizing computer software available from the Treasury website or other third party vendors. In fact, many institutions have outsourced this function. If automated, OFAC offers the SDN list in a delimited file format file that can be imported into some software programs. Commercial vendors also offer several OFAC screening software packages with various capabilities and costs. If an institution utilizes an automated system to screen accounts and transactions, examiners should ensure that the institution's policies and procedures address the following:

- OFAC updates are timely;
- OFAC verification can be and is completed in a reasonable time;
- Screening is completed by all of bank departments and related organizations; and
- Process is reasonable in relation to the institution's risk profile.

Wholly-owned securities and insurance subsidiaries of financial institutions must also adopt an OFAC compliance program tailored to meet industry specific needs. The OFAC website provides additional reference material to these industries concerning compliance program content and procedures.

OFAC maintains current information and FAQs on its website. For any questions, OFAC encourages financial institutions to contact its Compliance Hotline at 800-540-6322 (7:30am-6:00pm, weekdays).

EXAMPLES OF PROPER CITATION OF APPARENT VIOLATIONS OF BSA-RELATED REGULATIONS IN THE REPORT OF EXAMINATION

The situations depicted in the examples below are intended to provide further clarification on when and how to cite apparent violations of the BSA and implementing regulations, within the context of findings that are typical for BSA reviews conducted during regular Safety & Soundness examinations. As is often the case, deficiencies identified within an institution's BSA compliance policies and procedures may lead to the citation of one or more apparent violations. The identification of numerous and/or severe deficiencies may indicate an ineffective and inadequate program. When an institution's BSA compliance program is considered inadequate, an apparent violation of Part 326.8(b)(1) of the FDIC's Rules and Regulations should also be cited.

Example 1

An examiner is conducting a BSA review at Urania Bank, a $100 million dollar financial institution in El Paso, Texas. The examiner identifies a systemic violation because the financial institution has not filed CTRs on cash purchases of monetary instruments. This is an apparent violation of 31 CFR 103.22(b)(1). The examiner also identifies a complete failure to scrub the institution's database against 314(a) Requests. This is an apparent violation of 31 CFR 103.100(b)(2). In addition, the examiner identifies numerous incomplete CTRs in apparent violation of 31 CFR 103.27(d). Because of the internal control inadequacies, the examiner also cites an apparent violation of Section 326.8(c)(1). The examiner further determines that the problems are sufficiently serious, warranting the citation of an apparent violation of Section 326.8(b)(1) for failure to develop and provide for an adequate BSA program. After doing additional research, the examiner determines that an apparent violation of Section 326.8(c)(2) should also be cited for inadequate independent testing that should have identified the ongoing weaknesses found by the examiner. Furthermore, the examiner decides that an apparent violation of Section 326.8(c)(4) should be cited for inadequate training. Employees are given cursory BSA training each year; however, no training exists for appropriate identification of cash activity and adequate CTR filings. The examiner also determines that an apparent violation of Section 326.8(c)(3) is appropriate because the BSA officer at Urania Bank comes in only two days per week. This is clearly inadequate for a financial institution of this size and complexity, as exhibited by the systemic BSA problems. In addition to fully addressing these deficiencies in the Violations and Risk Management sections of the Report of Examination, the Examiner-In-Charge fully details the findings, weaknesses, and management responses on the Examiner Comments and Conclusions pages.

Example 2

Examiners at Delirium Thrift, a $500 million financial institution in Southern California, begin the BSA review by requesting the wire transfer log for incoming and outgoing transactions. Information being obtained by the institution for the outgoing wire transfers is identified as inadequate. Consequently, the examiners cite an apparent violation of 31 CFR 103.33(g)(1). Additional research reveals that deficiencies in the wire log information are attributed to several branch locations that are failing to provide sufficient information to the wire transfer department. Because the deficiencies are isolated to transactions originating in a few locations, examiners determine that the deficiencies are not systemic and the overall program remains effective. However, because it is evident in interviews with several branch employees that their training in this area has been lacking, examiners also cite an apparent violation of Section 326.8(c)(4) and request that the institution implement a comprehensive training program that encompasses all of its service locations.

Example 3

Examiners at the independent BSA examination of Bullwinkle Bank and Trust, Moose-Bow, Iowa, a $30 million financial institution, were provided no written BSA policies after several requests. However, actual internal practices for BSA compliance were found to be fully satisfactory for the size and BSA risk-level of the financial institution. Given the low risk profile of the institution, including a nominal volume of reportable transactions being processed by the institution, the BSA/AML procedures in place are sufficient for the institution. Therefore, examiners cite only an apparent violation of Section 326.8(b)(1) for failure to develop an adequate *written* BSA compliance program that is approved by the financial institution's board of directors.

Example 4

Appropriately following pre-examination scoping requirements, examiners obtain information from their Regional SACM or other designees on previous SAR filings relating to money laundering. Upon arrival at Mission Achievement Bank, Agana, Guam, a $250 million financial institution with overseas branches, examiners determine that several of the accounts upon which money laundering SARs had been previously filed are still open and evidencing ongoing money laundering activity. However, the financial institution has failed to file subsequent SARs on this continued activity in these accounts and/or the parties involved. Consequently, the examiner appropriately cites apparent violations of Section 353.3(a) of the FDIC Rules and Regulations for failure to file SARs on this ongoing activity. Further analysis identifies that the failure to appropriately monitor for suspicious or unusual transactions in its high-risk accounts and subsequently file SARs is a systemic problem at the financial institution. Because of the institution-wide problem, the examiner cites an apparent violation of Section 326.8(c)(1) for inadequate internal controls. Furthermore, after consultation with the Regional SACM, the examiner concludes that the institution's overall BSA program is inadequate because of the failures to identify and report suspicious activities and, therefore, cites an apparent violation of Section 326.8(b)(1).

The examples below provide examiner guidance for preparing written comments for apparent violations of the BSA and implementing regulations. In general, write-ups should fully detail the nature and severity of the infraction(s). These comments intentionally omit the management responses that should accompany all apparent violation write-ups.

Part 326.8(b)(1) of the FDIC Rules and Regulations

Part 326.8(b)(1) requires each bank to "develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with recordkeeping and reporting requirements" of the Bank Secrecy Act, or 31 CFR 103. The regulation further states that "the compliance program shall be written, approved by the bank's board of directors, and noted in the minutes."

The Board and the senior management team have not adequately established and maintained appropriate procedures reasonably designed to assure and monitor the financial institution's compliance with the requirements of the BSA and related regulations. This assessment is evidenced by the weak internal controls, policies, and procedures as identified at this examination. Furthermore, the Board and senior management team have not made a reasonable effort to assure and monitor compliance with recordkeeping and reporting requirements of the BSA. As a result, apparent violations of other sections of Part 326.8 of the FDIC Rules and Regulations and 31 CFR 103 of the U.S. Treasury Recordkeeping Regulations have been cited.

Part 326.8(b)(2) of the FDIC Rules and Regulations

Part 326.8(b)(2) states that each bank must have a customer identification program to be implemented as part of the BSA compliance program.

Management has not provided for an adequate customer identification program. Current policy requirements do not meet the minimum provisions for a customer identification program, as detailed in 31 CFR 103. Current policies and practices require no documentation for new account openings on the Internet with the exception of a "verification e-mail" sent out confirming that the signer wants to open the account. Signature cards are mailed off-site to the Internet customer, who signs them and mails them back without any evidence of third-party verification, such as notary seal. Based on the risk of these types of accounts, this methodology for verification is clearly inadequate to meet regulatory requirements and sound customer due diligence.

Part 326.8(c)(1) of the FDIC Rules and Regulations

Part 326.8(c)(1) states, in part, that the compliance program shall, at a minimum, provide for a system of internal controls to assure ongoing compliance.

Management has not provided for an adequate system of internal controls to assure ongoing compliance. Examiners identified the following internal control deficiencies:

- Incomplete BSA and AML policies for a bank with a high-risk profile.
- Insufficient identification systems for CTR reporting.
- Late CTR filings.
- Insufficient reporting mechanisms for identification of structured transactions and other suspicious activity.
- Weak oversight over high-risk customers.
- Insufficient customer identification program and customer due diligence.

Due to the financial institution's high-risk profile, management should go beyond minimum CIP requirements and do a sufficient level of due diligence that provides for a satisfactory evaluation of the customer. Management must provide for adequate reporting mechanisms to identify large cash transactions as well as suspicious activity. Timely completion and review of appropriate reports, in conjunction with a sufficient level of due diligence, should allow for the accurate and timely reporting of CTRs and SARs.

Part 326.8(c)(2) of the FDIC Rules and Regulations

Part 326.8(c)(2) states that the compliance program shall provide for independent testing for compliance to be conducted by an outside party or bank personnel who have no BSA responsibility or oversight.

The financial institution's BSA policies provide for independent testing. However, the financial institution has not received an independent review for over three years. An annual review of the BSA program should be completed by a qualified independent party. This review should incorporate all of the high-risk areas of the institution, including cash-intensive accounts and transactions, sales and purchases of monetary instruments; customer exemption list; electronic funds transfer activities, and compliance with customer identification procedures.

Part 326.8(c)(3) of the FDIC Rules and Regulations

Part 326.8(c)(3) states that the compliance program shall designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance.

The board of directors has named Head Teller Ben Bison as the BSA officer. While Mr. Bison has a basic understanding of CTR filing, he does not have any training on detecting and reporting suspicious activity. Furthermore, Ben Bison does not have policy-making authority over the BSA function. Management needs to appoint someone with policy-making authority as the institution's BSA Officer.

Part 326.8(c)(4) of the FDIC Rules and Regulations

Part 326.8(c)(4) states that the compliance program shall provide training for appropriate personnel.

Example 1:

While BSA training programs are adequate, management has trained less than half of the appropriate operational personnel during the last calendar year. Management must ensure that all appropriate personnel, including the board of directors and officers, receive adequate BSA training a minimum of once per year and ongoing for those whose duties require constant awareness of the BSA requirements.

Example 2:

BSA training needs improvement. While regular BSA training sessions are developed and conducted for branch operations personnel, the training programs do not address internal BSA policies and, more importantly, BSA and anti-money laundering regulations. Management must ensure that comprehensive BSA training is provided to all directors, officers, and appropriate operational personnel. Training should be provided at least annually, and must be ongoing for those whose duties require constant awareness of BSA requirements. The training must be commensurate with the institution's BSA risk-profile and provide specific employee guidance on detecting unusual or suspicious transactions beyond the detection of cash structuring transactions.

Part 353.3 of the FDIC Rules and Regulations and 31 C.F.R. 103.18

Part 353.3(a) and 31 C.F.R. 103.18 state, in part, that Suspicious Activity Reports (SARs) should be filed when:

- Insider abuse is involved in any amount;

- Transactions aggregating $5,000 or more when the suspect can be identified;
- Transactions aggregating $25,000 or more when the suspect can not be identified; and
- Transactions aggregating $5,000 or more that involve money laundering or violations of the BSA… if the bank knows, suspects, or has reason to suspect that:
    - The transaction involves funds derived from illegal activities,
    - The transaction is designed to evade BSA reporting requirements, or
    - The transaction has no business or apparent lawful purpose or is not the sort of transaction in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

Management failed to file SARs on several different deposit account customers, all of which appeared to be structuring cash deposits to avoid the filing of CTRs. These transactions all appeared on large cash transaction reports reviewed by management; however, no one in the institution researched the transactions or filed SARs on the incidents. Management must file SARs on the following customer transactions and appropriately review suspicious activity and file necessary SARs going forward.

Account Number	Dates	Total Cash Deposited
123333	02/20/xx-02/28/xx	$50,000
134445	03/02/xx-03/15/xx	$32,300
448832	01/05/xx-03/10/xx	$163,500
878877	03/10/xx-03/27/xx	$201,000

Part 353.3(b) of the FDIC Rules and Regulations and 31 C.F.R. 103.18(b)(3)

Part 353.3(b) of the FDIC Rules and Regulations and 31 C.F.R. 103.18(b)(3) state that a bank shall file a suspicious activity report (SAR) no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing a SAR. In no case shall reporting be delayed more than 60 calendar days after the date of initial detection.

Management and the board have failed to file several hundred SARs within 30 calendar days of the initial detection of the suspicious activity. The BSA officer failed to file any SARs for the time period of June through August 20XX. This information was verified through use of the FinCEN database, which showed than no SARs had been filed during that time period. In addition, SARs filed from February through May of 20XX were filed between 65 days and 82 days of the initial detection of the activity. Management must ensure that suspicious activity reports are not only identified, but also filed in a timely manner.

Part 353.3(f) of the FDIC Rules and Regulations

Part 353.3(f) of the FDIC Rules and Regulations states that bank management must promptly notify its board of directors, or a committee thereof, of any report filed pursuant to Part 353 (Suspicious Activity Reports).

Management has not properly informed the board of directors of SARs filed to report suspicious activities. The management team has provided the board with erroneous reports showing that the bank has filed SARs, when, in fact, the management team never did file such SARs. Board and committee minutes clearly indicate a reliance on these reports as accurate.

31 C.F.R. 103.22(c)(2)

This section of the Financial Recordkeeping Regulations requires the bank to treat multiple transactions totaling over $10,000 as a single transaction.

Management's large cash aggregation reports include only those cash transactions above $9,000. Because of this weakness in the reporting system's set-up, the report failed to pick up transactions below $9,000 from multiple accounts with one owner. The following transactions were identified which should have been aggregated and a CTR filed. Management needs to alter or improve their system in order to identify such transactions.

Customer Name / Account #	Date	Amount
Mini Meat Market		
122222222	12/12/xx	$8,000
122233333	12/12/xx	$4,000
122222222	12/16/xx	$6,000
122233333	12/16/xx	$5,000
Claire's Club Sandwiches		
a/k/a Claire's Catering		
15555555	12/22/xx	$4,000
17777777	12/22/xx	$7,000
17777788	12/22/xx	$3,000

31 C.F.R. 103.22(d)(6)(i)

This section of the Financial Recordkeeping regulation states that a bank must document monitoring of exempt person transactions. Management must review exempt accounts at least one time per year and must document appropriate monitoring and review of each exempt account.

Management has exempted three customers, but has failed to document monitoring of their accounts. Management has stated that they did monitor the account transactions and no suspicious activity appears evident; however, management must retain appropriate documentation for all account monitoring of exempt customers. Such monitoring documentation could include, but is not limited to:

- Reviews of exempt customers cash transactions,
- Review of monthly statements and monthly activity,
- Interview notes with account owners or visitation notes from reviewing the place of business,
- Documenting changes of ownership, or
- Documenting changes in amount, timing, or type of transaction activity.

31 C.F.R. 103.27(a)

This section of the Financial Recordkeeping regulation requires the financial institution to retain all Currency Transaction Reports for five years.

Management failed to keep copies of all of the CTRs filed during the past five years. Management can locate CTRs filed for the past two years but has not consistently retained CTR copies for the three years preceding. Management needs to make sure that its record-keeping systems allow for the retention and retrieval of all CTRs filed for the previous five year time period.

31 C.F.R. 103.27(d)

This section of the Financial Recordkeeping regulation requires the financial institution to include all appropriate information required in the CTR.

Management has consistently failed to obtain information on the individual conducting the transaction unless that person is also the account owner. This information is required in the CTR and must be completed. Since this is a systemic failure, management needs to ensure proper training is provided to tellers and other key employees to ensure that this problem is corrected.

31 C.F.R. 103.121(b)(2)(i)(A)(4)(ii)

This section of the Financial Recordkeeping regulation states that the financial institution must obtain a tax identification number or number and country of issuance of any government-issued documentation.

The financial institution's policies and programs require that all employees obtain minimum customer identification information; however, accounts in the Vermont Street Branch have not been following minimum account opening standards. Over half of the accounts opened at the Vermont Street Branch since October 1, 2003, when this regulation came into effect, have been opened without tax identification numbers or similar personal identification number for non-U.S. citizens. Management must ensure that BSA policies and regulations are followed throughout the institution and verify through BSA officer reviews and independent reviews that requirements are being met.

WEB-SITE REFERENCES

Financial Crimes Enforcement Network (FinCEN):
www.fincen.gov

FinCEN Money Services Businesses:
www.msb.gov

Financial Action Task Force:
www.oecd.org/fatf

Office of Foreign Assets Control:
www.ustreas.gov/offices/eotffc/ofac

INTRODUCTION

The early detection of apparent fraud and insider abuse is an essential element in limiting the risk to the FDIC's deposit insurance funds and uninsured depositors. Although it is not possible to detect all instances of apparent fraud and insider abuse, potential problems can often be uncovered when certain warning signs are evident. It is essential for examiners to be alert for irregular or unusual activity and to fully investigate the circumstances surrounding the activity. Examiners should not restrict concern to internal crimes, but should also be alert to any attempts by outsiders to defraud financial institutions.

This section is organized by separate subject areas with each providing a summary of potential problems, a listing of warning signs of possible fraud and insider abuse, and suggested action for investigation. The lists are not all-inclusive but rather cover only those areas in which fraud and insider abuse occur most frequently. This section is designed to help alert examiners to possible fraudulent activity and insider abuse. It is intended to serve as a reference source during examinations and should be used as a supplement to standard examination procedures on an "as-needed" basis.

Any important situations should be commented on in the Report of Examination. Appropriate comments should be included in the Examination Conclusions and Comments schedule and in any other report pages as applicable.

Note the restrictions on disclosing irregular transactions in examination reports. This is more fully explained in the Report of Examination Instructions.

Any apparent criminal activity should be investigated thoroughly and reported on the Interagency Criminal Referral Form. The procedures for reporting apparent criminal violations are included in the Criminal Violations Section, Part IV.

SUBJECT AREAS

Included under each of the following subject areas is a summary of potential problems, a listing of warning signs of potential fraud and insider abuse and suggested action for investigation.

1. Corporate Culture/Ethics
2. Insider Transactions
3. Loan Participations
4. Real Estate Lending
5. Secured Lending
6. Third Party Obligations
7. Lending to Buy Tax Shelter Investments
8. Linked Financing/Brokered Deposits
9. Credit Cards and ATM Transactions
10. Advance Fee Schemes
11. Offshore Transactions
12. Wire Transfers
13. Money Laundering
14. Securities Trading Activities
15. Miscellaneous

CORPORATE CULTURE/ETHICS

Potential Problems

Complete dominance of an institution's policies and administration by one or a few directors may lead to inept management at lower levels. Absence of a written code of conduct may make it difficult to discipline directors, officers or employees who may be involved in questionable activities and may cause problems for directors, officers, employees and agents under the Bank Bribery Statute (18 U.S.C. 215). The code of conduct should identify allowable nonbank activities and acceptable gifts or gratuities received in the normal course of business.

Warning Signs

1. Absence of a code of ethics.
2. Absence of a clear policy restricting or requiring disclosure of conflicts of interest.
3. Absence of a policy restricting gifts and gratuities.
4. Lack of oversight by the institution's board of directors, particularly outside directors.

5. Absence of planning, training, hiring and organizational policies.

6. Absence of clearly defined authorities and lack of definition of the responsibilities that accompany the authorities.

7. Lack of independence of management in acting on recommended corrections.

8. CEO controls internal and outside auditors.

9. Lax control and review of expense accounts.

Suggested Action

Review the institution's code of conduct. Determine if there is a policy covering conflicts of interest and if prohibited practices are clearly stated along with the consequences for failure to refrain from these practices. Determine whether all insider interests are accurately reported to the institution's board of directors. Closely review the minutes of the board of directors' meetings and note the reporting of insider interests and the dominance of any director(s) in discussion of policy matters and administration. Also note the discussion of insider transactions and see if there are any directors who frequently or consistently vote against insider transactions in general or against those of one or more insiders in particular. Attempt to determine the reason for the dissent. If directors, officers and employees are required to report gifts and gratuities from present or potential customers, review the report to see if the gifts or gratuities conform to the institution's guidelines.

INSIDER TRANSACTIONS

Potential Problems

Insider fraud has accounted for over one-half of all bank fraud and embezzlement cases closed by the FBI during the past several years. Insiders are in a position of trust and can abuse that trust for their own personal benefit. Insider abuses include failure to disclose their interests that borrow from the institution or otherwise have business dealings with the institution; diverting assets and income for their own use; misuse of position by approving questionable transactions for relatives, friends and/or business associates; abuse of expense accounts; acceptance of bribes and gratuities; and other questionable dealings related to their positions at the institution. Insider abuse undermines confidence in institutions and often leads to failure.

Warning Signs

1. Insider lending personal funds to customers or borrowing from customers.

2. Insider involvement in silent trusts or partnerships and/or shell corporations.

3. Insider appears to receive special favors from institution customers or shows unusual favoritism toward certain institution customers.

4. Insider purchases assets from the institution, directly or indirectly, and there is no evidence of independent appraisal of the assets.

5. Insider has apparent reciprocal lending arrangements with insiders of other institutions and his/her institution has correspondent relationships with those institutions.

6. Insider is involved in a business that arranges its financing through the institution.

7. Insider "perks" include use of expensive institution-owned automobiles, boats, airplanes, housing, etc., where the institution's earnings do not appear to support such extravagance.

8. Insider heavily indebted and debt service appears to require most, if not all, of the insider's salary.

9. Insider financial statements show large or unusual fluctuations. Net worth cannot be reconciled from disclosed sources of income.

10. Insider is financing large purchases (home, auto, etc.) through private, nonbanking sources that may have a business relationship with the institution.

11. Insider financial statement reflects heavy concentration of high-risk investments and speculative ventures.

12. Insider sells personal assets to third party and the institution provides financing without benefit of an independent appraisal.

13. Insiders or their interests frequently appear on transaction suspense item listings or on computer-generated past due loan lists, but do not appear on the "updated" version presented to the board of directors or to examiners.

14. Insider "unofficially" guarantees loans and/or loan participations.

15. Insider is responsible for clearing up audit exceptions on loan balance confirmations.

16. Insider "forgets" to process credit entry for official bank checks causing the account to be out-of-balance because checks are sometimes paid (debited) before the credit is posted, sometimes several days later.

17. Insider conducts a cash transaction over $10,000 but "forgets" to have the institution file a Currency Transaction Report or asks an employee to "structure" the transaction to avoid filing a Currency Transaction Report with the Internal Revenue Service.

18. Insider's stock in the institution is pledged to secure loans obtained from sources other than financial institutions. If true, what is the purpose of the loan and are payments current?

19. Insider conducts personal business from the institution using equipment, supplies, employees, etc., and/or spends most of their time out of the institution on business unrelated to the institution.

20. Insider has substance abuse problems or is known to associate with people who have these problems.

21. Insider is known to associate with "high rollers".

22. Insider suggests that institution change servicers or vendors even though there appears to be no problem with the current servicers or vendors.

23. Insider abruptly suggests changes in outside auditors or legal counsel.

24. Insider loans increase dramatically at about the same time as the institution is recapitalized.

25. Insider's major assets are parcels of real estate that appear to increase in value at a rate that is not consistent with market conditions.

26. Insider sells his stock to an Employee Stock Option Plan (ESOP), sometimes arranging for the ESOP to obtain a loan to purchase the stock.

27. Insider's interests have a direct business relationship with the institution and compensation for services is not commensurate with the level of services provided.

28. Insider agrees to buy fixed assets from the institution with the understanding that the institution will repurchase the fixed assets at some future date.

29. Insider receives incentive pay or "bonuses" based on volume of loans generated.

30. Insider buys a home from a builder whose development project is financed by the institution.

31. Insider is involved in "churning" of the institution's securities portfolio.

32. Insider arranges sale of EDP equipment at book value in connection with the conversion to a new data processing servicer. Also check "side" deals.

33. Insider authorizes ORE related expenses such as landscaping, remodeling, etc., when such expenses do not appear justified. (May be making improvements or repairs to personal residence.)

34. Insider makes frequent trips at the institution's expense to areas where the institution has no business relationships.

35. Insider will not allow employees to talk to examiners.

36. Insider keeps an unusual number of customer files in his/her office.

37. Insider is making payments on other borrowers' loans.

38. Insider's loan is being paid by someone else.

39. Insider receives commissions on credit life insurance premiums and those commissions are not properly adjusted in cases where the insurance company gives rebates for the borrower's prepayment of the loan or gives refunds to borrowers for premium overcharges.

40. Insider sells some of his/her personal stock of the institution to borrowers (as a condition for approving loan) and buys more stock from the institution at about the same time that the institution is under pressure to increase capital.

41. Insider purchases investment securities for his personal portfolio through the institution but

"forgets" to reimburse the institution until a few days or weeks later, and then only if the investment has increased in value. In spite of the increase in value, the insider only pays the original purchase price to the institution.

42. Insider's accounts at the institution are frequently overdrawn. Deposits to cover overdrafts come from loans or some undisclosed source.

43. Insider maintains total control over the institution and does not allow other officers and employees to make independent decisions.

44. Insider has past due loans at other financial institutions.

45. Insider maintains signed, blank notes in personal or customer loan files.

46. Insider is rumored to have financial problems due to divorce, business failure, gambling losses, etc.

47. Insider maintains several personal accounts outside of his/her own institution.

48. Insider frequently takes loan papers out of the institution for customer signatures; personally handles the disbursement of the loan proceeds; routinely cashes checks for customer loan proceeds; and insists on personally handling certain past due accounts as a "special favor" to certain customers.

49. Insider insists that different audit firms audit different divisions or departments. (Hopes there will be no comparison of findings between firms.)

50. Insider insists that different departments be audited at different times. (Makes it easier to hide fraudulent inter-departmental transactions.)

Suggested Action

Review all insider transactions to see if they comply with policy and applicable state and federal regulations. Follow up on any exceptions. Any nonconforming transactions should be discussed with the institution's board of directors. Apparent fraudulent activities should be referred to the proper authorities.

LOAN PARTICIPATIONS

Potential Problems

Loan participations can lead to substantial losses if not documented properly and if not subjected to the same credit standards and reviews as direct loans. Participations purchased as an accommodation to affiliated institutions often do not receive the same scrutiny as those purchased from non-affiliated institutions. Informal repurchase agreements between participating institutions may be used to circumvent legal lending limitations and could subject institutions to substantial undisclosed contingent liabilities. Participations may also be used to disguise delinquencies and avoid adverse classifications.

Warning Signs

1. Excessive participation of loans between closely related institutions, correspondent institutions and branches or departments of the lending institution.

2. Absence of any formal participation agreement.

3. Poor or incomplete loan documentation.

4. Investing in out-of-territory participations.

5. Reliance on third party guaranties.

6. Large paydown or payoff of previously classified loans.

7. Some indication that there may be informal repurchase agreements on some participations.

8. Lack of independent credit analysis.

9. Volume of loan participations is high in relation to the size of the institution's own loan portfolio.

10. Evidence of lapping of loan participations. For example, the sale of a loan participation equal or greater than, and at or about the same time as, a participation that has matured or is about to mature.

11. Disputes between participating institutions over documentation, payments, or any other aspect of the loan participation transaction.

12. Formal participation agreements are missing; therefore, responsibilities and rights of all participating institutions may be unclear.

13. Participations between affiliated institutions may be "placed" without the purchasing institution having the benefit of reviewing normal credit information,

particularly where there is dominant ownership and a "rubber stamp" board of directors.

14. Payments that are not distributed to each participant according to the participation agreement may indicate preferential treatment; or where the participants are affiliated, it may indicate an attempt to disguise the delinquent status of the loans in the weaker institutions.

15. Informal guaranties by insiders may be one method of disguising insider transactions.

16. There is some indication that the credit information contained in the selling institution's files is not the same as the credit information in the purchasing institution's files.

17. Be aware of reciprocal arrangements in the sale/purchase of participations. For example, Institution A sells a 100% participation in a loan to an insider of the selling institution to Institution B which, in turn sells a 100% participation in a loan to one of their insiders to Institution A.

18. There are a number of outstanding items in correspondent accounts just prior to or during an examination or audit which relate to participations purchased or sold.

19. There is some indication that payments on participations purchased are being made by the selling institution without reimbursement from the borrower.

Suggested Action

Where possible, determine the current status of participations at each participating institution. Make special note of any disputes between participating institutions and follow up. Review any debits or credits related to participations posted to the correspondent institution accounts just prior to or during the examination. Follow up on any exceptions. Attempt to determine if the participation has been adversely classified by examiners at any participating institution. Look for any indication of any informal repurchase agreements.

REAL ESTATE LENDING

Potential Problems

Real estate lending abuses have been given a lot of publicity due to the problems encountered by financial institutions that have suffered substantial losses from problem real estate loans. These problems have not been confined to any particular area of the country. Many of the problems revolve around inflated appraisals, land flips (interparty transactions), fraudulent sales contracts, forged title documents, misapplication of loan proceeds, financing of nonexistent properties, loans in the name of trustees, holding companies and offshore companies to disguise the true identity of the actual borrowers and fraudulent loan applications from purchasers, including false income statements, false employment verifications, false credit reports and false financial statements. In many cases, important documentation is missing or is intentionally deficient in an attempt to conceal material facts.

Warning Signs

1. An unusually large number of loans in the same development are exactly equal to the institution's maximum loan-to-value (LTV) ratio for real estate mortgages.

2. The institution has an unusually high percentage of "No Doc" loans. (A "No Doc" loan is one in which extensive documentation of income, credit history, deposits, etc., is not required because of the size of the downpayment, usually 25% or more. Theoretically, the value of the collateral will protect the lender.)

3. Borrower has never owned a home before and does not appear to have the financial ability to support the size of the downpayment made.

4. Property securing loan has changed ownership frequently in a short period of time. Related entities may be involved.

5. Insured value of improvements is considerably less than appraised value.

6. Appraiser is a heavy borrower at the institution.

7. Appraisal fee is based on a percentage of appraised value.

8. Borrower furnishes his/her own appraisal which is a photocopy of an appraisal signed by a reputable appraiser.

9. Use of "comparables" which are not comparable.

10. Appraisal is based on an estimated future value.

11. All comparables are new houses in the same development that were built by the same builder and appraised by the same appraiser.

12. An unusual number of "purchasers" are from out of the area or out of state.

13. Credit history, employment, etc., are not independently verified by the lender.

14. Large number of applicants have income from sources that cannot be verified, such as self-employment.

15. The value of the home the applicant desires to purchase is not in line with the applicant's income. For example, the applicant makes $90,000 per year and only wants to purchase a $90,000 home.

16. The applicant's credit history is incomplete. For example, the applicant is 45 years old, but credit history only dates back five years.

17. The institution's normal procedure is to accept photocopies of important documents rather than to make their own copies of the originals.

18. If copies of income tax returns are provided, columns are uneven and/or do not balance.

19. Appraiser is from out of the area and not likely to be familiar with local property values.

20. A close relationship exists between builder, broker, appraiser and lender.

21. Construction draws are made without visual inspections.

22. All "comparables" are from properties appraised by the same appraiser.

23. Generally, housing sales are slow, but this development seems unusually active in sales.

24. There seems to be an unusual number of foreclosures on 90% to 95% loans with Private Mortgage Insurance on homes in the same development built by the same builder. (Sometimes it is cheaper for the builder to arrange for a straw buyer to get the 95% loan and default than it is to market the home if the market is sluggish.)

25. Applications received through the same broker have numerous similarities.

26. Sales contracts have numerous crossed out and changed figures for sales price and downpayment.

27. Appraiser for the project owns property in the project.

28. Lending officer buys a home in a project financed by the institution.

29. Assessed value for tax purposes is not in line with appraised value.

30. The project is reportedly fully occupied, but the parking lot always appears to be nearly empty.

31. The parking lot is full, but the project appears empty. Nobody is around in the parking lot, pool, etc.

32. After a long period of inactivity, sales suddenly become brisk.

33. Sales contract is drawn up to fit the lender's LTV requirements. For example, the buyer wants an $80,000 home but has no down payment. The lender only lends 80% of appraised value or selling price. Contract is drawn up to show a selling price of $100,000 instead of the actual selling price of $80,000.

34. Builder claims a large number of presold units not yet under construction while many finished units remain unsold.

35. The borrower's interest in the property is not logical given the distance between the property and his/her place of employment and the supply of comparable housing near his/her employer. For example, employment of the prospective borrower/purchaser is 100 miles from the location of the property, while comparable housing is readily available within 10 miles of employment.

36. Applicant's stated income is not commensurate with his/her stated employment and/or years of experience.

37. Applicant's financial statement shows numerous assets that are self evaluated and cannot be readily verified through independent sources.

38. Applicant claims to own partial interests in many assets but not 100% of any asset, making verification difficult.

39. Appraised value of property is contingent upon the curing of some property defect such as drainage problems.

40. The applicant's financial statement reflects ownership of valuable items, such as jewelry and art work, but no insurance is carried on these items.

41. Applicant's tax return shows substantial interest deductions, but the financial statement shows little debt. For example, the borrower's tax return shows substantial mortgage interest deductions, but the self-prepared financial statement shows no mortgage or a very small mortgage.

42. Appraised value of a condominium complex is arrived at by using the asking price for one of the more desirable units and multiplying that by the total number of units.

43. Loans are unusual considering the size of the institution and the level of expertise of its lending officers.

44. There is a heavy concentration of loans to a single project or to individuals related to the project.

45. There is a heavy concentration of loans to local borrowers with the same or similar real estate collateral which is located outside the institution's trade area.

46. There are many loans in the names of trustees, holding companies, and/or offshore companies but the names of the individuals involved are not disclosed in the institution's files.

47. A loan is approved contingent upon an appraised value of at least a certain amount and the appraised value is exactly that amount.

48. Independent reviews of outside appraisals are never conducted.

49. The institution routinely accepts mortgages or other loans through brokers but makes no attempt to determine the financial condition of the broker or to obtain any references or other background information.

50. Borrower claims substantial income but his/her only credit experience has been with finance companies.

51. Borrower claims to own substantial assets, reportedly has an excellent credit history and above average income, but is being charged many points and a higher than average interest rate which is indicative of high risk loans.

52. The institution allows borrowers to assign mortgages as collateral without routinely performing the same analysis of the mortgage and mortgagor as they would perform if the institution were mortgagee.

53. Asset Swaps - Sale of other real estate or other distressed assets to a broker at an inflated price in return for favorable terms and conditions on a new loan to a borrower introduced to the institution by the broker. The new loan is usually secured by property of questionable value and the borrower is in weak financial condition. Borrower and collateral are often outside the institution's trade area.

Suggested Action

Review all real estate files and request any missing documents. Review appraisals to attempt to determine whether any land flips have been involved. Compare appraised value to other stated values such as assessed value or insured value. Attempt to identify any pattern or practice which appears to be suspicious such as a large number of borrowers having the same employer, a large number of properties appraised by the same appraiser, a large number of loans presented by the same broker, a large number of out-of-territory borrowers, etc. If possible, visit construction sites to see if activity is as represented.

SECURED LENDING

Potential Problems

Financial institutions are often lulled into a false sense of security when they believe that they have adequate collateral for their loans; however, many institutions fail to properly record their liens and/or fail to physically verify the existence of their collateral. In many cases, there are no independent appraisals to support collateral value. Out-of-territory collateral may be difficult to verify and monitor. Where fraud is suspected, it is often difficult to prove in cases where institutions have failed to follow generally accepted procedures for documenting collateral.

Warning Signs

1. Lack of independent appraisals of collateral.
2. Significant out-of-territory lending.
3. Loans with unusual terms or conditions.
4. Poor or incomplete documentation used to intentionally conceal material facts.
5. Loans that are unusual considering the size of the institution and the level of expertise of its lending officers.
6. Heavy concentration of loans secured by the same or similar types of collateral.
7. Financing of 100% of the value of any collateral that is subject to rapid depreciation or wide fluctuation in market value.
8. Appraisals which appear to be made to cover the borrower's loan request rather than to reflect the true value of the collateral.
9. Appraisal fee based on amount of loan or on appraised value of collateral may encourage inflated appraisals.
10. Review of records indicates numerous related party purchases and sales of the collateral which could be used to inflate the collateral price far beyond actual market value.
11. Loans in the names of trustees, holding companies, and offshore companies may disguise the identity of actual borrowers.
12. Assigned notes and mortgages are accepted as collateral without verifying all underlying documentation and conducting normal credit analysis on the obligor.

Suggested Action

Review collateral inspection records to determine if there are any exceptions. Review appraisals for similar types of collateral and reconcile any differences. Determine whether in-house appraisals are based on physical inspection of the collateral. If not, why not? Be sure that adequate collateral margins are required at the inception of loans and monitored throughout the term of the loans.

THIRD PARTY OBLIGATIONS

Potential Problems

A guaranty is only as good as the guarantor and a guaranty without adequate documentation to support its value to the institution may be worthless. A guaranty that is separate from the note may contain restrictions that could render it worthless unless the restrictions are closely followed and a guaranty signed in blank may be legally unenforceable if contested. A false third party obligation may be created for the sole purpose of obtaining a loan from the institution. It may have no actual value. This is particularly true where offshore "shell" institutions are involved.

Warning Signs

1. Documentation on guaranties is incomplete.
2. Loans are secured by obligations of offshore institutions.
3. Lack of credit information on third party guarantor.
4. Financial statements reflect concentrations of closely held companies or businesses that lack audited financial statements to support their value.
5. A guaranty signed in blank may be used indiscriminately by some dishonest individuals to cover weak loans. Guaranties signed in blank may also be legally unenforceable if contested.
6. Guaranties that are separate from the notes may contain restrictions that could render them worthless unless the restrictions are closely followed.
7. Third party obligor is not informed of the assignment of the obligation to an institution; this may allow payments to be diverted to some use other than payment of the loan.

8. Guaranties from insurance companies or letters of credit from insurance companies to guaranty payment are accepted without an evaluation of the financial soundness of the guarantors and their ability to honor the guaranties or letters of credit if necessary.

9. Guaranties or letters of credit from insurance companies are not directly verified with the issuer.

10. The institution's audit procedures do not include a request for acknowledgement of guaranties by guarantors.

11. Corporate guaranties are used, but there is no information in the institution's files to support the authority of the corporations to make the guaranties or to indicate that they are still in force.

12. The institution purchases substandard consumer contracts from a third party relying on recourse to the seller without performing proper analysis of seller's financial condition.

13. The institution purchases substandard consumer contracts for automobiles, home improvements, etc., while relying on some type of insurance to cover delinquencies, skips, etc., without verifying the financial condition of the insurer.

Suggested Action

All guaranties should be reviewed to determine that all documentation is complete and that each guarantor is financially sound and reputable. Corporate guaranties and letters of credit from insurance companies and financial institutions should be verified directly with the issuer. If a loan is collateralized by an obligation of an offshore bank, determine if the lender has attempted to verify the existence, reputation and financial stability of the offshore bank. Guaranties signed in blank should be reviewed to determine their validity.

LENDING TO BUY TAX SHELTER INVESTMENTS

Potential Problems

Be wary of deals where there is no economic purpose except to generate tax write-offs. If the Internal Revenue Service (IRS) successfully challenges the tax benefits claimed from the tax shelter, the investor would have to pay not only additional income tax on the amounts disallowed but also interest and possible penalties. Should this occur, investors might walk away from their loans, and institutions holding the loans would suffer losses.

Warning Signs

1. Block loans to individuals to buy tax shelters arranged by a tax shelter promoter.

2. Shelters which promise tax deductions that would not appear to withstand the scrutiny of the IRS.

3. Specific use of the invested funds cannot be ascertained.

4. Loan payments are to be made by a servicing company.

5. Investments reflect no economic purpose except to generate tax write-offs.

6. Financial "no cash" deals where transactions are structured to avoid any actual cash flow. For example, a long-term CD is matched against a loan payable from the proceeds of the CD at its maturity. Interest accumulates on the CD in an amount equal to or greater than the compounded interest owed on the corresponding loan. The depositor/borrower never provides or receives any cash but still gets the tax write-off.

Suggested Action

Try to determine if the tax shelter is legitimate. Section 465 of the Internal Revenue Code states that an investor can only use losses available from such at risk activity to the extent that the taxpayer is actually economically at risk in connection with the activity.

LINKED FINANCING /BROKERED DEPOSITS

Potential Problems

Linked financing and brokered deposit transactions have contributed to the failure of several banks and savings associations. Offers of large deposits in return for favorable treatment on loans to out-of-area borrowers or to other borrowers previously unknown to the institution should be handled with caution. Where the brokered deposits are not pledged to secure the associated loans, the institution is exposed to substantial risk since it must refund the deposits regardless of the collectability of the loans.

Warning Signs

1. Short-term volatile deposits are used to fund long-term loans of questionable credit quality.

2. A generous point spread exists between the loan interest rate and the interest rate on deposits, which are usually below prevailing market rates.

3. Out-of-territory lending to previously unknown borrowers.

4. Large dollar deposits are offered in consideration for favorable treatment on loan requests, but deposits are not pledged as collateral for the loans.

5. Brokered deposit transactions where the broker's fees are paid from the proceeds of related loans.

6. Institution is presented with a large loan request that cannot be funded without the use of brokered deposits.

7. An unsolicited offer to purchase the institution comes at about the same time as brokered deposits and related loans are processed.

8. Long term discounted certificates of deposit pledged or matched at face value and not actual book value and structured to repay the loan automatically.

Suggested Action

Loans and other transactions associated or connected with brokered deposits should be carefully reviewed. Special attention should be given to transactions where the broker's fee is paid out of loan proceeds or fees for other related transactions instead of being paid directly by the institution as a cost of obtaining the funds.

CREDIT CARDS AND ATM TRANSACTIONS

Potential Problems

Poor control by the issuing institution over unissued cards, PINs, returned mail, credit limit increases and name and address changes can contribute to credit card and ATM card fraud. Credit card merchant accounts can be used to defraud the institution, particularly where the institution does not exercise care in screening prospective accounts. If not handled properly, credit card programs secured by deposit accounts can create substantial liability to the institution for inadequate or improper disclosures of fees and interest charges to customers and can create losses where credit limits are not adequately monitored and/or controlled. Delay in payments to merchants and payments from cardholders could signal the beginning of problems with a third party servicer (generally an outside marketing firm).

Warning Signs

1. Lack of separation of duties between the card issuing function and issuance of personal identification number ("PIN").

2. Poor control of unissued cards and PINs.

3. Poor control of returned mail.

4. Customer complaints.

5. Poor control of credit limit increases.

6. Poor control of name and address changes.

7. Frequent malfunction of payment authorization system.

8. Unusual delays in receipt of cards and PINs by the customers.

9. The institution does not limit amount of cash that a customer can extract from an ATM in a given day.

10. Evidence that customer credit card purchases have been intentionally structured by a merchant to keep individual amounts below the "floor limit" to avoid the need for transaction approval.

11. Credit card merchant accounts are opened without obtaining any background information on the merchant.

12. Credit card merchant account activity reflects an increase in the number and size of chargebacks.

13. The institution's credit card merchant is depositing sales drafts made payable to a business or businesses other than the business named on the account.

14. Credit card merchant frequently requests the wire transfer of funds from the merchant account to other institutions in other parts of the country or to offshore institutions almost immediately after deposits are made.

15. Merchant is engaged in telemarketing activities and is the subject of frequent customer complaints.

16. The institution contracts with third party servicer to process credit card customer and merchant transactions without verifying the financial stability and reputation of the servicer.

17. The institution contracts with a third party to establish and market a secured credit card program without verifying the financial stability and reputation of the third party and without determining the institution's potential liability for participation in the program.

18. Credit card merchant account deposits appear to exceed the level of customer activity observed at the merchant’s place of business.

19. Merchant has access to EDC (electronic data capture) equipment but frequently inputs credit card account numbers manually. Be especially alert if manually keyed transactions exceed 10% of total transactions.

20. Merchant has a sudden or unexplained increase in the level of authorization requests from a particular merchant location.

Suggested Action

Review customer complaints, no matter how insignificant they may appear to be, and review the institution's follow-up procedures. Be sure proper controls are in place at all points throughout the card issuing and transaction processing functions. Review possible causes of frequent malfunctions of the payment authorization system and follow-up on remedial actions taken by the institution. Monitor the level of authorization requests to spot potential problems before sales drafts are deposited. Conduct on-site inspections of merchant's operations. Review contracts and correspondence between the institution and Visa, MasterCard, etc. Review contracts with third party servicers, secured credit card programs and marketing agencies to determine possible exposure to liability.

ADVANCE FEE SCHEMES

Potential Problems

Advance fee schemes have been around for many years. They usually involve offers of sizable funds available for loans at below market rates, with the funds supposedly coming from some foreign interests who are seeking a safe haven in the United States. The targets are usually individuals or businesses experiencing financial difficulties. The goal of the perpetrator is to collect a fee in advance since the rest of the transaction is a sham and will never be consummated.

Although Institutions have been victimized by advance fee schemes, they are seldom the primary targets. However, institutions may be unwittingly used to lend false credibility to an advance fee scheme. Evidence of association with a reputable United States financial institution is critical to the success of the scheme. Institutions that act as agent, custodian, or in some other legal capacity face potential liability: (1) They have been sued by the perpetrators of the scheme for nonperformance under agency or escrow agreements, (2) They could be charged criminally for aiding and abetting a fraud, or (3) They may be civilly liable to the victims of the fraud.

Warning Signs

1. A person having no previous relationship with the institution suddenly appears and offers fantastic opportunities for the institution and/or its customers.

2. Broker claims to be part of a major financial organization, but this claim cannot be verified.

3. Broker claims to have access to huge sums of money from a secret, undisclosable or unverifiable source.

4. Broker becomes irritated if the institution suggests that references be checked.

5. Broker makes frequent references to such terms as "ICC Form 254, 290 or 322" and frequently uses the terms "emission rate", "prime bank notes", "tranches", "letters of commitment", "bank acceptances", "arbitrage", "hedge contracts" or "escrow agreements".

6. Broker initially requests an advance fee for his services but often "reluctantly" agrees to defer the fee until settlement of the transaction.

7. As the deadline for settlement nears, the broker urgently requests an advance on his fee to cover expenses such as travel, documentation, communication costs, etc.

8. Broker states that funds will be forthcoming from some offshore bank in the Caribbean or South Pacific.

9. Attempts to verify the broker's references are unsuccessful.

10. Broker's references include telephone numbers which are answered by machines and addresses which are mail drops, hotel rooms, etc.

11. Broker proposes a self-liquidating loan where earnings from a deposit or other investment will be such that they will pay the principal and interest of the loan with no additional funds needed from the borrower.

12. Broker conducts most of the negotiations by telephone or telex and appears to resist any meeting with the institution's counsel.

13. Broker repeatedly delays the settlement of the deal citing numerous "technical" problems.

14. The deal frequently falls through at the last minute while the broker searches for another source of funds.

15. Broker asks institution to serve as a transfer bank, middleman or agent in the transfer of funds between a sending institution and a receiving institution.

16. Broker who originally presents the deal may be known to the institution but other persons involved may be unknown to the institution and may have questionable backgrounds.

17. Broker asks for the institution's telex numbers and frequently, a long, instructional telex from the lender's agent is received by the institution.

18. The receiving institution may be asked to send a number of letters, contracts, or telex messages to the lender's agent or the lender's institution.

19. Broker expresses a great deal of urgency in completing the transaction so that the loan will not be lost.

20. Broker offers funds that the borrower can invest in U. S. Treasury Notes or similar instruments at a 4 or 5 point spread which will help the borrower to cover part of the fees, but offers only flimsy excuses as to why the lender does not directly invest in these instruments.

21. Broker does not allow borrower or institution any direct contact with the proposed lender, often citing confidentiality requirements by the lender or some sensitive political situation in the lender's home country.

22. Broker often requests that the borrower's institution issue a standby letter of credit to the foreign lender to guarantee payment.

23. Broker is often a name dropper, but the people named are either deceased or impossible to contact for reference because of political reasons.

Suggested Actions

The key to avoiding direct losses and/or potential legal liability in an advance fee scheme is to "know the customer" and carry out an extensive due diligence review. Each proposal involving any offer of large sums of money from previously unknown sources should be thoroughly investigated. No commitments should be made until all references are directly verified through some reputable and reliable source. Until references are verified, telex and written communications concerning the transactions should be avoided. Fees should not be paid until funds are verified and physically transferred. Suspicious transactions should be immediately reported to the FDIC and to the FBI. Remember, if the deal sounds too good to be true, it probably is.

OFFSHORE TRANSACTIONS

Potential Problems

Although there are legitimate and reputable institutions operating offshore offices, many are only "shell" institutions with little or no capitalization, no actual main office, no fixed asset investment, no actual staff and few other characteristics of a legitimate institution. Licenses for many offshore financial institutions are issued upon receipt of relatively nominal fees and minimal background verifications. The names of these offshore "shell" institutions are often similar to those of major legitimate financial institutions which are listed in international banking directories. There have been many instances of fraud involving obligations of offshore institutions, including certificates of deposit, letters of credit, drafts, commitments, etc. In some cases, these obligations have been purchased for a fraction of their face value for the sole purpose of defrauding legitimate institutions and other businesses.

Offshore companies, including financial institutions, are frequently established for the purpose of hiding the true identity of the principals, laundering money, inflating financial statements and issuing false documents to secure loans. Loans to offshore companies and loans secured by obligations of offshore institutions must be viewed with extreme caution.

Warning Signs

1. Loans made on the strength of a borrower's financial statement when the statement reflects major investments in and income from businesses incorporated in bank secrecy haven countries such as Panama, Cayman Islands, Netherlands Antilles, Montserrat and others.

2. Loans to companies domiciled in bank secrecy haven countries.

3. Loans secured by obligations of offshore institutions.

4. Transactions involving an offshore "shell" institution whose name may be very similar to the name of a major legitimate institution.

5. Frequent wire transfers of funds to and from bank secrecy haven countries such as Panama, Cayman Islands, Netherlands Antilles, Montserrat and others.

6. Offers of multi-million dollar deposits at below market rates from a confidential source to be sent from an offshore institution or somehow guaranteed by an offshore institution through a letter, telex, or other "official" communication.

7. Offshore companies are used to disguise the true identity of borrowers or guarantors.

8. No independent verification of the financial strength of the offshore institution is available from any source.

9. In order to make an offshore bank transaction appear legitimate, innocent third parties are brought into the scheme, unaware of its fraudulent nature.

Suggested Action

Offshore transactions should be closely examined to determine the legitimacy of the entities involved. Suspicious wire transfers to and from offshore institutions should be reviewed to determine the source and disposition of the funds. Obligations issued by questionable offshore institutions should not be accepted at face value unless the value can be substantiated through independent sources.

WIRE TRANSFERS

Potential Problems

Wire transfer fraud is often possible because of a breakdown in internal controls and/or system security measures at the financial institution. Transactions may be introduced by unauthorized persons who have obtained the proper procedures from an unsuspecting employee. Transactions may be altered in processing and posted to the wrong account, posted in the wrong amount or posted to the correct beneficiary but wrong account. Wire transfers are a popular form of laundering money, providing an easy way of sending funds to and from bank secrecy haven countries.

Warning Signs

1. Lack of separation between authority to initiate a wire transfer and authority to approve a wire transfer.

2. Indications of frequent overrides of established approval authority and other internal controls.

3. Intentional circumvention of approval authority by splitting transactions.

4. Wire transfers to and from bank secrecy haven countries.

5. Frequent or large wire transfers for persons who have no account relationship with the institution.

6. Large or frequent wire transfers against uncollected funds.

7. Frequent requests for immediate wire transfer of funds from a credit card merchant account to institutions in other parts of the U. S., offshore institutions or foreign institutions.

8. Frequent wire transfers from accounts with numerous cash deposits of just under $10,000 each.

9. Frequent errors in payment by authorized system officials.

10. Lack of security of the wire transfer system safeguards such as the password and other details of wire transfer transactions.

11. Unconfirmed wire transfer requests initiated by telephone.

12. Incoming wire transfers in which the account name and account number do not match.

13. Wire transfer or payment request that does not conform to established procedures.

14. Absence of written funds transfer agreements between the institution and its customers.

15. Large international funds transfer to or from the accounts of domestic customers in amounts and of a frequency that are not consistent with the nature of the customer's known business activities.

16. Receipt of funds in the form of multiple cashier's checks, money orders, traveler's checks, bank checks or personal checks that are drawn on or issued by U. S. financial institutions and made payable to the same individual or business, in U. S. dollar amounts that are below the $10,000 Bank Secrecy Act reporting threshold and which are then wire transferred to a financial institution outside the U. S.

17. The deposit of funds into several accounts and then aggregated into one account followed by the wire transfer of those funds from that account outside of the U. S. when such action is not consistent with the known business of the customer.

18. Any other unusual international funds transfer requests wherein the arrangements requested appear to be inconsistent with normal funds transfer practices, e.g., where the customer directs the institution to wire transfer funds to a foreign country and advises the institution to expect same day return of funds from sources different from the beneficiaries initially named, thereby changing the source of the funds.

19. A pattern of wire transfers of similar amounts both in and out of the customer's account on the same day or next day.

20. Wire transfers by customers operating a cash business, i.e., customers depositing large amounts of currency.

21. Wire transfer volume is extremely large in proportion to the asset size of the institution.

22. The institution's business strategy and financial statements are inconsistent with large volumes of wire transfers, particularly outside the United States.

Suggested Action

Review wire transfer procedures for possible circumvention of internal controls and system security measures. Follow-up on any exceptions. Verify source and disposition of suspicious wire transfers. Review accounts with frequent wire transfers to determine if the activity appears legitimate.

MONEY LAUNDERING

Potential Problems

An institution may be liable for civil or criminal penalties for willful participation in a money laundering scheme. The length of time involved in a money laundering investigation and the surrounding publicity can be disrupting and costly to an institution even if no formal charges are filed and no fines are levied. A money launderer usually needs the assistance of someone within the institution to whom he is often willing to pay a substantial fee. With the employee's assistance, money launderers are often able to hide their activities for an extended period of time.

Warning Signs

1. Increase in cash shipments that is not accompanied by a corresponding increase in number of accounts.

2. Cash on hand frequently exceeds limits established in security program and/or blanket bond coverage.

3. Large volume of cashier's checks, money orders, traveler's checks, etc., sold for cash to noncustomers

in amounts ranging from several hundred to just under $10,000 each.

4. Large volume of wire transfers to and from offshore institutions.

5. Large volume of wire transfers for noncustomers.

6. Accounts which have a large number of small deposits and a small number of large checks with the balances of the accounts remaining relatively low and constant. The accounts have many of the same characteristics as accounts used for check kiting.

7. A large volume of deposits to several different accounts with frequent transfer of major portions of the balances to a single account at the same institution or at another institution.

8. Loans to offshore companies and loans secured by obligations of offshore institutions.

9. Large volume of cashier's checks, money orders and/or wire transfers deposited to an account where the nature of the account holder's business would not appear to justify such activity.

10. Large volume of cash deposits from a business that is not normally cash intensive, such as a wholesaler.

11. Cash deposits to a correspondent account by any means other than through an armored carrier.

12. Large turnover in large bills that would appear uncharacteristic for the institution's location.

13. Cash shipments which appear large in comparison to the dollar volume of currency transaction reports filed.

14. Dollar limits on the list of customers exempt from currency transaction reporting requirements which appear unreasonably high considering the type and location of the businesses. No information is in the institution's files to support the limits.

15. Currency Transaction Reports, when filed, are often incorrect or lack important information.

16. List of exempted customers appears unusually long.

17. Customer expresses some urgent need to be included on the institution's list of customers exempt from currency transaction reporting requirements.

18. Customer requests information on how to avoid the filing of currency transaction reports on cash transactions involving amounts over $10,000.

19. Upon being informed of the currency transaction reporting requirements, customer withdraws all or part of the transaction to avoid the filing of the CTR.

20. Customer frequently conducts cash transactions in amounts just under $10,000 each.

21. Customer refuses to provide information required to complete a CTR.

22. Corporate customer makes frequent large cash deposits and maintains high balances but does not avail itself of other services such as loans, letters of credit, payroll services, etc.

23. Customer almost never comes to the institution but has numerous couriers making deposits to the account.

24. A large increase in small denomination bills and a corresponding decrease in large denomination bills with no corresponding CTR filings.

25. Customers who open accounts providing minimal or fictitious information or information which is difficult or expensive for the institution to verify.

26. Customers who decline to provide information that normal customers would provide to make them eligible for credit or other banking services that normal customers would regard as valuable.

27. Customers who appear to have accounts with several institutions within the same locality, especially when there is a regular consolidation of balances in the accounts and transfer of funds out of the accounts by wire transfer, or other means, to offshore institutions or to large domestic institutions.

28. Customers whose deposits frequently contain counterfeit bills or bills which appear musty or extremely dirty.

29. Customers who have deposit accounts at the institution but frequently purchase cashier's checks, money orders, etc., with large amounts of cash.

30. Retail customer which deposits a large volume of checks but seldom, if ever, requests currency for its daily operations.

31. Retail business has dramatically different patterns of cash deposits than other similar businesses in the same general location.

32. Exempted customer frequently requests increases in exemption limits.

33. Substantial increase in cash deposits of any business without any apparent cause.

34. Substantial increase in cash deposits by professional customers using client accounts or in-house company accounts such as trust accounts, escrow accounts, etc.

35. Customers who make or receive large transfers of funds to or from countries associated with production, processing and marketing of narcotics.

36. Size and frequency of cash deposits increases rapidly without any corresponding increase in non-cash deposits.

37. Size and frequency of cash deposits is not consistent with observed activity at the customer's place of business.

38. Customer makes large and frequent cash deposits but checks or other debits against the account are not consistent with the customer's stated line of business. For example, customer claims to be in the retail jewelry business, but checks are mostly to individuals and/or firms not normally associated with the jewelry business.

39. Customer frequently deposits large amounts of currency that is wrapped in currency straps that have been stamped by other financial institutions.

40. Customer frequently deposits strapped currency or currency wrapped in rubber bands that is disorganized and does not balance when counted.

41. Customer is often observed entering the safety deposit box area just prior to making cash deposits just under $10,000.

Suggested Action

Review results of the institution's independent testing for compliance with the Bank Secrecy Act. Perform Bank Secrecy Act examination procedures. Request verification of Currency Transaction Reports filed by the institution. Review all transactions involving offshore institutions to see if they appear to represent legitimate business activities.

SECURITIES TRADING ACTIVITIES

Potential Problems

Speculative securities trading activities may result in unsafe and unsound banking practices. Some bond salesman have made extensive use of the telephone to employ high pressure sales techniques, sometimes accompanied by oral guarantees which purport to limit an institution's exposure. Situations have been reported where an institution's board of directors and/or senior management have not monitored or controlled these practices and, in effect, have relinquished the management of their institution's investment portfolio to a broker.

Warning Signs

1. Management lacks the expertise needed to fully understand the ramifications of proposals made by brokers and/or they perceive an unrealistic opportunity to enhance income.

2. Investments bear no reasonable relationship to the institution's size or its capital accounts.

3. Overreliance is placed on the purported safety of the securities since they involve U. S. Government issues.

4. Little or no attention is given to "interest rate risk" prior to the transaction taking place.

5. Delayed settlements over unreasonable time periods sometimes allow management to make imprudent purchases and avoid booking the transaction on a timely basis.

6. The institution engages in reverse repurchase agreements with brokers which allows institutions to erroneously defer recognition of losses.

7. Securities held for short-term trading are not appropriately identified and segregated from those that are held primarily as a source of investment income.

8. Trading account securities are not revalued periodically and are not reported consistently at market value or the lower of cost or market value.

Suggested Action

Review the institution's investment policy to see if the board of directors has implemented prudent limits and comprehensive controls to suit their particular circumstances. Review the institution's files to determine if the institution has satisfied itself that it is dealing with a reputable and financially stable dealer. Ensure that management has sufficient expertise to analyze each transaction independently of the broker's sales pitch and recommendations.

MISCELLANEOUS

Potential Problems

Lack of proper supervision and lack of effective internal controls makes an institution especially vulnerable to fraud and insider abuse. Customer complaints, even seemingly insignificant ones, may be an indication of much greater problems.

Warning Signs

1. Lack of supervision of lending activities by officers of the institution.
2. Lack of lending policies or failure to enforce existing policies.
3. Lack of code of conduct or failure to enforce existing code.
4. Dominant figure allowed to exert influence without restraint.
5. Lack of separation of duties.
6. Lack of accountability.
7. Lack of written policies and/or internal controls.
8. Circumvention of established policies and/or controls.
9. Lack of independent members of management and/or Board.
10. Entering into transactions where the institution lacks expertise.
11. Excessive growth through low quality loans.
12. Unwarranted concentrations.
13. Volatile sources of funding such as short term deposits from out of area brokers.
14. Too much emphasis on earnings at the expense of safety and soundness.
15. Compromising credit policies.
16. High rate - high risk investments.
17. Underwriting criteria allows high risk loans.
18. Lack of documentation or poor documentation.
19. Lack of adequate credit analysis.
20. Failure to properly obtain and evaluate credit data, collateral, etc.
21. Failure to properly analyze and verify financial statement data.
22. Too much emphasis on character and collateral and not enough emphasis on credit.
23. Lack of balance in loan portfolio.
24. Poor loan administration after credit is granted.
25. Unresolved exceptions or frequently recurring exceptions on exception reports.
26. Out-of-balance conditions.
27. Purpose of loan is not recorded.
28. Proceeds of loan are used for a purpose other than the purpose recorded.
29. Lax policies on payment of checks against uncollected funds.
30. The institution is defendant in a number of lawsuits alleging improper handling of transactions.

Suggested Action

Out-of-balance conditions should be given proper attention and not merely charged off if their amount is small. Be alert to rumors and gossip inside and outside the institution because in many cases, embezzlers and perpetrators of other frauds are betrayed by jealous peers or subordinates. Review any loans that do not appear to conform to the written loan policy. Determine the circumstances under which they were approved and who approved them. Each attempt to circumvent existing policies, controls and/or regulations should be investigated. Be alert to any overrides or attempted overrides of internal controls and determine who is responsible and the reason.

INTRODUCTION

Criminal conduct and fraudulent acts undermine public confidence in the financial system and contribute to financial institution failures. Confidence is especially eroded when offenses involve bank insiders. When failures occur, the FDIC deposit insurance fund can suffer significant losses.

If allegations or evidence of wrongdoing comes to the FDIC's attention, a prompt response is warranted. The scope of a response varies based on the severity and specificity of allegations and the reliability of corroborating evidence. Examiner discretion, sound judgment, and regional office coordination are needed to appropriately respond to indications of improper conduct or fraudulent acts.

The primary responsibility for preventing, detecting, and reporting fraud and insider abuse rests with a bank's board of directors and senior management. Early detection and reporting of suspicious activities is in a bank's best interest as it can reduce liabilities resulting from operational errors and may limit or prevent monetary losses. The board must establish appropriate internal controls and effective audit programs to fulfill their legal and fiduciary duties. Controls and safeguards should address internal and external offenses and include procedures for identifying and reporting suspicious activities. Financial institutions must report questionable actions using a Suspicious Activity Report (SAR).

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SUSPICIOUS ACTIVITY REPORTS

Part 353 of FDIC Rules and Regulations and CFR[1] Title 31, Chapter X, § 1020.320 of the Financial Crimes Enforcement Network (FinCEN) regulations require insured nonmember banks and state chartered savings associations to report suspicious activities to FinCEN, a bureau of the U.S. Department of the Treasury. The primary purpose of the reporting requirement is to ensure investigators and prosecutors are provided relevant information in an orderly and timely fashion. Financial institutions must report suspicious activities on electronically filed SARs, which allow law enforcement and regulatory agencies to more efficiently assess and respond to questionable actions.

Filing Suspicious Activity Reports

A financial institution is required to file an SAR when it detects a known or suspected criminal violation of federal law, a suspicious transaction related to potential money laundering, or a violation of the Bank Secrecy Act (BSA). Banks should file SARs with appropriate federal law enforcement agencies and the Department of the Treasury in accordance with the report's instructions. Generally, completed SARs should be transmitted to FinCEN in the following circumstances:

- Insider abuse[2] involving any amount when the financial institution believes it is either an actual or potential victim of a committed or attempted criminal transaction and the financial institution has identified a director, officer, employee, agent, or other institution-affiliated party as having committed or aided in the commission of the criminal act;
- Transactions aggregating $5,000 or more in funds or other assets when a suspect can be identified and the financial institution believes it is either an actual or potential victim of a committed or attempted criminal transaction;
- Transactions aggregating $25,000 or more in funds or other assets regardless of potential suspects and the financial institution believes it is either an actual or potential victim of a committed or attempted criminal transaction; or
- Transactions aggregating $5,000 or more that involve potential money laundering or violations of the BSA.

Note: Financial institutions are not required to file an SAR for a robbery or burglary committed or attempted that is appropriately reported to law enforcement authorities.

Reporting Timeframes

Financial institutions are required to file SARs no later than 30 calendar days after the date of the initial detection of facts that constitute the basis for filing an SAR. An institution may delay filing an SAR for an additional 30 calendar days to identify a suspect. However, in no case should institutions delay reporting more than 60 calendar days after the date of initial detection of a reportable transaction. Further, in situations involving violations that require immediate attention, such as ongoing money

[1] The U.S. Code of Federal Regulations (CFR) is the codification by subject matter of the general and permanent laws of the United States. It is divided by broad subjects into 50 titles and published by the Office of the Law Revision Counsel of the U.S. House of Representatives.

[2] Insider abuse may involve known or suspected criminal violations of federal law committed by an insider against a bank customer involving a transaction or transactions facilitated by or through the bank.

laundering activities, the financial institution should immediately notify an appropriate law enforcement authority by telephone in addition to promptly filing an SAR. Refer to Part 353 and CFR Title 31, Chapter X, § 1020.320(b) for additional details.

Record Retention

Financial institutions must maintain a copy of any SAR filed and the original, or business record equivalent, of any supporting documentation for a period of five years from the date of filing. Supporting documentation identified and maintained by the financial institution as such, will be deemed to have been filed with the SAR. The financial institution must make all supporting documentation available upon request to FinCEN, appropriate law enforcement agencies, and state or federal regulatory authorities that examine the bank for compliance with the BSA.

Board Reporting

Management is required by Part 353 to promptly notify its board of directors, or a committee thereof, of any SAR filed. In addition, the board should record such notification in its minutes.

Confidentiality

Suspicious activity reports are confidential. Any institution subpoenaed or otherwise asked to disclose an SAR or related information shall decline to produce the SAR or provide any information indicating an SAR was prepared or filed. Institutions should notify their FDIC regional office of any such requests.

Additionally, neither the financial institution, nor its current or former directors, officers, employees, agents, or contractors may notify any person involved in a transaction that an SAR was filed or disclose any information that would reveal the existence of an SAR.

Safe Harbor Provision

In general, financial institutions and their directors, officers, employees, and agents are protected from civil liability for filing SARs and for failing to provide notice of such filings to individuals named in the SARs. Refer to CFR Title 31, § 5318(g) for additional information.

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THE ROLE OF EXAMINERS

Examiners should consider the adequacy of internal controls at each examination and remain alert for suspicious or unusual activities during each functional review. If examiners identify or become aware of questionable conduct or transactions, they should discretely investigate their concerns and discuss the issues with the examiner-in-charge and field or regional office personnel. Examiners should securely retain documentation of transactions, discussions with management (or other bank personnel) and any other pertinent information relating to their investigations. Explanations by bank personnel that appear unreasonable should not be accepted without being fully investigated; however, information that supports management's explanations should be clearly documented.

If material concerns remain after examiners complete their initial investigations, they must immediately notify field and regional office personnel. This is paramount when board members or senior managers are suspected of wrongdoing, or when losses attributable to the activity imperils the institution's continued operation.

Examiners must consult with the supervisory regional office before informing the institution's board of directors or anyone associated with the institution of the suspicious activity. Generally, (after consulting with the regional office) apparent criminal violations that are detected by examiners should be brought to management's attention. However, the examiner should only present facts and must not make any statements or insinuations regarding possible conclusions as to particular individuals.

Generally, examiners should discuss the requirements of Part 353 with bank officials. However, it may be inappropriate to notify the board of directors or management when senior financial institution officials are implicated in the suspicious activity, or if the examiner has reason to believe that an official might flee, warn the target, destroy evidence, or otherwise jeopardize an investigation.

Further, if the financial institution fails to file an SAR, examiners should report the financial institution's decision to the regional office. The regional office should then determine whether a SAR should be filed.

Under certain circumstances, examiners may need to collect information supporting an SAR and submit it directly to the regional office. These situations generally occur when the financial institution is unable to file an SAR without alerting the subject, unwilling to file an SAR on an insider, or unwilling to file an SAR when the activity may imperil the institution's continued operation. If the regional office agrees with the examiner's assessment, an SAR may be filed by regional office staff.

The fact that an SAR has been filed does not prevent the examiner from making a more detailed written report. If necessary, the examiner may need to gather facts to support corrective actions, which may include recommendations for removal and prohibition.

Notification Prohibition

Pursuant to Title 31, U.S.C. 5318(g)(2)(A), no current or former officer or employee of, or contractor for, federal, state, local or territorial government who has knowledge that an SAR was filed, may disclose that fact to any person involved in the transaction, except in fulfilling official duties.

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INTERAGENCY COOPERATION

The FDIC, other federal banking regulators, and various other agencies have agreed to cooperate and exchange information when necessary to address suspicious activity affecting insured financial institutions.

Communication and Points of Contact

Procedures have been formalized for interactions between RMS and the Office of Inspector General - Office of Investigations (OIG) with respect to investigations involving operating institutions. If an examiner or other RMS staff member is contacted directly by law enforcement, they must report the contact through the appropriate channels to the RMS deputy regional director or designee, who will notify the OIG and the Legal Division. Furthermore, the transfer of FDIC documents or records requested by law enforcement must comply with 12 C.F.R. § 309.6 (Disclosure of Exempt Records). The OIG and the Legal Division will coordinate the transfer of such documents and records. The OIG may oversee the investigation and coordinate interviews of appropriate RMS employees or the review of documents. No RMS employee should communicate directly with law enforcement, without prior approval of regional management and the Legal Division. However, permission is not required when disclosure is made solely to the FDIC Office of Inspector General - Office of Investigations. Refer to the Right to Financial Privacy Act for more information.

Referrals to the Department of Justice (DOJ)

The referral of suspicious activity to the DOJ or various U.S. Attorney Offices does not restrict the FDIC from continuing its own research into the same activity. However, the FDIC may cease or suspend such activity if requested to do so by the DOJ due to an ongoing criminal investigation or prosecution. In all cases, the FDIC should keep the DOJ or U.S. Attorney informed of the progress of any parallel civil investigation with a view toward reaching a cooperative solution. Such cooperation might lead to a demand for restitution and stipulation to a prohibition from future banking employment being included in a criminal plea agreement or pre-trial diversion arrangement.

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ASSISTANCE TO LAW ENFORCEMENT

Examiners may be asked to provide expertise to law enforcement agents investigating suspicious activity or prosecuting a criminal case. Requests are usually made in connection with bank fraud or money laundering cases, and the assistance is often needed for the following reasons:

- To interpret subpoenaed documents obtained from the financial institution;
- To explain the flow or processing of documents;
- To determine whether acquired documents are relied upon by FDIC examiners, other regulators, auditors, or managers to formulate business decisions or opinions as to the condition of the financial institution;
- To provide information concerning banking policies or general banking practices; or
- To provide specific assistance, such as testifying at a trial or before a federal grand jury.

Examiners should cooperate to the fullest extent possible in honoring reasonable requests for assistance, and the regional office should supply examiners with specific guidance governing each assignment. A written agreement may be necessary for long-term assignments, and the following guidelines apply to most requests for examiner assistance:

- The request for assistance must be for a legitimate law enforcement purpose within the jurisdiction of the requesting agency;
- The information requested, or that which the examiner has been asked to review, must be relevant to a legitimate law enforcement inquiry;
- The suspicious activity should involve an FDIC-insured institution, its directors, officers, employees, agents or customers;
- Any known, potential respondents (employees, officers, directors, or other IAPs) resulting from an investigation should be identified in addition to naming the institution itself;
- Compliance with all applicable provisions of the Right to Financial Privacy Act covering disclosures of

information derived from financial institution customer records must be assured; and

- The examiner should be instructed that while assisting the law enforcement authorities, he or she will be acting solely as a representative of the law enforcement authority, will not represent the FDIC in any way, and should not assert or exercise any authority as an FDIC examiner.

Parallel Proceedings

Although administrative and criminal investigations may occur concurrently, they must remain separate, independent investigations. Maintaining independence is critical when conducting coordinated investigations. While a coordination of activities between investigations is acceptable, a lack of independence may result in the suppression of evidence and/or the dismissal of an indictment. Therefore, examiners should not accompany law enforcement agents onto a financial institution's premises in order to collect records as it may create the appearance of a lack of independence between separate investigations.

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FEDERAL GRAND JURY SUBPOENAS

A federal, grand jury subpoena is an investigatory tool used to build the prosecution's case without compromising the privacy of investigation targets or prematurely revealing their investigatory directions. Rule 6(e) of the Federal Rules of Criminal Procedure requires that grand jury proceedings be kept secret to the fullest extent practicable. Grand jury secrecy is maintained principally:

- To encourage witnesses to come forward and to testify freely and confidentially;
- To minimize the risks that prospective defendants will flee or use corrupt means to thwart investigations and escape punishment;
- To safeguard the grand jurors and proceedings from extraneous pressures and influences;
- To avoid unnecessary disclosures that may make individuals appear guilty of misconduct without their being afforded opportunity to challenge the allegations; and
- To prevent information given under compulsion and for purposes of public justice from being used for insubstantial purposes, such as gossip, to the detriment of the criminal justice system.

Rule 6(e)(3)(A)(iii) allows grand jury matters to be disclosed to government attorneys and banking regulators for enforcing civil forfeiture and civil banking laws pursuant to 18 U.S.C. 3322. However, 18 U.S.C. 3322 requires that a person to whom a matter has been disclosed shall not use such matter other than for the purposes for which such disclosure was authorized. The term "banking law violation" means a violation of, or a conspiracy to violate, sections 215, 656, 657, 1005, 1006, 1007, 1014, 1344, 1956 or 1957 of Title 18; as well as any violation of section 1341 or 1343 affecting a financial institution; or any provision of subchapter II of Chapter 53 or Title 31.

FDIC management must make a determination as to allowing appropriate and sufficient RMS and legal staff access to grand jury information. Nevertheless, possession of grand jury documents or testimony requires great care in order to comply with the secrecy requirements of Rule 6(e) of the Federal Rules of Criminal Procedure.

The FDIC's General Counsel has the delegated authority to authorize an examiner to appear and testify before the grand jury or at a criminal trial. The examiner may be directed to contact the prosecutor or investigator either before or after a grand jury subpoena is issued to assist in identifying and gathering documents pertinent to the investigation. The examiner will be provided with appropriate counsel before testifying.

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SAFEGUARDING EVIDENCE

Copies of the SAR and all supporting evidentiary documents should be segregated and stored in the regional office to ensure that the documents are readily retrievable and can be provided to law enforcement officials if needed.

Examiners should consult the regional office regarding necessary documentation. Generally, copies of documents must be made during the examination. The copies should be initialed and dated by the examiner in case the originals are misplaced or destroyed.

In addition to electronically copied documents, the examiner should document the flow of funds, approvals, and employees responsible for handling each transaction. Flow charts or similar methods may be appropriate for documenting complex transactions.

The following questions provide examples of the line of inquiry an examiner may follow in deciding how to review and document a particular circumstance:

- What is the financial institution's policy for handling this type of transaction?
- Was there deviation from the policy?
- Who was authorized to make this transaction?

- Who handled this transaction?
- Who had knowledge?
- Who benefited ultimately from the transaction?
- What knowledge did the financial institution's directors have?
- What was the credit quality at the time of making a loan and what it is now?
- Was the documentation adequate at inception?
- Was collateral value adequate at inception?
- Are there presently any credit or legal problems?
- Is the financial institution facing possible risk or damage other than financial loss?

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BONDING COMPANY NOTIFICATION

The FDIC and financial institution management have a mutual interest in ensuring that all of a financial institution's employees are protected by a fidelity bond. When a financial institution files an SAR involving an employee, it normally is required to notify its fidelity insurer of the subject activity. However, a financial institution may not provide a copy of the SAR to the insurer.

The notification requirement is usually included in the terms of the insurance contract and is not dependent upon the filing of a claim against the insurance coverage. The standard financial institutions bond contains a termination clause that automatically cancels coverage of any employee as soon as there is knowledge of any dishonest or fraudulent act on the part of such employee. The insurer need not give notice of such termination; in fact, the decision of the insurer may be made at a subsequent date. In the rare case in which a financial institution official has knowledge of a suspicious act on the part of an employee, yet wishes to continue to employ that person, management should obtain either an assurance in writing from the insurer's main office (agents generally are not so empowered) that such person is still covered under the bond, or obtain a new bond covering that person. Refer to the Manual Section 4.4, Fidelity and Other Indemnity Protection for additional information.

If an examiner becomes aware that an employee has or will be reported to the fidelity bond company for suspicious acts (whether coverage is terminated or not), the examiner should contact the regional office. The regional office and examiner should consider whether to commence an investigation of the employee's acts to determine if removal and prohibition or other administrative action under section 8 is warranted.

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OTHER MATTERS

Examiners that receive information about alleged misconduct by a financial institution, its officers, employees, or directors may be asked to protect the informant's identity. When this happens, the examiner should advise the informant that the FDIC will try to protect the identity of the informant. However, prior to receiving the information, the examiner should advise the informant of the following facts:

- Mere inquiry into the situation may allow the institution's management or employees to deduce the informant's identity;
- The information may be referred to another agency, such as the Department of Justice, which may request the informant's identity to continue or complete an investigation; and
- If the information becomes the basis for a criminal prosecution, the court may order disclosure of the informant's identity to the defendant.

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CRIMINAL STATUTES

United States Code Title 18 is applicable to many criminal or fraudulent acts relating to financial institutions. Several sections of Title 18 and other pertinent Titles that an examiner might encounter are described below.

Title 18 - Crimes and Criminal Procedure
Part I › Chapter 1 › § 2
Aiding and Abetting

Whoever aids, abets, counsels, commands, induces, or procures the commission of a federal offense is punishable as a principal.

18 U.S.C. § 4 - Misprision of Felony

This statute applies to a person who has knowledge of the actual commission of a felony but conceals the knowledge and does not report that knowledge to a judge or other person in civil or military authority. A financial institution that fails to report an offense of which it is aware can be charged with violating this section.

18 U.S.C. § 20 - Financial Institution Defined

The definition of financial institution was expanded under the Fraud Enforcement and Recovery Act (FERA) of 2009 to include a mortgage lending business or any person or entity that makes in whole or part, a federally related mortgage loan as defined in the Real Estate Settlement Procedures Act (RESPA) of 1974. Under § 27, a mortgage lending business is defined to include an organization which finances or refinances any debt secured by an interest in real estate, including private mortgage companies and any subsidiaries, and whose activities affect interstate or foreign commerce. Prior to the amendment, only FDIC or NCUA insured institutions, Federal Home Loan Banks, Farm Credit System, uninsured foreign banks, and Federal Reserve member banks were considered financial institutions.

Chapter 11 - Bribery, Graft, and Conflicts of Interest

18 U.S.C. § 201 - Bribery of Public Officials

This statute bans the offering or soliciting of bribes to or by federal officials, elected representatives, jurors or witnesses in official proceedings with the intent to influence an official act, or to influence the public official to commit, aid in committing, collude in, or allow any fraud; or to induce the public official to omit to do any act in violation of his lawful duty.

18 U.S.C. § 215 - Bank Bribery

Anyone who corruptly gives, offers, or promises anything of value with the intent to influence or reward an officer, director, employee, agent, or attorney of a financial institution in connection with any business or transaction, or any financial institution official who corruptly solicits or demands such things of value, would violate this statute.

Financial institutions are encouraged to prohibit insiders from self-dealing or otherwise trading on their positions at the financial institution; or accepting from one doing or seeking to do business with the financial institution, a business opportunity not generally available to the public. In this regard, the financial institution's code of conduct or policies should require that its officials disclose all potential conflicts of interest, including those in which they have been inadvertently placed due to either business or personal relationships with customers, suppliers, business associates, or competitors of the financial institution.

It should be noted that this section does not apply to bona fide salary, wages, fees, or other compensation paid, or expenses paid or reimbursed, in the usual course of business.

Chapter 19 - Conspiracy

18 U.S.C. § 371 - Conspiracy to Defraud

This statute covers a conspiracy of two or more persons to commit a federal offense or to defraud the United States or any agency thereof. This statute has been cited when two or more persons willfully ignored the notice requirements of the Change in Bank Control Act.

Chapter 25 - Counterfeiting and Forgery

18 U.S.C. § 471 - Counterfeiting and Forgery (Counterfeit Deterrence Act of 1992)

This statute applies to persons who falsely make, forge, counterfeit, or alter any obligation or other security of the United States with intent to defraud.

18 U.S.C. § 472 - Counterfeiting and Forgery

This statute applies to persons who intentionally defraud, pass, utter, publish, or sell the items contained in § 471 above. It also includes those persons who attempt to do so, or those who keep in their possession or conceal any such items.

18 U.S.C § 500 - Counterfeiting and Forgery - Money Orders

This statute applies to persons who intentionally defraud, falsely make, forge, counterfeit, engrave, or print any order in imitation of, or purporting to be, a blank money order. It also applies to those who receive or possess any such money order with the intent to convert it for their own use or gain, knowing that it had been embezzled, stolen, or converted.

Chapter 31 - Embezzlement and Theft

18 U.S.C. § 656 - Theft, Embezzlement, and Misapplication by Bank Officer or Employee

This statute prohibits the willful theft, embezzlement, or misapplication of financial institution funds by an officer, director, agent, or employee of a financial institution with the intent to injure or defraud the financial institution. For example:

- Loans granted by a financial institution officer to fictitious borrowers,
- Loans granted based on inadequate or valueless collateral if the loan officer benefited personally or acted in reckless disregard of the institution's interests, and
- Brokered loans where deposits are provided for a fee to fund a loan that is worthless from its inception.

18 U.S.C. § 657 - Theft, Embezzlement, and Misapplication of Funds

This statute requires that any officer, agent, or employee of, or connected in any capacity with the FDIC, et al., who embezzles, abstracts, purloins or willfully misapplies any moneys, funds, credits, securities, or other things of value belonging to an insured institution will be fined or imprisoned.

18 U.S.C. § 658 - Property Mortgaged or Pledged to Farm Credit Agencies

This statute applies to persons who intentionally defraud, knowingly conceal, remove, dispose of, or convert to their own use, or to that of another, any property mortgaged or pledged to, or held by, the Farm Credit agencies.

18 U.S.C. § 664 - Theft or Embezzlement from Employee Benefit Plans

This statute applies to persons who intentionally embezzle, steal, or unlawfully and willfully abstract or convert to their own use or to the use of another, any of the monies, funds, securities, premiums, credits, property, or other assets of any employee welfare benefit plan or employee pension benefit plan, or of any fund connected therewith.

18 U.S.C. § 667 - Theft of Livestock

This statute applies to those who market $10,000 or more in livestock, in interstate or foreign commerce, with the intent to deprive another of a right to the property or a benefit of the property or to appropriate the property to his or another's use.

Chapter 33 - Emblems, Insignia, and Names

18 U.S.C. § 709 - False Advertising or Misuse of FDIC Name

This statute covers false advertising or representations, misuse or unauthorized use of words such as national, reserve, federal deposit, or deposit insurance, or misuse of names such as FDIC, to convey the impression of federal agency affiliation.

Chapter 47 - Fraud and False Statements

18 U.S.C. § 1001 - False Statements or Entries

This statute generally covers oral or written false statements that are knowingly or willingly made, or concealment of a material fact, for the purpose of influencing a determination of any federal department or agency. It is not necessary to show that the governmental body was actually influenced thereby.

18 U.S.C. § 1005 - Bank Entries, Reports, and Transactions

This statute covers false entries and reports or statements, including material omissions, made by an officer, director, agent, or employee of an insured bank with intent to injure or defraud the bank, or to deceive the FDIC or other individuals or companies. This section also prohibits any such person from issuing or putting forth in circulation any notes of the bank or making, drawing, issuing, or assigning any certificate of deposit, draft, order, bill of exchange, acceptance, note, debenture, bond or other obligation, or mortgage, judgment or decree. The crime may be committed personally or by direction (e.g., an officer directing the making of false entries).

Examples:

- Actions taken by an officer or employee to conceal delinquencies or to disguise potential lending limit violations
- Recording securities transactions at other than market value to hide losses

18 U.S.C. § 1007 - Federal Deposit Insurance Corporation Transactions

This statute covers false statements made for the purpose of influencing an action of the FDIC in any way. This includes willfully over-valuing any security for the purpose of obtaining, extending, or renewing a loan and statements made to induce the payment of an insured deposit, the purchase of assets, or the payment of any claim by the FDIC. To establish a violation of this statute, it is not necessary to prove loss or damage to the FDIC caused by the falsification. Violations of this section occur when false statements are made to the FDIC in connection with an application for deposit insurance, notice to acquire control of an insured state nonmember bank, or other processes in which FDIC is required to take action. False or misleading statements made to an FDIC examiner during an examination are also covered.

18 U.S.C. § 1010 - Department of Housing and Urban Development (HUD) Transactions

This statute prohibits for the purpose of obtaining any loan or advance of credit from any person, partnership, association, or corporation with the intent that such loan or advance of credit will be offered to or accepted by HUD for insurance, or for the purpose of obtaining any extension or renewal of any loan, advance of credit, or mortgage insured by HUD, or the acceptance, release, or substitution of any security on such a loan, or for the purpose of influencing in any way the action of HUD, by making, passing, uttering, or publishing any statement, knowing the same to be false, or altering, forging, or counterfeiting any instrument, paper, or document, or uttering, publishing, or passing as true any instrument, paper, or document, knowing it to have been altered, forged, or counterfeited, or willfully overvaluing any security, asset, or income, will be fined and/or imprisoned.

18 U.S.C. § 1014 - False Statements on a Loan or Credit Application

This statute covers any false statements or reports made knowingly on a loan or credit application to an insured bank or to an entity that makes in whole or part, federally related mortgage loans as defined in RESPA of 1974. Such statements or reports must have been capable of influencing the financial institution's credit decision. Actual damage or reliance on such information is not an essential element of the offense.

The statute applies to the following:

- Applications,
- Advances,
- Discounts,
- Purchases,
- Purchase agreements,
- Repurchase agreements,
- Commitments,
- Credit renewals,
- Extensions or Deferments.

The statute applies to willful omissions as well as affirmative false statements. Obsolete information in the original loan application is not covered unless the applicant reaffirms the information in connection with a renewal request.

18 U.S.C. § 1028 - Fraud and Related Activity in Connection with Identification Documents, Authentication Features, and Information

This statute applies to persons who knowingly and without lawful authority produce or transfer an identification document, authentication feature, or a false identification document. This statute also applies to persons who knowingly possess with intent to use or transfer unlawfully five or more identification documents. Further, the statute applies to those who knowingly and unlawfully transfer, possess, or use a means of identification of another person with the intent to commit, or to aid or abet, or in connection with any unlawful activity that constitutes a violation of federal law, or a felony under any applicable state or local law. Finally, this statute covers trafficking in false or actual authentication features for use in false identification documents.

Identification document is defined as a document made or issued by or under the authority of the U.S. government, state or local government, or by a foreign government.

Means of identification is defined as any name or number that may be used, alone or in conjunction with any other information, to identify a specific individual, including:

- Any name,
- Social security number,
- Date of birth,
- Official state or government issued driver's license or identification number,
- Alien registration number,
- Government passport number,
- Employer or taxpayer identification number,
- Unique biometric data (fingerprints, voice, retina or iris image),
- Unique electronic identification number, address, or routing code, or
- Telecommunication identifying information or access device.

18 U.S.C. § 1028A - Aggravated Identity Theft

Persons who during and in relation to §1341, §1343, or §1344, knowingly transfer, possess, or use, without lawful authority, a means of identification of another person, will in addition to punishment for the conviction of §1341, §1343, or §1344, will be sentenced to a term of two years.

18 U.S.C. § 1029 - Fraud and Related Activity in Connection with Access Devices

This statute applies to persons who knowingly and with the intent to defraud, produces, uses, or traffics in one or more counterfeit access devices, **or** during any one-year period, obtains anything of value using an unauthorized access device with an aggregate value of $1,000 or more.

The statute also specifically prohibits whoever knowingly and with intent to defraud:

- Possesses 15 or more devices which are either counterfeit or unauthorized [§1029(a)(3)];
- Produces, traffics in, or has control, custody, or possession of device-making equipment [§1029 (a)(4)];
- Effects transactions with 1 or more access devices issued to another person(s) to receive payment or other

value of $1,000 or more over a 1-year period [§1029(a)(6)] ; or
- Uses, produces, traffics in, has control, custody, or possession of a modified or altered instrument to obtain unauthorized use of telecommunications services, [§1029(a)(7) and (9)] among other factors.

Further, soliciting a person for the purpose of offering an access device, or selling information or an application to obtain an access device is covered, as is causing or arranging for another person to present a credit card for payment evidences or records of transactions made by an access device[§1029(e)(7)] .

The term access device is defined as:

- Any card,
- Plate,
- Code,
- Account number,
- Electronic serial number,
- Mobile identification number,
- Personal identification number,
- Other telecommunications service, equipment, or instrument identifier, or
- Other means of account access that can be used, alone or in conjunction with another access device, to obtain money, goods, services, or any other thing of value, or that can be used to initiate a transfer of funds (other than solely by paper instrument).

18 U.S.C. § 1030 - Computer Fraud

This statute applies to persons who knowingly access a computer without authorization [§1030(a)(1)], or exceed authorized access levels; or who, having accessed a computer with authorization [§1030(a)(2)], but use it for unauthorized purposes [§1030(a)(2)(A)] (e.g., obtaining information contained in records of a financial institution or card issuer, or a file of a consumer reporting agency). This statute also applies to trafficking in any password or similar information through which a computer may be accessed without authorization [§1030(a)(6)] if such trafficking affects interstate or foreign commerce or if the computer is used by or for the U.S. government. Further, the statute covers those who have the intent to extort money or other thing of value by transmitting any interstate or foreign communication containing a threat to cause damage to a protected computer; threat to obtain information from a protected computer without authorization, or in excess of authorization, or to impair the confidentiality of information obtained from a protected computer; or, demand or request for money or other thing of value in relation to damage to a protected computer, where such damage was caused to facilitate the extortion [§1030(a)(7)]. Finally, whoever conspires to commit or attempts to commit an aforementioned offense is also covered by this statute [§1030(b)].

§ 1030(a)(2) applies to the observation or reading of the data and does not require the copying or transporting of the data. In addition, the provision does not require larcenous intent.

Other applicable provisions include the following:

- §1030(a)(4) - Prohibits computer intrusion
- §1030(a)(5) - Concerns damage or destruction of a financial institution's property

18 U.S.C. § 1032 - Concealment of Assets from FDIC

This statute applies to persons who knowingly conceal or endeavor to conceal an asset or property from the FDIC acting as conservator or receiver. This statute also covers impeding the FDIC as conservator or receiver, or placing assets or property beyond the reach of FDIC as conservator or receiver.

18 U.S.C. § 1037 - Fraud and Related Activity in Connection with Electronic Mail also known as the "Can-Spam Act of 2003"

This statute applies to those who, in or affecting interstate or foreign commerce, knowingly access a financial institution's computer without authorization and intentionally initiate the transmission of multiple commercial electronic mail messages from or through such computer; use a financial institution's computer to relay or retransmit multiple commercial electronic mail messages with the intent to deceive or mislead recipients, or any internet access service as to the origin of such messages; materially falsify header information in multiple commercial electronic mail messages and intentionally initiate the transmission of such messages; register, using information that materially falsify the identity of the actual registrant, for five or more electronic mail accounts or online user accounts or two or more domain names, and intentionally initiate the transmission of multiple commercial electronic mail messages from any combination of such accounts or domain names; or falsely represent oneself to be the registrant or the legitimate successor in interest to the registrant of five or more internet protocol addresses and intentionally initiate the transmission of multiple commercial electronic mail messages from such address, or conspires to do so.

Chapter 63 - Mail Fraud and Other Fraud Offenses

18 U.S.C. § 1341 - Frauds and Swindles, also known as the Mail Fraud Statute

This statute covers the use of the mail by sending or receiving items in furtherance of a fraudulent scheme. Note that the statute applies to items sent or received through the U.S. Postal Service and through "any private or commercial interstate carrier." In recent years, this statute has been used to prosecute the perpetrators of check kiting, advance fee, and mortgage fraud schemes where checks or other documents were sent or received through U.S. mail or interstate carriers. Use of the mail after a scheme to defraud has been completed is not an offense under this statute. See also §1349 Attempt and Conspiracy.

18 U.S.C. § 1342 - Fictitious Name or Address

This statute covers the use of a false, assumed, or fictitious name, address, or title for the furtherance of a fraudulent scheme or devise mentioned in § 1341.

18 U.S.C. § 1343 - Fraud by Wire, Radio, and Television also known as the Wire Fraud Statute

This statute applies to a scheme or an artifice to defraud or to obtain property or money through use of wire, radio, or television transmissions in interstate commerce. Recently, in addition to the prosecution of wire and Automated Clearing House transaction fraud cases, this statute has been used to prosecute cases in which commercial and mortgage loan proceeds were wired between states. This statute is also used to prosecute computer-related crimes. See also §1349 Attempt and Conspiracy.

18 U.S.C. § 1344 - Bank Fraud

The statute covers the use of a scheme or artifice to defraud an insured institution or to obtain, through misrepresentations, any of the monies, funds, credits, assets, securities, or other property owned by, or under the control of, the institution. The intent to defraud must be shown, although the scheme does not have to be successful.

Examples:

- Check kiting.
- Diverting loan proceeds for purposes other than stated, including repayment of other debt.
- Out-of-trust in floor plan lending.

18 U.S.C. § 1349 - Attempt and Conspiracy

Any person who attempts or conspires to commit any offense under this chapter will be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy. The conspiracy part of this statute is used frequently in the indictment of individuals.

Chapter 73 - Obstruction of Justice

18 U.S.C. § 1517 - Obstructing Examination of a Financial Institution

This statute applies to persons who corruptly obstruct or attempt to obstruct any examination of financial institution by an agency of the United States with jurisdiction to conduct an examination. The FDIC has agreed to report any such offense to the FDIC Office of the Inspector General (OIG).

18 U.S.C. § 1519 - Destruction, Alteration, or Falsification of Records in Federal Investigations and Bankruptcy

This statute applies to any person who knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the U.S. or any case filed under title 11, or, in relation to or contemplation of any such matter or case.

Chapter 83 - Postal Service

18 U.S.C. § 1708 - Theft or Receipt of Stolen Mail

This statute applies to persons who steal, take, or abstract, or by fraud or deception obtain, or attempt to obtain, from or out of any mail, post office, or station thereof, letter box, mail receptacle, or any mail route or other authorized depository. This statute also covers those who buy, receive or conceal, or unlawfully has in his possession, any item stolen, taken, embezzled, or abstracted.

Chapter 95 - Racketeering

18 U.S.C. § 1952 - Interstate and Foreign Travel or Transportation in Aid of Racketeering Enterprises

This statute is being used in a manner similar to that of the Foreign Corrupt Practices Act. See 15 U.S.C. § 78dd on the following page. The "Travel Act" applies to those who travel in interstate or foreign commerce or use the mail or any facility in interstate or foreign commerce with the intent to distribute the proceeds of any unlawful activity or commit any crime of violence to further any unlawful activity or otherwise promote, manage, establish, carry on, or facilitate the promotion, management, establishment, or carrying on, of any unlawful activity.

Unlawful activity is defined in the statute as any business enterprise involving gambling, liquor which lacks the federal excise tax, narcotics or controlled substances; or, extortion, bribery, or arson in violation of state laws.

18 U.S.C. § 1956 - Laundering of Monetary Instruments

This statute makes it illegal to conduct or attempt to conduct a financial transaction knowing that the property involved in the transaction represents the proceeds of some form of unlawful activity with the intent to promote the carrying on of specified unlawful activity; with the intent to engage in conduct constituting a violation of § 7201 (attempt to evade or defeat tax) or 7206 (false tax returns) of the Internal Revenue Code or knowing that the transaction is designed in whole or part to conceal or disguise the nature, location, source, ownership, or control of the proceeds of the specified unlawful activity or to avoid a state or federal transaction reporting requirement.

The statute also makes it illegal to transport or attempt to transport internationally a monetary instrument or funds with the intent to promote the carrying on of specified unlawful activity or knowing that the monetary instrument or funds constitute the proceeds of some form of illegal activity and knowing that the transportation is designed in whole or part to conceal the nature, location, source, ownership or control of the proceeds, or to avoid a transaction reporting requirement under state or federal law.

18 U.S.C. § 1957 - Engaging in Monetary Transactions in Property Derived from Specified Unlawful Activity

This statute makes it illegal to engage or attempt to engage in a monetary transaction in property constituting, or derived from, proceeds obtained from a criminal offense knowing that it is criminally derived property and has a value of over $10,000.

Chapter 103 - Robbery and Burglary

18 U.S.C. § 2113 - Bank Robbery and Incidental Crimes

In addition to covering theft of bank property by force, violence, or intimidation, this section also covers the entry or attempted entry of a bank building with intent to commit any felony affecting any bank and in violation of any statute of the United States, or any larceny.

Chapter 113 - Stolen Property

18 U.S.C. § 2314 - Transportation of Stolen Goods, Securities, Moneys, Fraudulent State Tax Stamps, or Articles Used in Counterfeiting

This statute applies to persons who transport, transmit, or transfer in interstate or foreign commerce, any goods, wares, merchandise, securities, or money in the amount of $5,000 or more, knowing that the transferred assets were stolen, converted, or taken by fraud. This statute covers falsely made, forged, altered, or counterfeited securities or tax stamps and the device(s) used to make such securities, tax stamps, or traveler checks bearing a forged countersignature. This section does not apply to falsely made, forged, altered, counterfeited obligation or security issued by the U.S. government, or that of any foreign government. This statute may be used in the prosecution of reverse mortgage fraud schemes.

18 U.S.C. § 2315 - Sale or Receipt of Stolen Goods, Securities, Moneys, of Fraudulent State Tax Stamps

This statute prohibits receipt, possession, concealment, storage, bartering selling, or disposing of goods, wares, securities, moneys in the amount of $5,000 or more, or pledges or accepts as security for a loan any collateral of $500 or more, which have crossed state or U.S. borders after being stolen, unlawfully converted, or taken, knowing the same to have occurred.

18 U.S.C. Title 15 - Commerce and Trade
Chapter 2B - Securities Exchanges

15 U.S.C. §§ 78dd and 78ff - Foreign Corrupt Practices Act (FCPA) of 1977

The FCPA is actually part of the Securities Exchange Act of 1934 and has two main provisions: the anti-bribery provisions; and the books, records, and internal control provisions. The anti-bribery provisions of §78dd-1 are applicable to issuers; §78dd-2 is applicable to domestic concerns, which are defined as a U.S. resident or citizen or any entity such as a partnership or corporation having its principal place of business in the U.S. and being organized under state (or comparable, such as territory) laws; and §78dd-3 is applicable to persons other than issuers or domestic concerns. § 78ff covers the penalties associated with violations of §78dd.

In general, the provisions make it unlawful for any person or entity to corruptly use the mail or other means of interstate commerce to further an offer, payment, or promise to pay any money, offer, or gift, etc., to any foreign official in violation of the lawful duty of such official in order to assist the issuer in obtaining or retaining business. See also, 18 U.S. C. 1952 Interstate and Foreign Travel or Transportation in Aid of Racketeering Enterprises

31 U.S.C. Chapter 53

- Subchapter II - Monetary Transactions
- Subchapter III - Money Laundering

Refer to the FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual for discussion.

42 U.S.C., Chapter 8A, Subchapter III, § 1490s - Enforcement Provisions, (a) Equity Skimming

Whoever, as an owner, agent, employee, or manager, or is otherwise in custody, control, or possession of property that is security for a loan made or guaranteed, willfully uses, or authorizes the use, of any part of the rents, assets, proceeds, income, or other funds derived from such property, for any purpose other than to meet actual, reasonable, and necessary expenses of the property shall be fined or imprisoned.

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SIGNIFICANT CIVIL STATUTES

Title 31 - Money and Finance

31 U.S.C. §3729-3733 False Claims Act (FCA)

This civil statute allows for triple damages for the amount that the government paid for false claims submitted. This statute covers many areas unrelated to financial institutions; however, it is currently being used against those who misrepresented the terms and quality of the loans insured by FHA. The statute was amended by the Fraud Enforcement and Recovery Act of 2009, the Dodd-Frank Act, and other acts. FCA lawsuits may be brought by individuals working for financial institutions who file claims on behalf of the government; the U.S. government may or may not join such lawsuits. As a civil action, either the individual or the U.S. government must prove each false claim to the standard of preponderance of evidence. The FCA has a 10-year statute of limitations.

The following are the four major liability clauses within §3729:

- §3729(a)(1)(A) Any person who knowingly presents or causes to be presented, a false or fraudulent claim for payment or approval by or to the U.S. government.
- §3729(a)(1)(B) Any person who knowingly makes, uses, or causes to be made or used, a false record or statement material to get a false or fraudulent claim paid or approved by the U. S. government. Both this provision and §3729(a) (1)(A) are required to pursue claims under the Act.
- §3729(a)(1)(C) involves conspiracy to commit a violation of §§3729(a)(1)(A) - (G). The conspiracy applies in getting a false claim paid as in §3729(a)(1)(A) or conspiring to underpay the government as in §3729(a)(1)(G).
- §3729(a)(1)(G) Any person who knowingly makes, uses, or causes to be made or used, a false record or statement material to an obligation to pay or transmit money or property to the government, or knowingly conceals or knowingly and improperly avoids or decreases an obligation to pay or transmit money or property to the government is liable under the FCA.

Under the FERA amendment, material is now defined as having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property.

Other sections:
§3730 - Civil Actions for False Claims
§3731 - False Claims Procedures
§3732 - False Claims Jurisdictions
§3730 - Civil Investigative Demands

INTRODUCTION

This section of the Manual of Examination Policies provides a broad perspective of international banking. It begins by addressing the concept of country risk, which is the primary risk associated with international banking activities. The section then discusses common international banking products and services such as foreign loans, investments, placements,[1] currency exchange, and funds management.

Within the discussion on foreign loans, significant attention is given to trade finance, which is an important, yet declining, segment of U.S. banks' international credit exposures. Due to increased globalization of international markets and competition from non-bank intermediaries, U.S. banks have become less involved in trade finance and more involved in direct loans to foreign banks, participations in syndicated credit facilities, and loans to individuals and foreign businesses.

This section also discusses the international banking operations of foreign banks in the U.S., the operational structures established by U.S. banks in order to conduct banking activities in foreign jurisdictions, and parallel-owned banking organizations (PBOs). A PBO exists where there is common control or ownership of domestic and foreign banks outside of a traditional bank holding company structure (similar to chain banks). The PBO structure results in a global financial organization that may not be subject to comprehensive, consolidated supervision standards and could present unique supervisory concerns.

Finally, this section discusses supervisory methods and examination guidance relating to the supervision of foreign banking organizations (FBOs) and provides references to applicable laws and regulations. The section concludes with a glossary of international banking terms.

Overview of International Bank Activities

While the number of U.S. banks involved in international finance is relatively small in comparison to the overall number of U.S. banks, many large institutions have notable cross-border exposure and significant international activities. Moreover, in certain markets, a considerable number of smaller banks continue to allocate significant resources to international banking.

Many international banking activities parallel those conducted in domestic banking operations. For example, in both international and domestic markets, a bank may extend credit, issue and confirm letters of credit, maintain cash and collection items, maintain correspondent bank accounts, accept and place deposits, and borrow funds. Other activities are more closely associated with international banking, such as creating acceptances and trading foreign currencies.

The most important element of international banking not found in domestic banking is country risk, which involves the political, economic, and social conditions of countries where a bank has exposure. Examiners must consider country risk when evaluating a bank's international operations.

Despite similarities between domestic and international activities, banks often conduct international operations in a separate division or department. Large banks typically operate an independent international division, which may include a network of foreign branches, subsidiaries, and affiliates. Smaller banks, or banks with limited international activity, often use a separate section that works with a network of foreign correspondent banks or representative offices. In either case, international activity is usually operated by separate management and staff using distinct accounting systems and internal controls.

Given the risks introduced by doing business in a foreign country, particularly in emerging markets, examiners must review and understand international activities when assessing a bank's overall condition. Furthermore, examiners should coordinate international reviews with Bank Secrecy Act (BSA), Anti-Money Laundering (AML), and Office of Foreign Assets Control (OFAC) reviews.

Examination Objectives

The objectives of examining international activities are largely the same as those of examining domestic activities. However, the specialized nature of international banking may require modification of some examination activities due to different accounting procedures, documentation requirements, or laws and regulations. For example, access to information at foreign branches varies according to foreign laws governing such access and the FDIC's relationships with foreign supervisors.

The examination of international activities is usually conducted concurrently with the risk management examination. The scope of the examination and staffing requirements should be established during pre-examination planning. Prior examination reports will usually indicate the existence of an international department, identify foreign branches or subsidiaries, and discuss the type and volume of international activities. Reviewing regulatory reports that the bank may be required to file, such as

[1] Interest-bearing time deposits held in foreign banks or overseas branches of U.S. banks.

Federal Financial Institutions Examination Council (FFIEC) 009 and 009a Country Exposure Reports or Treasury International Capital (TIC) Form B Reports, can also assist examiners determine a bank's level of country exposure. Other resources include recent Reports of Condition and Income (Call Reports) and Uniform Bank Performance Reports.

Examiners can usually examine international activities at a bank's main domestic office or other centralized location. Part 347 of the FDIC Rules and Regulations governs minimum recordkeeping standards at state nonmember banks that operate foreign branches or meet certain investment or control levels. These standards require banks to maintain certain information concerning offshore activities at their head office. This requirement generally enables a centralized review of asset quality, funding operations, contingent liabilities, and internal controls.

In some cases, on-site examinations of foreign branches (branches in the foreign country) may be necessary because of inadequate information at the main domestic office or the existence of unusual branch activities. Examiners should determine the availability and quality of information maintained at the main office during the pre-examination process to gain a general understanding of any unusual branch activities before considering a foreign branch examination. If the information at the centralized location appears inadequate or unusual branch activities are identified, it may be appropriate to conduct a pre-examination visitation or begin the domestic examination before commencing the foreign branch examination in order to obtain additional information.

Note: Examiners must consult with field and regional management before commencing a foreign branch examination. The consultation should include a discussion of the protocol governing notification of the foreign supervisor prior to commencement of the visitation or examination.

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COUNTRY RISK MANAGEMENT

Most facets of international banking are exposed to country risk. To address country risk, the federal regulatory agencies jointly issued a statement titled *Sound Country Risk Management Practices*, (March 2002 Statement). Examiners should assess a bank's conformance with the risk management standards detailed in the March 2002 Statement and summarize the results of their assessment in the Report of Examination (ROE) on the Analysis of the Country Exposure Management System page.

The remainder of this section describes various country risk concepts and risk management processes and describes how the federal agencies evaluate transfer risk (an aspect of country risk). The foundation for the discussion that follows is the March 2002 Statement and the Guide to the Interagency Country Exposure Review Committee (ICERC Guide). Examiners should refer to these documents for further information.

Concept of Country Risk

In addition to the risks present in their domestic operations, institutions engaged in international activities are exposed to country risk. Country risk involves the possibility that economic, social, or political conditions and events in a foreign country will adversely affect an institution's financial interests, such as defaults by obligors in a foreign country. Country risk also includes the possibility of nationalization of private assets, government repudiation of external indebtedness, exchange controls, or significant currency devaluations.

Country risk has a pervasive effect on international activities and should be explicitly considered when assessing the risk of all exposures (including off-balance sheet items) to public- and private-sector foreign-domiciled counterparties. The risk associated with even the strongest foreign counterparties will increase if, for example, political or macroeconomic conditions cause the exchange rate to depreciate and the cost of servicing external debt to rise.

The March 2002 Statement recognizes that country risk is not limited to an institution's exposure to foreign-domiciled counterparties. In some situations, the performance of domestic counterparties may also be adversely affected by conditions in foreign countries. When appropriate, examiners should consider country risk factors when assessing the creditworthiness of domestic counterparties.

Country risk is not limited solely to credit transactions. Changing policies or conditions in a foreign country may also affect matters such as investments in foreign subsidiaries, servicing agreements, or outsourcing arrangements with foreign entities, including those associated with the bank through its holding company.

Country Risk Management System

Country risk management systems should be commensurate with the type, volume, and complexity of the institution's international activities, and examiners should consider these factors when assessing country risk management systems and practices. As more fully described in the March 2002 Statement, sound country risk management systems should include:

- Effective oversight by the board of directors,
- Adequate risk management policies and procedures,
- Accurate systems for reporting country exposures,
- Effective processes for analyzing country risk,
- Forward-looking country risk rating systems,
- Country exposure limits,
- Regular monitoring of country conditions,
- Periodic stress testing of foreign exposures, and
- Adequate internal controls and audit function.

The March 2002 Statement indicates that to effectively control risk associated with international activities, institutions must have a risk management system that focuses on the concept of country risk. A program that is limited to an assessment of transfer risk, and especially one that solely relies on transfer risk designations assigned by the ICERC, ignores other important facets of country risk and would not be appropriate. Transfer risk and the ICERC program are discussed in subsequent subsections.

Policies and Procedures

Management is responsible for developing and implementing sound, well-defined policies and procedures for managing country risk. Management should also ensure that country risk management policies and practices are clearly communicated to applicable offices and staff. At a minimum, policies and procedures should:

- Articulate a strategy for conducting international activities;
- Specify appropriate products, services, and affiliates (e.g., banks, branches, affiliates, joint ventures, etc.);
- Identify allowed and disallowed activities;
- Describe major risks in applicable countries or regions;
- Establish risk tolerance limits;
- Develop standards and criteria for analyzing and rating country risk;
- Delineate clear lines of responsibility and accountability for country risk management decisions;
- Require periodic reporting of country risk exposures and policy exceptions to senior management and the board; and
- Ensure compliance with regulatory guidance and reporting requirements.

Rating Country Risk

Countries often experience political and economic shocks, and institutions with international activities must appropriately manage country risk. Critical risk mitigation components include effective country risk monitoring, accurate risk ratings, and timely implementation of exit strategies.

When collecting data to examine country risk, useful sources of qualitative information may include market data from the bank's internal country studies or representative office; officer visits to the home country, central bank, or correspondent bank; and external credit-rating-agency information. For instance, foreign/local currency ceiling ratings for the sovereign country, foreign/local currency deposit ratings for banks, and bank financial-strength ratings can be effectively employed as part of a country risk management program. Management should have a clear understanding of the assumptions and analysis that rating agencies use to develop external ratings if they consider the information when assigning internal ratings.

The causes of sovereign defaults can be broadly grouped into the following categories:

- Banking crises,
- Chronic economic stagnation,
- High debt burden, and
- Institutional or political factors.

In general, country risk ratings should encompass qualitative and quantitative analysis and reflect an estimate of the likelihood of adverse events. Qualitative analysis does not require sophisticated modeling and may simply involve a careful, general analysis of key indicators. When quantitative models are used, management should apply sound modeling practices typically employed elsewhere (e.g., credit and interest rate risk modeling).

Quantitative factors to consider include gross domestic product (GDP) growth, GDP per capita, inflation and unemployment rates, bond yields, government and private sector debt levels, current account deficits, short- and long-term external debt, credit default swap prices, and foreign exchange/international reserves. Statistics regarding these items are often available through multilateral agencies or official national sources. While the availability of data has substantially improved, examiners should be aware that in certain less-developed countries, data may be unavailable, infrequently reported, or unreliable, and qualitative in-country analysis may be significantly more reliable.

Although a country risk rating should be assigned to all foreign countries, it may be helpful to vary rating methodologies between emerging and non-emerging market countries (or other similar delineations). Also, in certain high-export countries, such as countries heavily dependent on oil exports, it may be useful to monitor specific market factors to more effectively evaluate risks.

Additionally, depending on the size and complexity of certain exposures, it may be appropriate for management to consider institution-specific factors when assigning internal ratings. For example, management should consider the legal and governance framework of the institution's activities in the foreign country, the type and mix of exposures, reliance on in- or out-of-country funding sources, and the economic outlook for specific industries. Additionally, management should consider potential risk mitigants, including the ability to effectively manage foreign exposures through in-country personnel.

It is common for banks to adjust or qualify country risk ratings based on the level and type of exposure of the counterparty. For example, trade-related and banking-sector exposures may receive better risk ratings than other categories of exposure. The importance of trade and banking transactions to a country's economy often results in preferential treatment by foreign governments for repayment. However, management should closely monitor signals from foreign governments when conditions deteriorate to ensure expectations of support are still warranted.

Finally, while country risk rating and monitoring systems can affect general and specific risk management decisions, the information provided should be an integral part of the strategic decision making process as it relates to foreign operations. Ultimately, the information provided should stimulate discussion, assessment, and potential action at the senior management and board levels.

Country Exposure Concentrations

The federal banking agencies recognize that concentration limits and diversification are useful ways to moderate country risk. Diversification is especially relevant to international lending because the assessment of country risk can involve major uncertainties. Diversification provides some protection against a dramatic change in the economic or political environments of a particular country or region.

As part of their country risk management process, internationally active institutions should adopt a system of country exposure limits. Because the limit setting process often involves divergent interests within the institution (such as senior management, country managers, and the country risk committee), country risk limits will usually require the balancing of several considerations, including:

- The overall strategy guiding the institution's international activities,
- The country's risk rating,
- The institution's risk appetite,
- The perceived business opportunities in the country, and
- The desire to support the international business needs of domestic customers.

The March 2002 Statement notes that concentrations of exposures to individual countries that exceed 25 percent of Tier 1 Capital plus the ALLL are considered significant. In the case of troubled countries, lower exposure levels may be considered significant and should be carefully monitored. Refer to the ROE Instructions for preparing ROE commentary and the concentrations schedule.

Sovereign crises are often not limited to just one country. Surrounding regions and industries are typically affected as well, and the March 2002 Statement advises banks to consider limiting exposures on a broader (e.g., regional) basis. Examiners should identify exposures to broader country groupings in the ROE when bank or market analyses identify links or risks between countries where the bank is exposed (e.g., Central America or the Caribbean).

Risk Mitigation - Exit Strategies

Effective risk mitigation requires the development of board-approved policies regarding exit strategies (a.k.a., action plans). Action plans should define trigger points that indicate portfolio exposure in a given country may have escalated beyond an acceptable threshold and should be reduced or eliminated. The substance of an exit strategy should be commensurate with an institution's level of exposure. Items for consideration include how a bank will reduce risk to:

- Aggregate country exposures;
- Asset classes (e.g., loans, Eurobonds, medium-term notes, commercial paper, etc.);
- Issuers (sovereign, financial, private sectors, etc.);
- Product types and concentrations (trade transactions, pre-export finance, foreign-deposit concentrations, derivatives, off-balance sheet items, etc.); and
- Tenor (generally, tenor should be reduced when country risk is increasing).

Management should use quantitative and qualitative data to define, substantiate, and initiate action plans. Related policies should include procedures for estimating risk levels and reporting material exposures. The policies should also incorporate risk-reduction strategies stemming from contagion risk (the likelihood that economic problems in one country, region, or market will affect another).

Some institutions have increased the use of credit derivatives to reduce country risk. When complex financial products are used, management should consider all relevant issues, such as counterparty, credit, and correlation risks.

Transfer Risk

Transfer risk is an important part of country risk. Transfer risk reflects the possibility that an asset cannot be serviced in the currency of payment because the obligor's country lacks the necessary foreign exchange or has put restraints on its availability.

In general, transfer risk is relevant whenever a bank extends credit across international borders and the extension of credit is denominated in a currency other than the obligor's country of residence. In these situations, an obligor must, in the absence of an ability to obtain and retain foreign currency outside the country of residence, obtain the foreign currency from domestic sources. When a country is beset by economic, political, or social turmoil leading to a domestic shortage of foreign currencies, the obligor could default on its external obligations because it is unable to obtain foreign currency at a reasonable price.

Although a country risk management program must be based on the broadly defined concept of country risk, the federal banking agencies consider transfer risk when assigning classifications, designating cross-border exposures, and determining minimum transfer risk reserve requirements on cross-border exposures.

Interagency Country Exposure Review Committee (ICERC)

The ICERC consists of representatives from all federal banking agencies that are jointly responsible for providing uniform transfer risk designations. Transfer risk designations serve as a starting point for adverse classifications of all cross-border exposures. Aided by tools such as balance-of-payment statistics and internal studies of country conditions, the ICERC makes decisions on the extent of transfer risk in countries where U.S. bank exposure meets the committee's review criteria.

When a country is experiencing political, social, or economic conditions leading towards an interruption in debt servicing by obligors within the country, or when an interruption in payments appears imminent, credits within the country are adversely classified using the designations of *Substandard*, *Value Impaired*, or *Loss*. When an adverse classification is assigned, the committee prepares a standard narrative on the country to be used in the ROE. The criteria for reporting transfer risk classifications and designations established during an examination are discussed in the ROE instructions.

For sovereign exposures, ICERC's designation is the only applicable rating. However, if they are carried on the institution's books as an investment, securities issued by a sovereign entity are also subject to the interagency Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts. If a rating is different under the two systems, the examiner should assign the more severe of the two ratings. For private sector exposures, the applicable rating is the more severe of either the ICERC-assigned transfer risk rating for the country or the examiner-assigned credit risk rating (including ratings assigned as a result of the Shared National Credit Program). Further discussion of the application of transfer risk ratings can be found in the ICERC Guide.

Contingent liabilities subject to transfer risk (including commercial and standby letters of credit as well as unfunded loan commitments) that will result in a concomitant increase in bank assets if the contingencies convert into an actual liability (Category I contingent liabilities) should also be considered for special comment or classification, as applicable. Contingent liabilities extended for classification should be classified according to the type and tenor of the bank asset that would result from conversion of the contingency into an actual liability. For example, commercial import/export letters of credit would be accorded the same classification as trade transactions, while commitments to fund long-term project loans would be accorded the same classification as long-term loans. In cases where type or tenor is not easily discernible and the exposure is accorded a split classification, the more severe classification should prevail.

Transfer Risk Reserve Requirements

The International Lending Supervision Act of 1983 (ILSA) directs federal banking agencies to require banks to establish and maintain a special reserve when the value of international loans has been impaired. The ILSA requires that the special reserves be established through a charge against current income and segregated from both the ALLL and capital. A bank must establish a special reserve when an appropriate federal banking agency determines that a bank's assets have been impaired by a protracted inability of borrowers in a foreign country to make payments on their external indebtedness. Factors indicating such impairment include:

- A failure by such public or private borrowers to make full interest payments on external indebtedness,

- A failure to comply with the terms of any restructured indebtedness,
- A failure by the foreign country to comply with any International Monetary Fund (IMF) or other suitable adjustment program, or
- No definite prospects exist for the orderly restoration of debt service.

The federal banking agencies refer to this special reserve as the Allocated Transfer Risk Reserve (ATRR). The ATRR requirements are established on an interagency basis through the ICERC program. When applicable, ICERC assigns ATRR requirements to country exposures classified as Value Impaired. Banks also have the option of taking a charge-off in lieu of establishing an ATRR. The ATRR is a contra-asset to the international asset and is not included as part of the ALLL nor is it included in regulatory capital. For further details on the ATRR, refer to Part 347, Subpart C, of the FDIC Rules and Regulations.

Country Risk Exposure Report

One of the tools examiners may use to monitor a bank's country risk exposure is the FFIEC's Country Risk Exposure Report (Form 009), which details material international exposure and must be filed quarterly by certain financial institutions. This report provides information regarding the amount, type, and location of foreign assets. The examination process should include assurances that management adheres to the reporting requirements and that such reports are accurate. Differences between a bank's method of calculating country exposure and the methods required by the Form 009 are generally acceptable; however, management should be able to reconcile any differences between the two reports, as well as explain the logic behind their internal method.

Form 009 requires reporters to disclose foreign claims (assets excluding premises, ORE, and intangibles) based on the residency of the counterparty, as well as residence of the ultimate obligor (which may be different). A central concept of Form 009 is the difference between *immediate-counterparty* and *ultimate-risk* exposure. Even though a loan may be extended to a counterparty in one country, a common feature of international lending is that the presence of credible guarantees or financial collateral shifts the ultimate repayment source (and thus the source of country risk) to a different country.

For example, if a bank lends to a Brazilian subsidiary of a German parent company, the bank must report the loan as a foreign claim to Brazil on an immediate-counterparty basis. If the German parent guarantees the loan, the bank must report a *risk-transfer*, which is an outward risk-transfer (decrease) from Brazil and a commensurate inward risk-transfer (increase) to Germany. The loan is then reported as a German claim on an ultimate-risk basis. In addition to parent-subsidiary guarantees, cash and securities collateral, insurance, and credit derivatives can all be used to risk-transfer.

Form 009 is required for every U.S.-chartered insured commercial bank or savings association that has, on a fully consolidated bank basis, total outstanding claims on residents of foreign countries exceeding $30 million in the aggregate, and has at least one of the following:

- A branch in a foreign country,
- A consolidated subsidiary in a foreign country,
- An Edge or Agreement subsidiary,
- A branch in Puerto Rico or in any U.S. territory or possession (except that a bank or savings association with its head office in Puerto Rico or any U.S. territory or possession need not report if it meets only this criterion), or
- An International Banking Facility (IBF).

Additionally, institutions that report total gross notional values of derivative contracts exceeding $10 billion on Schedule RC-L of the FFIEC 031 Call Report or FR Y-9C are also required to submit Form 009, regardless of the preceding criteria. In addition, bank regulatory authorities may specifically require a report (or any specific schedule therein) to be filed by other banking organizations that are deemed to have significant country exposures. Detailed instructions for compiling the report can be found on the FFIEC.gov website under Reports/Reporting Forms.

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INTERNATIONAL ACTIVITIES

International banking embraces a wide spectrum of financial services and products. This sub-section describes products and services that an examiner is likely to encounter in a bank that has international activities.

International Lending

Entities that borrow funds from banks include importers, exporters, multinational corporations, foreign businesses, governments, consumers, foreign banks, and overseas branches of U.S. banks. International lending is concentrated at the largest global institutions and a number of smaller institutions in select markets, such as New York City, Miami, and San Francisco.

Interest earned from lending to foreign borrowers, both internationally and domestically, remains a major source of profit for banks that conduct international activities.

Other international activities, such as fund transfers, are necessary components of international banking and enhance a bank's ability to service correspondent relationships, but do not necessarily produce significant, if any, income after expenses.

The tendency for international loans to be larger than domestic loans promotes economies of scale by allowing banks to originate, monitor, and collect the loans more efficiently than smaller loans. However, larger credits often attract strong price competition from other global lenders, which may result in lower net interest margins.

International Lending Risks

All loans involve some degree of default risk, and credit officers must effectively assess the degree of risk in each credit extension. However, while foreign loans share many of the same risks of domestic credits, several other risks are unique to international lending.

As discussed earlier, all international activities are exposed to country risk. International lending is especially exposed, as problems that may arise in a particular country can lead to default, payment moratoriums, or forced modifications.

Additionally, the amount and mix of international credits can affect liquidity, capital, and sensitivity to market risk requirements and risk management practices. Credit and currency risks are also key risks associated with international lending.

Credit Risk refers to the potential inability of a borrower to comply with contractual credit terms. Evaluation of foreign credit risk is similar to domestic credit analysis and requires the review of appropriate information, including the amount of credit requested, loan purpose, collateral, anticipated terms, and repayment source. In addition, reviews should assess standard credit file information such as financial statements covering several years and the borrower's performance history on previous loans.

A key problem with assessing international credits is that applicable information is often less readily available and less detailed than in domestic credit files. Foreign loans are often extended in foreign currencies, and financial statements are often in a foreign language and formats that vary from country to country. Moreover, there are often barriers to acquiring such information from foreign sources. Therefore, when evaluating international loans, credit decisions are frequently based on information inferior to that available in domestic credit files.

Currency Risk reflects the possibility that variations in value of a currency will adversely affect the value of investments denominated in a foreign currency. Currency conversion exposure exists in every international credit extension, and currency risk can affect financial transactions in several ways. For borrowers, rapid depreciation in the home currency relative to the borrowing currency can significantly increase debt service requirements. For lenders, rapid appreciation or depreciation in currencies can substantially affect profit or loss depending on how the institution finances the assets. If a U.S. bank lends in a foreign currency, it must acquire that currency by either borrowing or exchanging dollars for the new currency. In the latter situation, a bank might find itself effectively financing its cross-border lending with domestic liabilities, exposing itself to currency risk. If the foreign currency assets depreciate, a bank might suffer economic or accounting losses even without a default because the foreign currency assets must be translated back into dollars for financial statement purposes. In this capacity, currency risk is a sub-set of market risk, and institutions should apply appropriate techniques to monitor and manage this risk.

U.S. banks can attempt to reduce the market risk aspect of currency risk by lending and requiring repayment in U.S. dollars, but the effectiveness of this technique is limited and may simply substitute currency risk for transfer risk (the risk that occurs when a borrower incurs a liability in a currency different from the currency in which revenues are generated).

For example, a foreign borrower might borrow dollars to use the proceeds in a foreign country because of the relative ease of obtaining loans denominated in dollars from a global institution. In this situation, the borrower may convert some or all of the proceeds into the foreign currency. Subsequently, when payments become due, the borrower will need to exchange some foreign currency for dollars. If the local currency depreciated against the dollar, the borrower may find itself unable to meet its debt service requirements.

Another situation that could arise in smaller markets is the inability to obtain sufficient currency at official exchange rates. This could occur because the exchange rate does not reflect competitive market dynamics, or because the loan being repaid is too large for the private-sector foreign exchange market of that country. Consequently, the borrower may be unduly controlled by its central bank or feel compelled to obtain currency from illicit market sources.

Forms of International Lending

Trade Finance

The most common function of international banking is the financing of trade. Generally, several types of trade credit facilities are used by banks, with the most common types being letters of credit and bankers acceptance financing. Exporters may be willing to ship goods on open account (self-financed) to credit-worthy customers in developed countries, but are often unwilling to accept the risk of shipping goods without established bank financing when dealing with an importer in a high-risk, or developing country. Other types of trade finance instruments and methods, such as discounting of trade acceptances and direct trade advances, are also covered in this section.

Letters of Credit

Letters of credit are issued in many forms depending on the type and circumstances of the underlying transaction. Historically, the use of letters of credit involved many documents and was labor intensive. However, automation has made it easier to create letters of credit, verify documents evidencing shipped goods, and collect payments. In some cases, the process has been streamlined into simple tracking of a bar code, similar to techniques employed at retail stores or shipping companies. Despite technological advances, the careful review of documents is paramount in order to protect the bank from liabilities and financial loss.

Commercial documentary letters of credit are instruments in which a bank (issuing bank) agrees to pay money on behalf of the customer (account party/buyer/ importer) to the party (beneficiary/seller/exporter) named in the instrument. The beneficiary is paid when specific documents are submitted to the issuing bank, as required by the terms of the letter of credit. Therefore, through a letter of credit, the bank substitutes its creditworthiness for that of the account party.

Issuance and negotiation by banks of documentary letters of credit are governed by the *Uniform Customs and Practice for Documentary Credits* of the International Chamber of Commerce. All letters of credit must:

- Be issued in favor of a definite beneficiary,
- Be for a fixed or determinate amount,
- Be in a form clearly stating how to make payments and under what conditions, and
- Include a definite expiration date.

The usual routing of a documentary letter of credit is from the issuing bank, through its correspondent bank in the country of the exporter, to the exporter. Basic letters that correspondent banks receive include *revocable* and *irrevocable* letters of credit.

The revocable form is generally of little use to the exporter. As the term indicates, the importer's bank can revoke its credit if requested to do so by its principals (the buyers) or a bank can amend credit terms without the specific agreement of the beneficiary. Ordinarily an exporter would request an irrevocable letter of credit. In this case, the buyer could not instruct their bank to rescind or change the letter of credit without first securing the consent of the exporter. When the exporter presents their documents exactly as described in the letter of credit to the correspondent bank, the latter will be able to secure payment from the importer's bank.

An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay upon presentation of the documents. The letter of credit may be sent directly to the exporter by the issuing bank or through a local correspondent bank of the issuer. In the latter case, the correspondent may merely *advise* the letter of credit. This means that it is acting as an agent of the importer's bank without any commitment on its part. This is evidenced by a printed clause appearing in the credits such as, "This advice is not an engagement on our part, but is simply for your guidance in preparing and presenting drafts and documents."

Some exporters, especially when they are not familiar with the issuing bank, require an agreement from bankers in their own country. For this purpose, the exporter will ask its local (correspondent) bank to *confirm* the irrevocable letter of credit, which requires the correspondent to obtain authorization and compensation from the issuing bank. Once confirmed, the exporter has a definite agreement from a bank in their country that it will make payment upon presentation of documents in accordance with the terms of the letter of credit, regardless of payments by the issuing bank or customer. This is evidenced by a printed clause in the agreement from the confirming bank such as, "We undertake that all drafts drawn and presented as specified above will be honored by us." The result of this transaction is that an exporter no longer has credit risk/cross-border risk from the original customer.

Payment terms of a letter of credit usually vary from when presented (sight letter of credit) to 180 days, although special forms of letters of credit allow for other terms. Usually the letter of credit will call for drafts to be drawn on the advising (and confirming) bank. If drawn at sight, the bank will effect payment immediately, provided the terms of the credit have been met. If drawn on a time basis, the bank will accept the draft, which thereafter can be held by the exporter, or by the bank on the exporter's behalf, until maturity. Alternatively, accepted drafts can usually be discounted or sold at going market rates. (Refer to the section on Bankers Acceptances.)

The ultimate repayment of letters of credit generally depend upon the eventual sale of the goods involved, and subsequent negotiations regarding letters of credit rarely occur unless caused by document discrepancies. If discrepancies occur, banks often charge a fee to resolve identified issues. The proper handling and accuracy of the documents used to process letters of credit is of primary concern, and management should maintain appropriate internal controls to ensure transactions are accurately and timely processed.

All commercial documentary letters of credit are contingent liabilities and should be included as such in the Call Report. If the payment of a letter of credit is refinanced, or the draft is discounted, it should be included as an asset in the loan schedules of the Call Report. Management should regularly monitor the volume of letters of credit outstanding through a general ledger memorandum account or contra accounts.

Standby letters of credit are another type of instrument used to facilitate international transactions. This instrument guarantees payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the bank's customer). A standby letter of credit is payable against an official statement of default or nonperformance (whereas a commercial documentary letter of credit is normally payable against the presentation of documents conveying or securing title to goods, such as a bill of lading). Some of the most common purposes for standby letters of credit include:

- Standby credit for the account party's performance under a contract award. In this case, the beneficiary presents the issuing bank a draft accompanied by a statement to the effect that the contract bidder (account party) did not perform under an awarded contract. The issuing bank is obligated to pay the beneficiary and seek reimbursement from the account party (customer).
- Standby credit for the account party's borrowing or advances from another bank. This arrangement requires the issuing bank to reimburse the lending bank if the account party (customer) does not repay their loan.
- Standby credit to back commercial paper or other obligations of the bank's customers.

A standby letter of credit transaction usually involves more risk for the issuing bank than a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of this instrument generally retains nothing of value to protect it against loss, unlike a commercial documentary letter of credit that provides the bank with title to the goods being shipped. Therefore, to reduce the credit risk of standby letters of credit, the issuing bank's credit analysis should be strong and at least equivalent to that applicable to ordinary, unsecured loans.

Back-to-back letters of credit are another type of trade finance transaction that examiners may encounter in international banks. Though the term *back-to-back* does not appear on the letter of credit, this situation is similar to a confirmed letter of credit, except that two separate letters of credit are issued.

These transactions occur when a seller receives a letter of credit covering goods that must first be obtained from a third party, which in turn requires a letter of credit. In this situation, the second issuing bank looks to the first bank for reimbursement by securing the second letter of credit with the first letter of credit.

Banks are typically reluctant to issue back-to-back letters of credit, partly because more documents are involved and the likelihood of technical problems is elevated. Generally, banks issue back-to-back letters of credit only when they have recourse to an alternative source of repayment (usually the applicant's general financial resources) in addition to the first letter of credit.

Bankers Acceptances

Most letters of credit are part of ongoing transactions that evolve from letters of credit to sight or time drafts, acceptances, notes or advances. Bankers acceptances are a common method of financing international trade that was facilitated by a letter of credit. These instruments are used to finance the successive stages of transactions that move goods from a point of origin to a final destination. Bankers acceptances are fundamental methods that banks use to finance trade transactions.

Bankers acceptances are orders in the form of time drafts (a.k.a., *bill of exchange*) that have been drawn on and accepted by a banking institution (accepting bank), or its agent, to pay the holder a certain sum on or before a specified date. The drawee bank creating the acceptance is primarily liable for the instrument, while the payee, as first endorser, is secondarily liable for paying the holder. If the drawee (buyer) is other than a bank, the instrument is a trade acceptance, not a bankers acceptance.

Bankers acceptances are sometimes eligible for purchase and rediscount by Federal Reserve banks. The rules governing whether an acceptance meets eligibility requirements are important for two major reasons. First, acceptances meeting the conditions of eligibility for discount or purchase are more readily salable in the secondary market. As such, they provide a greater degree of liquidity for the accepting bank. Second, ineligible acceptances are subject to reserves (eligible acceptances are not), which increases a borrower's costs.

The creation of eligible bankers acceptances is governed by Sections 12A, 13 and 14 of the Federal Reserve Act and Federal Reserve Board (FRB) Regulation A. Bankers acceptances must meet certain criteria established in Regulation A and by the Federal Open Market Committee (FOMC) in order for the instrument to be eligible for either discount or purchase by Federal Reserve banks. Since banks' holdings of acceptances form part of their secondary reserves, it is important that the paper they buy be readily marketable by conforming to all the rules that make the acceptance eligible for discount by a Federal Reserve Bank.

Examiners that review bankers acceptances should develop a fundamental understanding of acceptances and the regulatory rules relating to eligibility. Since acceptances are negotiable and traded in the secondary market, there are applicable lending limit considerations. Lending limit rules affecting bankers acceptances in nonmember banks are controlled by state banking laws, and many states that are oriented toward international banking have adopted pertinent sections of the federal statutes. Under Section 13 of the Federal Reserve Act, acceptances eligible for discount at the Federal Reserve (subject to specific criteria) are exempt from both reserve requirements and federal lending limits. Bankers acceptances that are ineligible for discount at the Federal Reserve become an unsecured obligation of the accepting bank (for the full amount of the draft) and are subject to prevailing lending limits.

Acceptances Discounted

In a typical letter of credit transaction, a draft is presented to the bank (along with other documentation), is stamped *accepted* on its face, and is endorsed by an appropriate officer. By accepting the draft, the bank acquires an unconditional obligation to pay a specified amount of money at maturity, either to the seller or, more frequently, to the holder of the instrument.

The seller/exporter, or holder, may choose to hold the draft until maturity, but typically chooses to receive immediate payment by selling the acceptance at a discount, usually to the accepting bank itself. The acceptance then becomes what is known as an *acceptance discounted*. If the accepting bank purchases or discounts the acceptance, it may elect to hold it in its own portfolio. In this event, it is recorded as a loan to the borrower who bought the goods and must be funded like any other loan. Once the acceptance discounted is created, it appears on the bank's balance sheet statement. Its accounts for *customers' liabilities on acceptances outstanding* (asset) and *liability for acceptances executed and outstanding* (liability) are reduced and the discounted acceptance is recorded with other loans. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, the acceptance should be appropriately recorded in asset and liability accounts.

Foreign Receivable Financing

Foreign receivable financing is a method of trade finance completed through direct advances against foreign collections, which the exporter pledges to the bank. The exporter may borrow from the bank up to a stated maximum percentage of the total amount of receivables lodged with the bank at any one time. Besides having a pledge on the exporter's outward collections, the bank usually retains recourse to the exporter, whose credit strength and reputation are of prime consideration. The bank also maintains control of the merchandise by ensuring the export bill of lading is *to-the-order-of* the shipper and endorsed in blank or to-the-order-of the bank. The bill of lading must not be consigned to the buyer (importer) since this would give them control over the goods.

Banks also finance foreign receivables through bankers acceptances. To obtain acceptance financing against receivables, the exporter draws two drafts. The first is a time draft drawn on the foreign buyer (importer), which, along with the necessary documents, is sent for collection in the usual manner. The second, for the same or a lesser amount and for the same tenor as the first, is drawn on the exporter's bank. The bank accepts the second draft and discounts it, crediting the net amount to the exporter's account. The bank may hold the acceptance in its loan portfolio or may sell it in the market. When payment is received from the importer on the first draft, the bank applies the proceeds to pay its own acceptance. Should the importer default, the bank has recourse to the drawer (exporter) for payment.

Government-guaranteed Trade Finance

Government-guaranteed trade finance is used by international banks to reduce the risk associated with international trade financing. Many governments have export credit agencies (ECAs) that provide subsidized credit to exporters. These entities are often independent agencies or government-authorized, private sector entities. For a fee, these agencies protect banks from commercial and political risk. Although the programs differ in cost and scope of coverage, they are all designed to encourage commercial banks to participate in export financing and mitigate concerns about transfer risk.

In the United States, the official ECA is the Export-Import Bank (Ex-Im Bank), a government chartered corporation. The Ex-Im Bank was founded in 1934 to finance and facilitate exports from the U.S. to other countries by guaranteeing repayment of loans made to foreign buyers of U.S. exports. The Ex-Im Bank offers a wide range of credit insurance policies covering the risk of nonpayment by foreign debtors. The policies, some designed specifically for financial institutions, cover certain percentages of commercial and political risks as well as interest repayment.

Other agencies that provide government-guaranteed trade financing include:

- The Overseas Private Investment Corporation, which provides project financing, investment insurance, and a variety of investor services, insuring investment projects against political risks.
- The Small Business Administration, which provides revolving lines of credit to fund the short-term needs of exporting firms.
- The Agency for International Development, which provides direct funds to emerging market countries and supports development projects.
- The Commodity Credit Corporation, which provides assistance in the production and marketing of U.S. agricultural commodities.

As with any government-guaranteed financing, familiarity with the specific conditions and requirements of each agency and program is paramount. Like domestic transactions, failure by the lender to comply with the program's conditions may allow the agency to rescind the guaranty. Documentation should be maintained for each participating transaction to show compliance with the outstanding guaranty. These documents should be scrutinized by the examiner when reviewing these credits to determine that the loan is compliant with the guaranty. Failure to comply with the terms of the guaranty may warrant adverse classification or criticism by the examiner.

Loans to Foreign Banks

Loans to foreign banks represent an important segment of international credit. Credit to foreign commercial banks may be in the form of direct loans or through deposit placements, which are discussed under a separate heading below. Often interbank loans are used to facilitate transactions by foreign counterparts that are denominated in U.S. dollars. In some instances, loans to foreign banks may be used for trade-related purposes.

Trade-related loans to foreign banks are commonly referred to as *pre-export/import financing*, and the loans usually function like a working capital line with advances requested so that the foreign bank can fund loans to its local clients. Because of improvements in global communication and payment systems, this type of lending has gained in popularity as a form of trade finance. Changes in foreign bank regulations, increased availability of financial information, and higher costs associated with letters of credit have contributed to the growth of pre-export/import financing.

The trade lines are typically unsecured and tend to have longer terms than letters of credit. Because the local clients are not directly obligated to pay the line of credit, bank underwriting and examination assessments of these lines should be based on the creditworthiness of the foreign bank.

An accurate appraisal of the foreign bank's management is the key consideration when evaluating loans to a foreign bank. Also, when granting these trade lines, U.S. banks should consider:

- The ability of the foreign bank to repay (not simply its current financial condition);
- If there is an established relationship with the foreign bank;
- Prior payment histories of the foreign bank;
- The foreign bank's standing within the market;
- The performance of comparable banks (peer group analysis);
- The foreign country and central bank's financial position and political conditions; and
- The foreign country's banking structure, supervisory programs, and method of reporting problem assets.

In some cases, the foreign bank may secure individual transactions, or an entire line, with cash collateral at the U.S. bank. Alternatively, the foreign bank may agree to maintain compensating balances at a percentage higher than the amount of its trade-related lines to mitigate the repayment risk.

Alternatively, loans may be extended directly to a foreign bank for working capital purposes or capital expenditures, but these loans are less common. The lending institution may also extend credit directly to a foreign borrower, based primarily on the foreign bank's guarantee of the loan. Such credit extensions may be for trade-related purposes, but are often accommodations to the foreign bank, with little or no contact between the lending bank and the direct borrower. This type of transaction should be considered as part of the aggregate credit extended to the foreign bank for legal lending limit purposes.

Domestic Loans

Although some loans to domestic borrowers are extended to facilitate international transactions, they are essentially underwritten as domestic loans, but handled by the international department. A typical transaction would be a loan or other form of credit to a domestic customer to finance imports of inventory shipped on open account or under a letter of credit or bankers acceptance facility. The credit would be in U.S. dollars with repayment expected from the sale of the inventory in the U.S. Since the ultimate repayment is based on the borrower's domestic, not foreign sales, the transaction is generally considered to be a domestic loan.

Loans to overseas units of domestic corporations that are guaranteed by a U.S. parent may also be encountered in international lending. These loans may be for purposes such as short-term working capital or long-term capital improvements of the foreign subsidiary. In these cases, the domestic company's guarantee generally has a significant effect on credit underwriting and approvals, but institutions should also conduct thorough country risk analysis because the borrower operates in a foreign jurisdiction and is subject to the political and legal risks associated with that particular country. Proper execution of the guaranty is also a critical factor in underwriting the credit. On the other hand, loans to foreign affiliates of U.S. corporations, not supported by a guarantee of the domestic corporation, must be considered as any other international loan to a foreign borrower and underwritten on its own merits, without consideration of the domestic parent's support.

The same principles may hold true for domestic subsidiaries of foreign corporations, or loans to domestic entities with a high level of international operations, such as import/export companies or companies that are part of an international supply chain. While these loans may be considered domestic loans by the bank because of the location of the borrowers, country risk analysis is generally required if the ultimate source of repayment is foreign. Analysis should also consider whether any form of support from the foreign parent is legally binding or subject to country risk.

Loans to Foreign Business or Individuals

Banks also lend to foreign companies, their subsidiaries, and wealthy individuals (e.g., international private banking customers). Direct loans to foreign businesses and individuals are based on the same credit principles as domestic loans. As with domestic credits, a bank must know its customer, identify the purpose of the loan, and assess the source of repayment. In evaluating these loans, the examiner must consider these factors and also consider the unique conditions related to international businesses that may influence repayment. Country risk, foreign exchange risk, and reliability of financial statements are additional factors that should be considered.

Loans to foreign customers can be granted on an unsecured basis, and are generally reserved for well-established and highly reputable customers of the lending institution. Usually compensating factors, such as large deposit balances at the lending institution, serve to mitigate the risks associated with this type of unsecured lending. These credits are sometimes granted as accommodation facilities for important customers of the bank's personal banking department.

Loans to foreign borrowers are typically not secured by foreign-based collateral given the difficulties of perfecting liens in foreign locations and jurisdictions. The loans are often directly supported by a domestic affiliate, foreign guarantor, or a foreign government, and evaluation of that support is integral to analyzing the credit.

In some cases, loans to foreign borrowers may be secured with assets located in the U.S. These loans could be for consumer purposes, such as residential real estate, or for commercial purposes, such as foreign entities borrowing to invest in commercial, U.S. real estate. The residency of the borrower determines whether these loans are international transactions for the purposes of regulatory reporting. Often, these loans have some type of foreign-based repayment source and are exposed to risks similar to cross-border loans. In these situations, they should also be included in country-exposure risk management systems.

In certain markets, consumer lending to non-resident aliens is a prevalent form of international lending. This form of lending is often handled outside of the international department because of the homogeneous nature of the credits and market-driven pricing. Because the repayment source is often foreign, the loans should be treated as international loans and assessed in a similar way as other types of domestic loans to foreign borrowers.

Loan Syndications

A bank may enter the international loan market quickly by purchasing participations through syndications. Syndication is the typical structure used by multinational banks to offer credit to entities with significant global funding requirements. Loan syndications are typically put together by international groups for borrowers requiring substantial funding, often to finance public works projects, large capital expenditures, or trade in commodities.

These participations tend to be specialized loans, which are often managed by another bank and may or may not involve existing customers. Nevertheless, participation in syndicated loan markets can offer benefits such as allowing for additional loan portfolio diversification and greater selection of loans with desirable features.

The participating bank should have sufficient financial information and documentation to adequately understand the transaction, as well as conduct analysis of the borrower, risks involved, and source of repayment. The bank's systems should be able to handle the unique operational issues of this type of lending and adequately monitor repayments. Examiners should verify that appropriate risk controls are in place and compatible with the risks applicable to this type of international lending.

When entering these markets, management should define and conform to acceptable risk limits. Often, smaller banks participating in syndicated loans may have limited input in structuring or managing the loans. For the largest institutions, certain loan terms and types are a small part of the loan portfolio, and the retained portion of any one transaction may be inconsequential. This may not be the case for smaller institutions, and all banks should exercise appropriate controls and strict monitoring and reporting systems, especially if they are new to the syndicated loan market.

Placements

Banks may maintain interest-bearing time deposits with foreign banks and overseas branches of U.S. banks, often referred as placements, interbank placements, or re-deposits. The maturity of these deposits may range from overnight to several years. Deposit placements are usually connected with foreign exchange markets and international money centers such as New York and London, and are carried in a *due from foreign banks* time account. The placements are generally made in conjunction with a pre-approved placement line that is, in essence, a line of credit.

The majority of these deposits are Eurodollar placements, with smaller amounts in other Eurocurrencies. Eurodollars and Eurocurrencies are simply dollars or foreign currencies domiciled outside the respective country of denomination. Due from bank time deposits contain the same credit and country risks as any extension of credit to a bank in a foreign country; consequently, a prudently managed bank should place deposits only with sound, well-managed banks after thoroughly investigating their creditworthiness.

Placement activity should be governed by a formal bank policy similar to that used for federal funds transactions. The policy should define acceptable terms, designate tolerable concentration levels (in relation to credit and country risks), and identify appropriate banks for placements. Lists of acceptable depositories with prescribed limits should be provided to traders and placement officers and reviewed regularly by credit officers, particularly during periods of money market uncertainty or changing economic and political conditions.

International Lending Policies

Every bank engaged in international lending should be guided by a formal, written, board-approved policy. Content will vary depending on the risk profile of the bank and the extent of its international activities, but certain factors should be addressed in almost all situations. These include basic credit standards for international lending, a statement of the bank's international lending objectives, a description of its system for credit approval, and the establishment of committee and officer lending authorities. In addition, the policy should define procedures that ensure the board of directors is regularly apprised of the size, performance, and risk profile of the international loan portfolio.

Defining geographic loan limits is one of the most significant components of an adequate international lending policy. Limits should be set according to estimates of where the bank can profitably lend (in accordance with its strategic objectives, financial capacity, and personnel resources). Maximum aggregate limits should be established for each political entity where credit is advanced, based on a comprehensive country risk analysis. Banks should also consider establishing country and credit sub-limits by transaction type. Limits should be considered for specific countries, as well as groups of countries (regions) that have close economic ties.

When evaluating international credit risk, special consideration must be given to reviewing foreign financial statements, types of borrowers, and the forms of indirect support provided by parent companies, banks, and financial institutions. Many banks analyze foreign currency statements in U.S. dollar terms (with a single conversion from the foreign currency), versus U.S. dollar equivalents at the end of each period, which could have several different conversion rates. The merits of either approach depend on the currency of repayment and a clear understanding of which approach is used. Nevertheless, lenders should review financial statements that reflect amounts in both dollars and foreign currencies and that are translated into English.

Because financial information from foreign countries is not always reliable, the bank's policies should enable it to determine borrower capacity and reputation by other means. One of the most effective methods is a program of regular visits to borrowers' countries by bank account officers and by obtaining credit references, followed by preparation of candid reports that become significant parts of credit files. When managing the accounts of international borrowers, there is generally no substitute for regular account officer visits in obtaining this type of information. It may also be prudent to send multiple officers or obtain independent assessments. Banks can also consider the Financial Sector Assessment Program, jointly established by the World Bank and the International Monetary Fund, which analyzes a country's adherence to sound financial sector principles such as the Core Principles of Banking Supervision prescribed by the Basel Committee on Banking Supervision.

Other International Activities

Investments

In addition to international loans and deposit placements, international banks may periodically allocate capital, through international capital markets, to investments such as foreign debt securities or debentures. Banks use the international capital markets to invest funds at a competitive advantage to lending. Capital market activities have increased for several reasons, including:

- Excessive loan losses incurred on emerging-market loans,
- Small spreads between the interest earned on loans and the interest expense of foreign deposits,
- Increasingly stringent risk-based regulatory capital standards, and
- Global recessions and regional financial crises.

These factors have de-emphasized banks' commitment to direct foreign lending, but countries and corporations continue to have capital needs, and banks assist them by underwriting and investing through capital market instruments. Banks are exposed to numerous risks when investing in international markets and should have appropriate risk management in place before engaging in these activities.

Foreign debentures may be issued by a foreign bank, corporation, or sovereign government. Banks with foreign offices might hold the securities of foreign government entities to meet various local laws or reserve requirements, reduce tax liability, retain sufficient asset liquidity, or as an expression of goodwill. As with domestic bond issues, the instruments will have varying durations and maturity and usually represent an unsecured obligation of the issuer.

Foreign debt securities held by U.S. banks are often denominated in U.S. dollars and are in the form of Eurobonds, Medium Term Notes, or Yankee Bonds. These instruments provide liquidity in secondary markets (during normal market conditions) and, depending on the country and circumstances of the issuer, may offer much higher yields than would otherwise be obtainable in the highly competitive trade finance market. Higher yields (over comparable U.S. Treasury instruments) are driven by a confluence of factors including credit quality, country risk (including transfer risk), inflation, monetary policy, and foreign exchange movements.

International investments may be internally reported within a bank's domestic bond portfolio, even though they are reported separately for Call Report purposes. To monitor overall country exposures properly, the instruments should also be included in the appropriate country of risk in both internal and regulatory reports.

Banks with foreign branches are permitted a broader scope of investment activities, including investment services and underwriting of debt and equity securities. International investments and permissible activities are governed by the FRB's Regulation K, which is incorporated into Part 347 of the FDIC Rules and Regulations (for state nonmember banks).As with the domestic investment portfolio, the purchase of foreign debt securities for speculation is an unsuitable investment practice. While risk management considerations are similar to those contained within the Securities section of this Manual, the foreign aspect of Eurobonds, notes, and debentures requires greater due diligence, consideration, and monitoring than would otherwise be expected of a non-complex domestic bond portfolio. Jurisdictional issues and legal systems must be considered when investing in securities issued by sovereigns, and resolving defaults and restructurings of sovereign debt can be problematic if not properly underwritten.

Private Banking

Many banks market personalized services to high net worth customers through a separate unit of the bank commonly known as the private- or personal-banking department. Private banking is an important business line for many financial institutions as it encourages wealthy individuals to develop banking relationships and can generate substantial fee income.

U.S. banks manage private banking relationships for both domestic and international customers. Private-banking departments may provide customers typical financial services, or complex assistance such as facilitating the establishment of shell companies and offshore entities (e.g., private investment companies (PIC) or international business corporations). Typical private-banking services include:

- Cash management,
- Funds transfers,
- Asset management (e.g., trust, investment advisory),
- Lending services,
- Financial planning (e.g., tax and estate planning),
- Custody services, and
- Other support as requested.

Privacy and confidentiality are important elements in international private banking, but may increase a bank's vulnerability to money laundering. Risks of money laundering or other illicit activities may be increased due to having operations in jurisdictions with weak anti-money-laundering laws, the use of shell companies or accounts with fictitious names, or the establishment of accounts in the name of a PIC or blind/numbered trust.

International *private banking accounts* are covered by the Bank Secrecy Act, USA PATRIOT Act, and other recordkeeping and reporting rules and regulations. The accounts are generally defined as an account (or any combination of accounts) maintained at a financial institution that requires a minimum aggregate deposit of funds (or other assets) of not less than $1,000,000, is established on behalf of or for the benefit of one or more non-U.S. persons who are direct or beneficial owners of the account, and is assigned to, or is administered by, in whole or part, an officer, employee, or agent of the bank acting as a liaison between a covered financial institution and the direct or beneficial owner of the account.

Typically, private banking accounts are based on minimum deposit levels and require management to implement effective due diligence, monitoring, and reporting systems. Even when the accounts do not meet the required minimum deposit criteria described above, it is expected that the relationships be subject to appropriate internal controls and due diligence under the institution's risk-based Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance program.

Effective risk management policies, procedures, and practices help protect banks from becoming conduits for money laundering and terrorist financing, which may arise through private banking relationships. Such illicit activities can impair an institution's reputation and have significant costs due to litigation expenses, regulatory sanctions, and loss of business. Additional information relating to required due diligence and risk management of these activities is contained in the FFIEC's BSA/AML Examination Manual and other guidance.

Correspondent Banking

Financial institutions can use U.S. banking relationships to provide services to foreign banks, yet limit their overall exposure to foreign activities. Correspondents provide a range of services to banks located in other countries that do not have local offices, or whose local offices are prohibited from engaging in certain types of activities. This arrangement allows the foreign bank to offer these services more efficiently and economically. Banking services performed through a foreign correspondent bank arrangement may include:

- Cash Management,
- International Funds Transfers,
- Check Clearing,
- Pouch Activities,
- Foreign Exchange Services,
- Sweep Accounts/Overnight Investments,
- Trade Financing, and
- Payable-through accounts (PTAs).

Note: PTA activities should not be confused with traditional international correspondent banking relationships, which do not provide correspondent bank customers with direct access to their account at the U.S. bank, as would be the case in a PTA account arrangement.

Foreign correspondent banking is highly scrutinized because of concerns that some foreign financial institutions are subject to less effective regulatory guidelines than U.S. banks and therefore pose a higher risk of money laundering or other illicit activities.

Per existing regulations, a *correspondent account* is established by a bank for a foreign bank to receive deposits or make payments or other disbursements on behalf of the foreign bank, or to handle other financial transactions related to the foreign bank.

Investigations have disclosed that correspondent accounts have been used by criminals to launder funds and facilitate criminal or terrorist activities. Shell companies are sometimes used to hide the true ownership of accounts. Because of these risks, restrictions that are more stringent have been enacted within the regulatory framework to prevent the use of these accounts for illicit purposes. For instance, according to the amended regulations, a bank is prohibited from establishing, maintaining, administering, or managing a correspondent account in the U.S. for, or on behalf of, a foreign shell bank.

Additionally, a bank that maintains a correspondent account in the U.S. for a foreign bank must maintain records in the U.S. identifying the owners of each foreign bank. A bank must also identify a person who resides in the U.S. who is authorized to be an agent to accept *service of legal process*. (Service of legal process means the agent is willing to accept legal documents, such as subpoenas, on behalf of the foreign bank.)

These stringent regulatory restrictions make foreign correspondent banking an area that requires a higher degree of scrutiny than other international banking activities. Examiners should be aware of the heightened risk posed by this activity, and carefully review policies and risk management controls using the guidelines provided by the FFIEC BSA/AML Examination Manual and other examination guidance on the subject.

Deposit Accounts

Deposit gathering and retention activities of international banks arise from the exercise of other banking activities, such as:

- Receipt of wire transfers,
- Compensating or collateral balances required against credit facilities,
- Disbursement of loan proceeds,
- Payments for trade transactions, and
- Savings or cash-management balances of private banking customers.

The various types of deposit instruments used by banks are defined in applicable Federal Reserve and FDIC regulations governing demand, savings, and NOW accounts. The origin, as well as the types and amounts of deposits that international banks can accept, is dependent on the licensing agency's guidelines or applicable state restrictions, FDIC insurance status, and limitations imposed based on the type of banking office being examined. For instance, U.S. branches and agencies of foreign banks may have restrictions on accepting deposits from U.S. citizens or residents under certain conditions. Examiners should become familiar with the regulatory deposit-taking restrictions that may apply to the type of banking structure under review.

In addition, the volatility and composition of the foreign deposit structure are important elements to consider in the examination process. Foreign deposits tend to have a higher degree of volatility than domestic deposits because of strong competition for funds among banks, the needs of individual and corporate account holders to minimize idle funds, and the effects of disintermediation (the movement of deposits to other higher-yielding markets). A comprehensive deposit development and retention program, which is often included in the funds management policy, is a useful tool for mitigating this volatility.

Management should establish appropriate deposit development and retention policies that include reasonable limits on foreign deposits. When establishing the limits, management should consider prudent competition and the bank's scope of international services. Deposit policies and programs should not only be concerned with deposit growth but also address the desired characteristics of the deposit structure and provide for reporting mechanisms to monitor foreign deposits. Management of the international operations must be able to determine what percentage of the overall foreign deposit structure is centered in stable/core deposits, fluctuating/seasonal deposits, and higher-risk/volatile deposits. Management information systems should provide sufficient information to enable bank management and examiners to evaluate the effect that all material, foreign deposit accounts have on the bank's risk profile.

In addition, examiners should consider BSA/AML risks, and other regulatory/compliance risks related to certain types of deposit accounts, when analyzing the bank's foreign deposits. Deposit products and programs that exhibit elevated risk characteristics are discussed below.

Payable-through Accounts (PTAs) are used directly by customers of the correspondent bank to transact business on their own behalf. Under this arrangement, the sub-account holders of the PTA are generally non-U.S. residents or owners of businesses located outside of the United States. PTAs may be prone to higher BSA/AML compliance risk because banks holding the PTA account may not implement the same due diligence requirements on the sub-account holders that they require of domestic customers. Also, the typically high volume of transactions conducted through PTAs, coupled with inadequate oversight by the banks, may increase money-laundering risks and related criminal activities. The inability of the holding bank to identify and adequately understand the transactions of the ultimate users significantly increase risks associated with money laundering, terrorist financing, and OFAC violations.

Brokered Deposits generally represent funds the bank obtains, directly or indirectly, by or through a deposit broker or agent. Historically, internationally active banks have not relied heavily on funds obtained through deposit brokers to supplement their traditional funding sources. But, in some cases, large, out-of-area deposits are obtained because the U.S. bank is offering attractive rates.

When acquiring foreign deposits, internationally active banks often rely on the assistance of affiliated or parent institutions. International banks may also use independent agents to augment their deposit base. Agented deposits may be the product of personal relationships at a related institution abroad or initiated by foreign customers of related institutions, who are interested in the stability of U.S. insured deposits.

Fundamentally, the risks associated with foreign brokered deposits share many similarities with the risks associated with domestic brokered deposits. Examiners should consult with Capital Markets and International Banking subject matter experts as needed when evaluating foreign deposit gathering and retention activities.

Deposit Sweep programs are often offered by internationally active banks. These sweep programs exist primarily to facilitate the cash management needs of customers who might otherwise move their account to an entity offering higher yields. In sweep programs, banks use an agreement with the deposit customers (typically corporate accounts) that permits the bank to transfer, or sweep, funds, which are above a designated level, from a deposit account into an overnight investment product. The money is transferred out of a deposit account before the close of business and transferred back into the account the next morning. (Conversely, banks may also engage in deposit sweep arrangements with risk averse customers that wish to sweep funds into the bank overnight, in part to obtain deposit insurance.) Investment product examples include Eurodollar deposits, money market funds, and reverse repurchase agreements. *Note:* If a sweep is not properly executed, the depositor may become an uninsured general creditor of a foreign branch or have their funds invested in other short-term obligations and have no claim on the institution if the branch or institution fails.

Banking organizations with deposit sweep programs should have adequate policies, procedures, and internal controls to ensure sweep activities are conducted consistent with sound banking practices and in accordance with applicable laws and regulations. Policies and procedures should ensure that deposit customers participating in a sweep program are given proper disclosures and information regarding the insured status of their deposits.

Borrowings

Borrowings generated through the international department include all non-deposit liabilities. Common forms of borrowings include:

- Federal funds purchased (overnight and term);
- Bills payable to the Federal Reserve;
- Notes and trade bills rediscounted with central banks;
- Short sales from trading securities;
- Overdrafts on deposit accounts;
- Notes, acceptances, import drafts, or trade bills sold with the bank's endorsement or guarantee; and
- Notes or other obligations sold subject to repurchase agreements.

All international borrowing transactions should be treated similar to domestic transactions and be properly recorded on the general ledger and reported in Call Reports.

Note: Foreign time deposits are not borrowings and should be reflected as deposits for reporting purposes and borrowing limit calculations. However, for many banks, little difference exists between how time deposits and borrowings are used and obtained, and foreign time deposits are often viewed as borrowing vehicles.

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FOREIGN EXCHANGE

Foreign exchange involves substituting one country's currency for another. Because international trade and investment require the exchange of currencies, the trading of one country's money for another is a necessary function in international banking.

This section provides examiners with basic information regarding foreign exchange activities. While banks of any size can engage in foreign exchange transactions on behalf of their customers, generally only the largest institutions specializing in international business or international capital markets enter into material foreign exchange transactions for their own account. When necessary, examiners reviewing complex foreign exchange activities should seek assistance from regional, Capital Markets, or Large Bank Supervision subject matter experts.

The Foreign Currency Exchange Market

Foreign exchange transactions can be conducted between any business entity, government, or individual. Financial institutions are ideal foreign exchange intermediaries due to their knowledge of financial markets and experience providing financial services. Banks are involved in a majority of worldwide, foreign exchange transactions with the volume of an activity largely dictated by customer demand.

Importers and exporters often rely on banks to facilitate their foreign currency transactions. The transactions are usually processed in the foreign currency exchange market, which has no specific location or hours of business. Instead, it is a loose collection of entities (commercial banks, central banks, brokers, and private investors) joined by near instantaneous communications links.

The foreign exchange market meets the definition given by most economists of perfect competition, as there are large numbers of buyers and sellers with equal access to price information who are trading a homogeneous product with few transportation costs. Foreign exchange is generally traded in an interbank/dealer network, or organized exchanges such as the London International Financial Futures and Options Exchange or the Chicago Mercantile Exchange.

The interbank market, which is by far the largest market, is housed in the foreign exchange departments of larger banks around the world. It is an over-the-counter (OTC) market because it has no single location or fixed listing of products. It provides opportunities for customers to buy and sell currencies in virtually any amount, for immediate or forward delivery, through contracts to exchange one currency for another at a specified exchange rate (price).

Delivery of currencies may be *spot* (short-term contracts of two business days or less) or *forward* (more than two business days). In either case, the rate of exchange may be established prior to the finalization of the transaction with all related costs calculated and often passed on to the customers. Exchange rates are based upon the amount of time required to exchange currencies. For example, the British Pound Sterling is quoted at a certain rate for immediate (spot) transactions and another rate is quoted on the same day for future (forward) transactions.

In general, exchange rates vary depending on the agreed payment date (value date) of the transaction, i.e., overnight, one week, one month, etc. Also, dealers may quote a different exchange rate for a given transaction depending on whether they are buyers or sellers of currency. This applies to both spot and forward transactions and the two rates are usually referred to as the *bid* (buy) or *offer* (sell) price. The spread between the bid and offered rates represents the dealer's profit.

The system for establishing currency prices is virtually unregulated with exchange rates determined by supply and demand. Exchange rates for most major currencies are free to float to whatever level the market is willing to support, a level that often fluctuates significantly over short periods.

Foreign Exchange Trading

As a result of modern communication systems and rapid price movements, opportunities have soared for speculative trading in the exchange markets. In addition to serving the financial needs of importers and exporters, foreign exchange markets support speculation, arbitrage, and sophisticated hedging strategies, which can create profitable opportunities for banks that have the resources and managerial capabilities to participate in the interbank markets as market makers. While the volume of foreign exchange activity varies widely among banks, transaction volumes are increasingly being driven by interbank trading for banks' own accounts. Banks trading for their own account or as a business line present complex risks.

Banks specializing in this complex and specialized field, particularly those banks that trade foreign exchange for their own account, typically maintain a foreign exchange department with qualified dealers. Banks that only execute their customers' instructions and do no business for their own account (essentially maintaining a *matched book*) generally use the services of another bank or foreign exchange intermediary to place customer transactions.

While trading in foreign exchange is usually encountered only in large global institutions, examiners should be familiar with the fundamental risks inherent in foreign exchange trading.

Foreign Exchange Risks

Trading in foreign currency or holding assets and liabilities denominated in a foreign currency entail risks that fall into five main categories: exchange rate risk, maturity gap risk, credit risk, operational risk, and country risk.

Exchange rate risk arises when a bank takes an open position in a currency. An open position occurs when a bank holds or agrees to buy more foreign currency than it plans to sell, or agrees to sell more foreign currency than it holds or plans to buy. Open positions are either long or short. When a bank buys more of a currency, either spot or forward, than it sells, it has a long position. Conversely, if more currency is sold than bought, a short position is created. Until an open position is covered by the purchase or sale of an equivalent amount of the same currency, the bank is exposed to adverse movements in exchange rates.

Banks often hedge open positions with a forward contract, thereby matching a requirement to deliver with a future contract to receive. The hedging of open positions can be very complex, sometimes using swaps or options, multiple contracts, different types of contracts, or even different currencies. It is important to remember that the level of exchange rate risk is not necessarily dependent on the volume of contracts to deliver or receive foreign currency, but rather the extent that these contracts are not hedged either individually or in aggregate.

All banks that engage in foreign exchange activity should monitor their open positions at least daily. Banks that actively trade foreign currencies should monitor intra-day open positions, closing out or matching exposures at various times during the day.

Maturity-gap risk is the foreign exchange term for interest rate risk. It arises when there are mismatches, or gaps, in a bank's total outstanding spot and forward contracts. Gaps may be present in intra-day, daily, or longer periods of uneven cash inflows or outflows. For example, a maturity spread of a bank's assets, liabilities, and future contracts may reflect a prolonged period over which large amounts of a particular currency will be received in advance of scheduled offsetting payments. The bank's earnings are therefore exposed to adverse shifts in interest rates on the funds provided by cash inflows or on the rates paid on the funds required to meet cash outflows.

In these situations, generally, the bank must hold the currency, invest it short term, sell it for delivery at the time the gap begins and repurchase it for delivery at the time the gap closes, or use a combination of the techniques. The problems of managing gaps are complex; however, banks can mitigate interest rate risks by closely monitoring positions and establishing limits on the volume of mismatches in total foreign exchange positions. Decisions to close a gap when it is created or to leave it until a later date should be based upon a thorough analysis of money market interest rates and spot and forward exchange rates.

Institutions should have firm policies on the maximum gap exposure permitted in certain currencies. The decision to close a gap when it is created, or to let it remain open for a time, will generally depend on money market interest rates as well as the difference between applicable spot and forward exchange rates (commonly known as the swap rate) or the deviations between two forward exchange rates. Estimated movement in the swap rate (primarily determined by interest rate differentials between the two countries) is the customary measure of profit potential or loss exposure during the period within which the gap exists.

Credit risk involves the ability of a bank's customer, or counterparty in a foreign exchange transaction, to meet their financial obligations. Two types of credit risk exist in foreign exchange trading. The first is that a customer might not be able to deliver the currency as promised in order to settle the contract. In this case, the potential mark-to-market profit on the transaction is at risk. The second is delivery or settlement risk. Delivery or settlement risk refers to the possibility a counterparty will take delivery of currency from the bank, but not deliver the counterpart currency. In this situation, the bank is exposed to loss of the entire transaction, not just from currency fluctuations.

To limit both risks, banks must carefully evaluate customers' creditworthiness. The credit reviews should be used to establish an overall limit for exchange contracts for each customer. In order to limit settlement risk, major dealers and third parties also participate in the CLS (Continuous Linked Settlement) system. The CLS reduces risks by facilitating foreign exchange settlements between dealer institutions on a simultaneous or daily basis.

Operational risk reflects the possibility that ineffective controls and operations for foreign exchange activities may result in unanticipated losses to the bank. Banks that engage in foreign exchange transactions must have systems and personnel capable of identifying, controlling, and reporting risks.

Banks should have systems in place to accurately record transactions, perform daily mark-to-market adjustments, reconcile currency positions daily, and assess compliance with established limits. Personnel should also ensure that all confirmations are received or sent to counterparties daily. Appropriate separations of duty are essential in managing operational risk, with the responsibilities of the traders and back-office personnel being strictly segregated. While the form of trades and trade confirmations have changed with the advent of new technology, the independence and appropriate control of these functions remains of paramount importance regardless of the extent of a bank's trading operations.

Country risk reflects potential political changes or adverse economic trends in a country. These types of events are often accompanied by changes in policies that could affect such factors as interest rates, balance of payments, foreign exchange reserves, and capital flows. The policies, whether based on economic necessity or changed attitudes, might affect the availability or transfer of currency to the bank's customers or to the bank itself, and could even affect the convertibility of that country's currency in foreign exchange markets. Exchange controls imposed by a country's central bank may limit the amount of currency that can be exchanged in any single transaction, by any given customer, or within a particular period, and the sources for covering desired currency positions may vanish. Additionally, the exchange rate for the currency may be subject to additional supply and demand influences.

Due-From Nostro Accounts

Domestic banks must be able to make and receive payments in a foreign currency in order to meet the needs of international customers. Since physical movement of currency is impractical, financial institutions maintain accounts or inventories of foreign currency in correspondent banks located in the countries where the institution and its customers conduct business. These accounts are commonly called due-from or *nostro* accounts. Conversely, *vostro* accounts are due-to accounts (demand deposits) representing foreign currency owned by a foreign bank maintained at a U.S. bank.

Close supervision of nostro accounts is required to ensure adequate balances are available to meet customers' needs while avoiding excessive idle funds or overdrawing the nostro account and incurring service charges. Transactions occur in foreign currency denominations, but deposits and withdrawals are normally recorded on a bank's ledgers in both the foreign currency and its U. S. dollar equivalent. All foreign currency transactions, except over-the-counter cash trades, are settled through nostro accounts. Therefore, the volume of activity may be substantial and must be adequately controlled.

Examination objectives are similar to those of domestic correspondent accounts with the additional problem of exchange risk. Nostro account balances are included with other general ledger accounts to determine the department's *position* in each foreign currency. Some banks do not include foreign currency in their net position reports or monthly valuations. Currencies of other countries are foreign assets held in nostro accounts and should be included in position reports.

Conversely, physical control over foreign currencies kept in cash should also be maintained and complemented with adequate accounting systems and controls. Accounting reports should include the U.S. dollar equivalent of foreign currency balances. Separate controls for cash items should be maintained in the general ledger, supported by subsidiary records that permit an evaluation of each item.

Dealing in foreign notes and coins can involve more risk than engaging in foreign currency activity through a due-from account because institutions may unknowingly accept counterfeit currency, and because the physical movement of notes and coins is expensive and time-consuming. Appropriate internal controls should be instituted to compensate for these additional risk factors.

Examination Guidance for Foreign Exchange

An examination of a bank's foreign exchange activities seeks to assess the impact of the foreign exchange activities on the financial condition of the bank. Large, global banks with extensive foreign exchange trading operations earn substantial fee income from this activity, while banks that conduct trades entirely on behalf of their customers generally do not. The nature of foreign exchange trading, wherein a single trader can commit a bank to substantial forward commitments in a short time, makes examinations of related risks and controls important for banks of any size and level of activity. At a minimum, examiners should:

- Determine the extent of foreign exchange activities,
- Identify the types of exchange contracts used by the bank,
- Consider the risks presented by each exchange activity,
- Assess the adequacy of internal controls and risk management systems, and
- Evaluate the overall impact of foreign exchange activities on earnings and capital.

Another important examination objective is to assess the quality of personnel, systems, and controls in relation to the volume of activities and complexity of transactions. When assessing foreign exchange activities and controls, examiners should consider the bank's compliance with Part 349 (Retail Foreign Exchange Transactions) of the FDIC Rules and Regulations.

Examiners should also review compliance with internal exchange limits and note any unusual concentrations or lines of credit to banks with known market problems. Examiners should obtain a current report of all outstanding foreign exchange contracts and determine if there are any contracts in excess of approved limits, other than those reported on the exceptions report. If contracts that exceed approved limits are identified by examiners or included on exception reports, examiners should assess the adequacy of management's plans to bring contract levels into conformance with approved limits.

Banks that are active in foreign exchange trading should have internal controls commensurate with their risk profile. Banks with limited foreign exchange activity and low-risk profiles (e.g., most state nonmember institutions) may not need the sophisticated monitoring/reporting systems and internal controls maintained by larger institutions or that are required by minimum regulatory standards. However, it is incumbent upon management to maintain adequate systems and controls, and to demonstrate to examiners that their systems provide adequate protection for their risk profile.

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STRUCTURE AND SUPERVISION

Foreign Banking Organizations (FBOs) in the U.S.

Foreign banks that conduct operations in the U.S. are known as foreign banking organizations. The FBOs have a longstanding presence in the U.S. and their operations encompass a wide variety of banking and non-banking activities. The activities of FBOs can generally be divided into four main categories: branches, agencies, foreign-owned U.S. bank subsidiaries, and representative offices.

Parallel-owned banking organizations are similar to U.S. bank subsidiaries of FBOs. The critical difference is that a PBO does not have comprehensive, consolidated supervision of all banking entities by the home country. PBOs pose unique supervisory concerns and are covered in more detail under a separate sub-heading.

Branches and Agencies of Foreign Banks

Branches and agencies of foreign banks in the U.S. are extensions of a foreign bank, much like a domestic branch of a U.S. bank. All U.S. branches of foreign banks are required to be licensed at either the state or federal level and are subject to separate insolvency laws. The International Banking Act (IBA) of 1978 established uniform federal requirements for U.S. branches of foreign banks. The main principle of the IBA is one of non-discrimination or *national treatment*, which eliminates the advantages and disadvantages that foreign branches previously faced compared to domestic branches.

U.S. branches of foreign banks may perform all banking functions permissible in the U.S., including accepting deposits and extending loans (unlike a representative office); however, the deposits may not be insured by the FDIC. The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA)[2] effectively prohibits the FDIC from granting deposit insurance to U.S. branches of foreign banks except for those that were insured prior to FBSEA's enactment.

Agencies, similar to branches, may be licensed under state[3] or federal law, but, unlike a branch, an agency may not accept deposits. Agencies are permitted to have occasional credit balances under certain conditions. Such credit balances must be incidental to, or arise from the exercise of other lawful banking powers. Credit balances must be for a specific purpose and should be withdrawn within a reasonable period of time after the specific purpose has been accomplished. These balances are not to be solicited from the general public or used to pay for routine operating expenses in the U.S.

[2] The FBSEA was enacted in 1991 to improve the degree of supervision of foreign banks operating in the U.S. As a result, the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations (the FBO Supervision Program) was established and applied to all FBOs that have a presence in the U.S.

[3] Twenty-six states and the District of Columbia currently authorize the establishment of agencies by foreign banks.

Edge and Agreement Corporations

Edge and Agreement corporations are subsidiaries of financial institutions organized for the purpose of engaging solely in certain international financial and investment activities. There are two types of Edge corporations - *banking* (which accepts deposits) and *investment* (which are essentially holding companies for foreign investments).

Agreement corporations are similar to Edge corporations, except that they are chartered under state law rather than by the FRB. Both Edge and Agreement corporations may be located anywhere in the U.S., can establish branches in the U.S. or overseas, and are permitted to engage in a broad range of banking activities, provided that the transactions are international in nature or directly related to international transactions. Operations of Edge and Agreement corporations are governed by Section 211.6 of the FRB's Regulation K.

Although the operations of Edge and Agreement corporations are governed by Regulation K, the entities are not members of the Federal Reserve System. The FDIC does not insure their deposits, but the entities are required to maintain reserves against deposits. They are also required to maintain capital adequate to support their operations.

Representative and Commercial Lending Offices

Representative offices are usually an organization's first form of entry into a foreign market because of lower operating costs. Representative offices are established under state law with the prior approval of the FRB. These offices have limited presence, as they are mainly a marketing facility for their foreign parent. Unlike branches, they cannot provide traditional banking services, such as accepting deposits or lending funds. Commercial lending offices are similar to representative offices. They are state licensed and cannot accept deposits, but they may borrow and lend on behalf of their parent companies.

FBO Supervision and Examination Guidance

FBOs are supervised under the Interagency Program for Supervising the U.S. Operations of FBOs (FBO Program). The FBO Program is a risk-focused supervisory framework designed to focus on an organization's principal risks and its internal systems and processes for managing and controlling these risks. The FBO Program consists of four primary and interrelated components:

- Understanding the FBO,
- Assessing FBO risks and how they relate to U.S. operations,

- Planning supervisory activities in the U.S., and
- Determining the overall condition of its U.S. operations.

The FBO program is designed to coordinate the regulatory efforts of both domestic and foreign supervisors and to promote a consolidated, comprehensive supervisory approach to analyzing an organization's overall condition.

While the examination of the U.S. bank subsidiary of an FBO is similar to the examination of a domestic institution, the FBO program enables the examiner to understand the FBO's U.S. operations in the context of the entire banking organization. In order to streamline FBO supervision, enhance cooperation, and reduce regulatory costs, the federal regulatory agencies have entered into examination coordination agreements with state banking agencies that protect the confidentiality of information shared by all participants. The information is shared through a secure software platform. When planning the examination of an FBO, the examiner should contact their region's International subject matter expert (SME) and review available information. These parties may have access to more recent information that should be considered in the overall assessment of the FBO.

As part of its oversight responsibility, the FRB coordinates the examinations of FBOs with other federal agencies and with various state banking authorities. FBO oversight requires that the parent company be evaluated through a strength-of-support assessment (SOSA). The purpose of the SOSA is to determine the parent company's ability to support its U.S. operations and the FBO's overall risk profile, as well as to develop an examination strategy and frequency that is commensurate with the risk profile.

As part of the SOSA process, regulatory agencies gain a better understanding of the FBO by also reviewing its home country financial system, supervisory practices, and accounting standards. An assessment of these components result in a combined assessment of an FBO's banking activities in the U.S., which is shared with the FBO's home country supervisors in order to enhance their consolidated supervisory programs.

The Core Principles[4] of the Basel Committee on Banking Supervision (BCBS) recommends that cross-border banking groups be supervised on a consolidated basis. The consolidated approach helps ensure banks within the group are adequately capitalized, risks are managed on a group-wide basis, and contagion risks within a banking group are adequately mitigated. An important principle within this framework is one of the *home-host relationship*, which considers the relationship between the home supervisor where the FBO is headquartered, and the host supervisor where the foreign operations are conducted, e.g., the U.S. branch of an FBO.

[4] Basel Committee on Banking Supervision-Core Principles for Effective Banking Supervision, September 2012.

The U.S. Banking Agencies' emphasis on consolidated, comprehensive supervision programs have served as the benchmark for many current and evolving international standards for the consolidated supervision of financial groups. Key concepts that have been part of the Agencies' approach to consolidated supervision for many years are reflected in the BCBS Minimum Standards for Internationally Active Banks, capital accords, and Core Principles for Effective Banking Supervision. The concepts are now used by the International Monetary Fund and the World Bank in connection with their assessments of countries' bank supervisory regimes. Refer to the Glossary for additional information on the BCBS.

Insured Branches

Much like the Uniform Financial Institutions Rating System (a.k.a., CAMELS), ratings assigned to domestic banks, branches, and agencies of foreign banks are assigned a ROCA rating. The ROCA rating is a confidential management information and supervisory tool designed to assess the condition of a branch and to identify significant concerns in a systematic, consistent fashion.

The ROCA rating system rates four areas:

- **R**isk Management,
- **O**perational Controls,
- **C**ompliance, and
- **A**sset Quality.

Similar to CAMELS, each ROCA component rating is based on a scale of 1 through 5 in ascending order of supervisory concern, with the risk management component generally considered to be the most important factor. A single component rating (called a *Combined U.S. Operations Rating*) between 1 and 5 is assigned for Operational Controls on a combined basis with the FBO. Unlike CAMELS, ROCA does not rate capital, earnings, or liquidity, as these areas are difficult to separately evaluate at a branch. And, while liquidity is not a separate rating, examiners should be aware of supervisory concerns regarding the nature and tenor of borrowings that could put depositors at risk.

Examination findings must be addressed in a Summary of Condition Letter to senior management. The letter should highlight overall strengths and supervisory weaknesses in the FBO's combined U.S. operations, and be shared with the foreign bank's home country supervisor.

Because there are so few FDIC-supervised branches, the FDIC does not maintain a specific examination program in this area. Therefore, examiners may refer to the International Banking Examination Documentation module or other regulatory examination manuals for additional guidance.

FBO Reporting Requirements

The regulatory agencies rely on the timely and accurate filing of regulatory reports by domestic and foreign financial institutions to monitor FBO financial trends. Data collected from regulatory reports facilitate the early identification of problem situations. Some of the reports required for submission by foreign branches and agencies include:

- The Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC Form 002);
- Report of Assets and Liabilities of Non-U.S. Branches that are Managed or Controlled by a U.S. Branch or Agency of a Foreign (Non-U.S.) (FFIEC Form 002s);
- Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (FFIEC Form 019);
- Foreign Branch Report of Condition/Abbreviated Foreign Branch Report of Condition (FFIEC Forms 030/030s); and
- Report of Transaction Accounts, Other Deposits, and Vault Cash (Federal Reserve 2900).

In addition to the reporting requirements for branches and agencies, additional reporting requirements for FBOs include:

- Annual Report of Foreign Banking Organizations (Federal Reserve Form FY-7),
- Financial Statements of U.S. Nonbank Subsidiaries Held by FBOs (Federal Reserve Form Y-7N/Y-7NS),
- The Capital and Asset Report for FBOs (Federal Reserve Form Y-7Q), and
- Changes in Organizational Structure (Federal Reserve Form Y-10).

Parallel-Owned Banking Organization (PBO)

Parallel-owned banking organizations are another form of foreign bank ownership in the U.S. A PBO exists when a U.S. depository institution[5] and a foreign bank[6] are controlled, either directly or indirectly, by an individual, family, or group of persons[7] with close business dealings, or that are otherwise acting in concert. PBOs do not include structures in a recognized financial group[8] subject to comprehensive consolidated supervision via the FBO Supervision Program.

PBOs are not included in the FBO Supervision Program because the parent organization is not a foreign bank or holding company. PBOs present unique challenges to the supervisory process. One key challenge involves assessing risks at PBOs where control is vested in individuals or companies located in a foreign country where U.S. regulatory agencies are unable to obtain reliable, organization-wide information.

Supervisory Control Definition

Identifying a PBO is difficult because control based on common ownership, management, or decision-making authority, often is not clear. The lack of a globally accepted and easily understood definition of control complicates the identification of PBOs. A supervisory definition of presumed control is derived from applying the criteria in the April 2002 Joint Agency Statement on PBOs. The statement indicates, in part, that the U.S. banking agencies consider whether an individual, family, or group of persons acting in concert *control*[9] a depository institution if the individual, family, or group of persons controls 10 percent or more of any class of the voting shares of the bank. In general, 10 percent ownership of voting shares typically results in a rebuttable presumption of control, whereas 25 percent ownership is not rebuttable.

The presence of certain other characteristics may indicate that a PBO relationship exists. These criteria may include situations where the individual, family, or group of persons acting in concert:

- Constitutes a quorum or a significant presence on the board of directors of both the U.S. depository institution and the foreign bank;

[5] References to *U.S. depository institution* represent all banks and savings associations insured by the FDIC.

[6] References to *foreign bank* include a holding company of the foreign bank and any foreign or U.S. non-bank affiliates of the foreign bank.

[7] The term *persons* includes both business entities and natural persons, which may or may not be U.S. citizens.

[8] The term *recognized financial group* refers a structure in which a bank is a subsidiary of another bank, or an entity that is controlled by a company subject to the Bank Holding Company Act or the Savings and Loan Holding Company Act.

[9] A variety of presumptions and technical rules apply to determinations of control. See 12 CFR 5.50, 225.41, 303.82, 391.43.

- Controls, in any manner, the election of a majority of the directors of both the U.S. depository institution and the foreign bank;
- Constitutes a quorum or a significant portion of the executive management of both the U.S. depository institution and the foreign bank;
- Exercises a controlling influence over the policies and/or management of both the U.S. depository institution and the foreign bank;
- Engages in an unusually high level of reciprocal correspondent banking activities or other transactions or facilities between the U.S. depository institution and the foreign bank;
- Requires the U.S. depository institution to adopt particular/unique policies or strategies similar to those of the foreign bank, such as common or joint marketing campaigns, cross-selling of products, sharing customer information, or linked web sites;
- Obtains financing to purchase the stock of either the U.S. depository institution or the foreign bank from, or arranged through, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan;
- Names the U.S. depository institution in a similar fashion to that of the foreign bank; or
- Presents any other factor(s) or attribute(s) that indicate that a PBO relationship exists.

While the presence of any single condition listed above may not demonstrate that an individual, family, or group controls the U.S. depository institution and foreign bank, the existence of multiple conditions may indicate that a PBO relationship exists.

An individual, family, or group of persons acting in concert can rebut both the objective and subjective criteria considered in reaching this conclusion. Therefore, examiners must weigh each factor in relation to all of the other available information in determining whether a PBO relationship does or does not exist, especially when evaluating control relationships that are rebuttable.

PBO versus Affiliate Relationships

An individual, family, or group acting in concert may exercise sufficient control to meet the supervisory definition of presumed control for establishing that a PBO exists; however, they may not meet the criteria to be considered affiliates, as specified in Section 23A of the Federal Reserve Act. Thus, the entities that comprise a PBO may or may not be affiliates. In instances where a PBO relationship exists, but an affiliate relationship does not exist, the transactions between the U.S. bank and the foreign bank may not be subject to the Federal Reserve Act (FRA). However, non-affiliated PBOs cannot be disregarded because such relationships can pose the same or greater risks than those from affiliated PBOs.

The FRA provides a definition of control that serves as a legal basis for determining if an affiliate relationship exists between a U.S. bank and a foreign institution. Section 23A(b)(1)(C) defines an affiliate of a U.S. bank to include any company that is controlled directly or indirectly by shareholders who also directly or indirectly control the bank. In general, Section 23A(b)(3)(A) defines control as:

1. Owning, controlling, or having the power to vote 25 percent or more of any class of voting securities of the U.S. bank;
2. Controlling in any manner, the election of a majority of the directors of the U.S. bank; or
3. Receiving a determination from the FRB that the shareholder or company exercises a controlling influence over the management or policies of a U.S. bank.

Based on this definition, if an individual, family, or group of persons acting in concert collectively has the power to vote 25 percent or more of any class of stock of a U.S. bank and a foreign bank, then a PBO and an affiliate relationship exist. All transactions between the affiliated entities would be subject to the restrictions in the FRA. In addition, the affiliated entities in a PBO cannot take advantage of the sister bank exemption, as it requires ownership by a holding company.

For example, Mr. Smith owns 51 percent of a U.S. depository institution and 30 percent of a foreign bank. This scenario reflects that these two entities are both PBOs and affiliates, and subject to the restrictions in the FRA. If Mr. Smith owned/controlled 12 percent of each institution's outstanding stock, then the two entities would not be affiliated per the FRA, but a PBO may still exist.

If the beneficial owner's stock ownership or voting rights are less than 25 percent, but the criteria in item (2) is met, or the beneficial owner(s) constitute a majority of the boards at both the U.S. bank and the foreign bank, then a PBO and an affiliate relationship exist and the FRA is applicable.

For example, Mr. Jones, Mr. Smith, and Mr. Williams each own 12 percent of a U.S. depository institution. Each person also owns 10 percent of a foreign bank. The minutes of the shareholders meeting of both the U.S. and the foreign bank reflect that these three individuals constitute a quorum of each institution's board. This scenario reveals that these two entities are both PBOs and affiliates subject to the restrictions in the FRA. If these three individuals did not represent a quorum of each institution's board, then the two entities may not be affiliated per the FRA, but a PBO would still exist.

Lastly, if the FRB determines that the shareholder/company exercises a controlling influence over the management or policies of the bank, as stated in Item (3) above, then a PBO and an affiliate relationship exist and the FRA applies.

It is important to note that transactions between the U.S. bank and any person, where the proceeds of the transaction are used for the benefit of, or are transferred to, an affiliated entity, is considered a covered transaction for purposes of Section 23A(a)(2). In situations where regulations do not apply to transactions between a U.S. bank and a foreign affiliate, examiners should still review material transactions for reasonableness and identify any questionable practices.

PBO versus Related Interests of Insiders

An individual, family, or group acting in concert may exercise sufficient control to meet the preceding supervisory definition of presumed control for establishing that a PBO exists; but, they may not meet the criteria to be considered affiliates as specified by FRB Regulation O.[10] Regulation O restricts extensions of credit to the related interests of executive officers, directors, and principal shareholders, collectively known as bank insiders. Related interests are companies controlled by one or more bank insiders, or a political or campaign committee that is controlled by one or more bank insiders or the funds or services of which will benefit bank insiders.

Congress made virtually all of these restrictions applicable to state nonmember banks in Section 18 of the Federal Deposit Insurance Act (FDI Act).[11] Thus, extensions of credit from a state nonmember bank to a domestic or foreign company commonly controlled, as defined by Regulation O, by a bank insider are generally subject to the limitations in Regulation O.

Regulation O defines control as directly or indirectly:

1. Owning, controlling, or having the power to vote 25 percent or more of any class of voting securities of the company or bank;
2. Controlling in any manner the election of a majority of the directors of the company or bank; or
3. Having the power to exercise a controlling influence over the management or policies of the company or bank.

Note that the first two items are very similar to those on the previous page from the FRA. The third item is different. Also, these criteria are not as expansive as the preceding supervisory definitions of control.

If an individual, family, or group of persons acting in concert collectively has the power to vote 25 percent or more of any class of stock of both the U.S. depository institution and the foreign bank, then the same situation exists as under Item (1) of the FRA control definition and all transactions with related interests would be subject to Regulation O.

If the beneficial owner's stock ownership/voting rights are less than 25 percent, the next criteria must be reviewed. Item (2) considers whether the beneficial owner(s) controlled the election of a majority of the directors. For example, Mr. Jones, his son, and his brother each own 20 percent of a U.S. depository institution. Each individual also owns 10 percent of a foreign bank. Minutes of the shareholder meetings of both the U.S. and the foreign bank reflect that these three individuals nominated the candidates for each institution's Board and voted their shares in a block. This scenario reveals that these two entities are PBOs and subject to the restrictions of Regulation O. If these three individuals had voted their shares independently or in a different manner from each other, then it would indicate that these two entities are not subject to Regulation O, but a PBO does exist.

If neither the beneficial owner(s)'s stock ownership/voting rights percentage nor control of the board's election thresholds are met, then Item (3) must be reviewed. Regulation O also states that a person is presumed to have control, including the power to exercise a controlling influence over the management or policies of a company or bank, if the person:

- Is an executive officer or director of the company or bank; and directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; or
- Directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; and no other person owns, controls, or has the power to vote a greater percentage of that class of voting securities.

Ascertaining whether an individual, family, or group acting in concert exercises a controlling influence over the management or policies of the bank is difficult. If the criteria in either item (a) or item (b) above are met, then a

[10] 12 CFR Part 215.

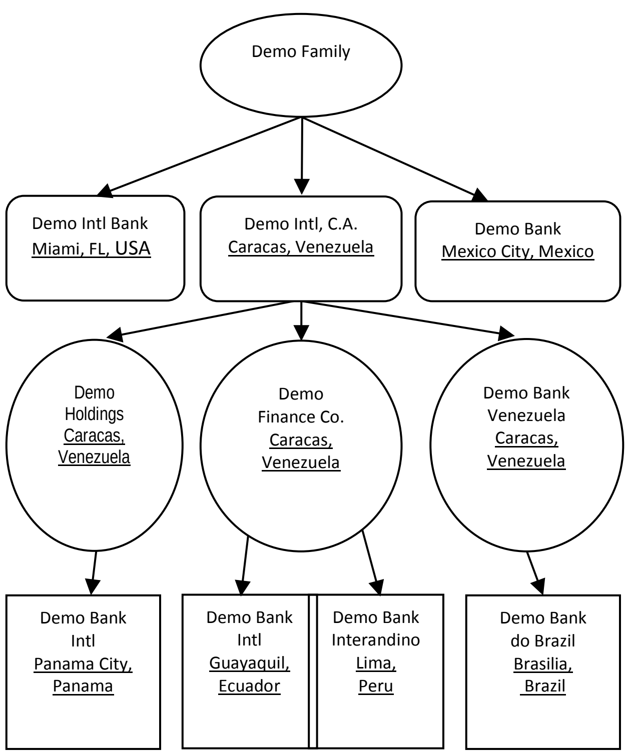
[11] See generally 12 CFR § 337.4, which implements Section 18(j)(2) of the FDI Act (12 U.S.C. § 1828(j)(2).

PBO exists and all transactions with related interests would be subject to the restrictions of Regulation O.

An individual, family, or group acting in concert may exercise sufficient control to meet the supervisory definition of presumed control for establishing that a PBO exists; but not meet the level of control required by Regulation O. In these instances, the transactions between the U.S. bank and the bank insiders' related interests would not be subject to the restrictions of Regulation O. In situations where these types of transactions are not subject to Regulation O, examiners should still review material transactions for reasonableness and identify any questionable practices.

Business Structure of PBOs

A PBO can have a simple or complex organizational structure. A simple PBO business structure consists of an individual who directly controls both a U.S. depository institution and a foreign bank. A complex organizational structure may include multiple domestic and foreign shareholders working in concert, who individually do not have direct control of the U.S. and the foreign bank, but collectively exercise a controlling influence throughout the PBO. The following illustration is an example of a complex PBO structure.



The existence of cross-border organizations compounds the difficulty of supervisory oversight because foreign organizations are often not as transparent as U.S. companies, and U.S. bank supervisors may be unable to effectively evaluate their ownership structure or conduct on-site evaluations of the foreign entities.

Complex PBOs also could be part of privately held multi-national conglomerates that service a particular business sector or geographic region. These privately held PBOs often are the most challenging to understand because public information on their ownership structure, operations, and affiliations is generally difficult to obtain. Conversely, PBOs can be part of large multi-national conglomerates that are publicly traded but do not provide financial services as a main enterprise activity. In these structures, information on ownership, operations, and affiliations is generally easier to obtain.

Supervisory Risks

An examiner's main priority, and frequently greatest challenge, is to gain a comprehensive understanding of a PBO's structure and risk profile. The organizations are complex and often involve cross-border, multi-tiered companies that can be difficult to analyze. Therefore, initial discussions with management are important elements in determining whether the bank is part of a PBO.

The fundamental risk posed by PBOs is that they may act in a de facto organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision.

PBOs present supervisory risks similar to those arising from a chain banking organization (CBO) with the added dimension that part of the chain is in a foreign country or multiple foreign countries. From a regulatory perspective, the risks presented by PBOs may be greater than the risks presented by domestic CBOs because a portion of the PBO structure is subject to the laws and jurisdiction of one or more foreign countries.

The lack of a globally accepted supervisory approach to evaluate risk on an organization-wide basis makes it more difficult to obtain information from foreign regulatory agencies. Additionally, coordinated examinations of the U.S. depository institution and the foreign bank may not be a viable option. Therefore, relationships between the U.S. depository institution and the foreign bank may be difficult to understand and monitor.

PBOs may foster other management and supervisory risks. In 2002, the U.S. bank regulatory agencies issued the Joint Agency Statement on PBOs to assist banks in identifying these entities and managing the risks that PBOs present. Examiners should refer to this guidance when examining PBOs.

In all instances where a PBO relationship exists, examiners should complete the Parallel-Owned Banking Organizations report page; refer to the ROE Instructions for additional guidance.

U.S. Banking Activities Abroad

U.S. banks conduct international banking activities abroad through overseas branches, representative offices, subsidiaries, Edge and Agreement corporations, IBFs, export trading companies (ETCs), consortium banks, offshore branches, and correspondent banking. These structures enable the U.S. banking organizations to serve the needs of their customers in the U.S. and abroad and to compete with foreign banks in the U.S. and foreign markets. The choice of structure is often driven by market opportunity vis-à-vis the laws of the host country, or by tax considerations. U.S. banks' investments in subsidiaries around the world are frequently held in investment Edge corporations that are often managed at the banks' headquarters.

International strategies and vehicles for market entry differ among the numerous types of U.S. banks and are influenced by the banks' structure, strategy and, scale of operations. The largest U.S. banks (money-center and multinational banks) are most likely to utilize the full range of vehicles available to conduct international operations. These banks typically have an extensive network of branches, subsidiaries, and representative offices abroad, and they often maintain correspondent relationships around the world. In the U.S., these banks may have a banking Edge corporation subsidiary located in a major city with branches in other key U.S. locations.

Regional banks in the U.S. that engage in international activities generally have a more limited structure, strategy, and scale of operations. While larger banks can offer international services through their own operations worldwide, banks with limited or no international structure are not precluded from these activities. Smaller banks generally serve their customers' global needs through correspondent banking relationships.

Offshore U.S. Branches

As international trade and foreign exchange trading increased in the 1960s, most major U.S. banks actively expanded their worldwide network to capitalize on this growth. Some banks established full-service branches in important business centers. Many other banks, that could not justify the cost of such branches, established offshore or *shell* branch operations. Many smaller regional banks established offshore branches to obtain a low-cost entry into the Eurodollar market to finance international trade and fund a growing portfolio of purchased international loans.

An offshore, or shell, branch is an overseas branch established for a special purpose, often to take advantage of a favorable tax or regulatory environment in a foreign country. Many of these branches are banking vehicles for booking Eurodollar deposits and loans originated through the home office. These branches generally are no more than a post office box number with few or no personnel. The administration of the branch's assets and liabilities is maintained at either the head office or a designated branch or agency in the U.S. The offshore office is governed by the laws and regulations of its home country and the host country from which it operates.

The passage of the USA PATRIOT Act of 2001 gave the U.S. government expanded authority to combat money laundering, with a particular emphasis on activities conducted through shell banking operations. As such, there have been recent efforts by the international community for offshore banking centers to improve supervision, transparency, disclosure, and cooperation with other bank regulators. For more details, refer to the Bank Secrecy Act, Anti-Money Laundering and Office of Foreign Assets Control sections of this Manual.

International Banking Facilities (IBF)

An IBF is a set of asset and liability accounts, segregated on the books and records of the establishing entity, which reflect international transactions. An IBF is established in accordance with the terms of FRB Regulation D after appropriate notification to the FRB. The establishing entity may be a U.S. depository institution, a U.S. office of an Edge or Agreement Corporation, or a U.S. branch or agency of a foreign bank established pursuant to FRB Regulation D.

An IBF is permitted to hold only certain assets and liabilities. In general, IBF accounts are limited to residents of foreign countries, residents of Puerto Rico and U.S. territories and possessions, other IBFs, and U.S. and non-U.S. offices of the establishing entity. An IBF is an attractive tool for banks because its deposits are not subject to reserve requirements or deposit insurance premiums since they are not FDIC insured. This provides a lower cost of funds and facilitates banking activities. An IBF may also serve to diversify the bank's liability mix and prove less volatile to changes in interest rates.

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LAWS AND REGULATIONS

Several laws and regulations govern international activities of banks. Some are discussed briefly in this section; however, examiners should be familiar with the entire body of laws and regulations that deal with international banking. These can be found in the various examination resource tools available within the FDIC's online library and training materials.

Part 347-International Banking

Part 347 of the FDIC Rules and Regulations specifically covers international banking activities of state nonmember banks; its provisions are similar to FRB Regulation K, which is applicable to state-member banks, as well as Edge and Agreement corporations of state nonmember banks.

Subpart A of Part 347 (and corresponding sections of Part 303) implements Sections 18(d) and 18(l) of the FDI Act and outlines the application process by which state nonmember banks may be given permission to operate foreign branches or invest in foreign banks or other financial entities. The powers or permissible activities of overseas branches are defined by the regulations and, generally, these branches are allowed a wider range of financial activity than is permitted domestically. The regulations also establish minimum standards for accounting and internal controls in foreign branches or subsidiaries. In certain circumstances, state nonmember bank applicants may be granted expedited processing of their applications.

Subpart B of Part 347 implements Sections 6, 7, and 15 of the International Banking Act of 1978 and governs FDIC-insured branch operations of FBOs. This subpart establishes asset pledging and maintenance requirements for insured branches of foreign banks. Subpart B also provides for examinations of these branches and establishes minimum recordkeeping requirements.

Subpart C of Part 347 implements the provisions of the International Lending Supervision Act of 1983 (ILSA). This section deals with the establishment of an Allocated Transfer Risk Reserve (ATRR) and the accounting and reporting of international loans and assets. As with other loan fees, Part 347 requires banks to follow generally accepted accounting principles (GAAP) for the amortization of fees on international loans.

Part 349-Retail Foreign Exchange Transactions

On July 12, 2011, the FDIC adopted rules regarding state nonmember banks' involvement with retail foreign exchange transactions, defined by the regulation as foreign exchange transactions other than traditional spot and forward contracts. Retail foreign exchange transactions include *rolling-spot* transactions, which are spot transactions that are not settled within two days (they are instead perpetually renewed). Retail customers do not include eligible customer participants (such as other financial institutions) as defined by the Commodity Exchange Act. The regulation has requirements in six different areas: disclosure, recordkeeping, capital and margin, reporting, business conduct, and documentation. The regulation does not apply to retail foreign exchange activity conducted between foreign branches of state nonmember banks and non-U.S. customers.

Dodd-Frank Act

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was signed into federal law. Specific to international banking, Sections 165 and 166 of the Dodd-Frank Act affect the oversight of FBOs. Under Section 165(d), *systemically important financial institutions* (SIFIs) and bank holding companies over $50 billion in worldwide assets must create a detailed plan for rapid and orderly resolution (living will) in the event of material financial distress or failure. In the case of FBOs, worldwide assets are used to determine the applicability of planning requirements, but the actual plans must cover only assets in the U.S. Plans must be credible and are to be reviewed jointly by the Federal Reserve and the FDIC. Part 381 of the FDIC Rules and Regulations implements section 165(d) of the Dodd-Frank Act for the purpose of establishing rules and requirements regarding the submission and content of a resolution plan for FBOs, as well as procedures for its review by the FDIC.

The FDIC monitors FBOs to better understand their U.S. operations and to assess their resolution plans in order to facilitate rapid and orderly resolutions in the event of material financial distress or failure.

Regulation YY - Enhanced Prudential Standards

Capital Stress Tests

Foreign banking organizations with total consolidated assets between $10 and $50 billion are required to conduct internal capital stress tests. Annually, the FBO's home-country supervisor must directly conduct a capital stress test or review an internal company-run stress test. If the FBO does not meet the stress-testing requirement, it must conduct a stress test of its U.S. subsidiaries, as well as maintain eligible assets of not less than 105 percent of the total liabilities (asset maintenance) in its U.S. branches and agencies.

A publicly traded FBO of this size is also required to maintain a committee of its global board of directors (either on a standalone basis or as part of its enterprise-wide risk committee) to oversee the risk management policies of its combined U.S. operations. At least one member should have experience identifying, assessing, and managing risk exposures of large, complex firms.

Increased Requirements

Regulation YY has increased requirements for FBOs with assets greater than $50 billion. These FBOs must certify that they meet, on a consolidated basis, the capital adequacy standards established by their home-country supervisor that are consistent with the regulatory capital framework published by the Basel Committee on Banking Supervision. If an FBO's home-country supervisor has not established capital standards consistent with the Basel framework, the FBO must demonstrate that it would meet or exceed the Basel capital standards at the consolidated level if it were subject to them. In addition, these FBOs must maintain a U.S. risk committee that approves and periodically reviews the risk management policies of the combined U.S. operations of the FBO and oversees the risk management framework of the combined U.S. operations of the FBO.

All FBOs of this size must report the results of an internal liquidity stress test for either the consolidated operations of the FBO or the combined U.S. operations of the FBO on an annual basis to the Federal Reserve. The stress tests must be conducted consistent with the Basel Committee principles for liquidity risk management and must incorporate 30-day, 90-day, and one-year stress-test horizons. An FBO that fails to comply with this requirement must limit, on a daily basis, the net aggregate amount owed by its non-U.S. affiliates to the combined U.S. operations to 25 percent or less of the third party liabilities of its combined U.S. operations.

Regulation YY also implements more stringent requirements for FBOs with combined U.S. Assets of $50 billion or more, including more intensive risk committee and liquidity requirements. Companies with U.S. non-branch assets of $50 billion or more are subject to the intermediate holding company requirement in Section 252.153 of Regulation YY. This section requires these FBOs to establish an intermediate holding company organized in the U.S. to hold all ownership interests in any U.S. subsidiary.

Regulation K - International Banking Operations

As explained above, Regulation K is similar to Part 347, but has been revised periodically to implement new laws and amendments and to keep pace with developments in supervisory and regulatory policy. In its last major revision, October 2001, the FRB streamlined application requirements for foreign banks seeking to expand operations in the U.S. and procedures for U.S. banking organizations to branch into foreign countries. Changes were also made to provisions governing: permissible foreign activities of U.S. banking organizations, including securities and investment activities; investments by U.S. banking organizations under the general consent procedures; and the qualification of FBOs for exemption from the nonbanking prohibitions of the Bank Holding Company Act. Lastly, changes were implemented authorizing a bank, with prior Federal Reserve approval, to invest up to 20 percent of capital and surplus in Edge corporations.

Joint Agency Statement on PBOs

The Joint Agency Statement on Parallel-Owned Banking Organizations discusses the characteristics of PBOs, reviews potential risks associated with these banking organizations, and sets forth the supervisory approach of the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System, and the FDIC to monitor those risks. It also provides information on the applications process for proposals involving PBOs.

USA PATRIOT Act

In 2001, Congress enacted the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act, which contains several provisions designed to deter and combat the financing of terrorism and international money laundering. This law substantially increases anti-money laundering responsibilities of financial institutions, including U.S. bank subsidiaries of FBOs and U.S. branches and agencies of FBOs.

Financial Crimes Enforcement Network (FinCEN) and Office of Foreign Assets Control (OFAC)

The FinCEN issues advisories to inform banks and other financial institutions operating in the U.S. of the risks of money laundering and financing of terrorism associated with jurisdictions identified by the Financial Action Task Force, as having deficiencies in their anti-money laundering practices. A listing of FinCEN advisories can be found on FinCEN's website at www.fincen.gov.

Similarly, the OFAC administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries and regimes; terrorists; international narcotics traffickers; those engaged in activities related to the proliferation of weapons of mass destruction; and other threats to the national security, foreign policy, or economy of the U.S. Banks are expected to closely scrutinize transactions with these individuals and countries.

Refer to RMS Manual, Section 8.1, Bank Secrecy Act for additional details regarding the specific laws that would be cited for infractions/non-compliance with FinCEN or OFAC regulations.

Foreign Corrupt Practices Act

Public disclosure of improper payments made by U.S. companies to foreign officials led Congress to enact the Foreign Corrupt Practices Act of 1977 (the Act). The Act is designed to prevent the use of corporate assets for corrupt purposes and applies to all U.S. companies, including banks, bank holding companies, and Edge Corporations.

The Act applies to all state nonmember insured banks, among other U.S. corporations, but does not apply directly to foreign subsidiaries. However, Congress has made it clear that any U.S. corporation that engages in bribery of foreign officials indirectly through any other person or entity, including a foreign subsidiary, would itself be liable under the Act. Since 1998, the Act also applies to foreign firms and persons who take any act in furtherance of corrupt payments while in the U.S.

All violations of the Act are criminal in nature and should be reported following the procedures for reporting apparent criminal violations. Violations of the Act may also result in civil fines and, in the case of private actions under the Racketeer Influenced and Corrupt Organizations (RICO) Act, treble damages. For more information, refer to the Internal Routine and Controls section of this Manual.

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GLOSSARY

Acceptance – A time draft (bill of exchange or usance draft) drawn by one party and acknowledged by a second party. The drawee, known as the *acceptor*, stamps or writes the word *accepted* on the face of the draft and, above their signature, the place and date of payment. Once the draft is accepted, it carries an unconditional obligation on the part of the acceptor to pay the drawer the amount of the draft on the date specified. A *bank acceptance* is a draft drawn on and accepted by a bank. A *trade acceptance* is a draft drawn by the seller of goods on the buyer, and accepted by the buyer.

Account-dealing – Foreign-exchange dealing that involves settlement from bank to bank in the due from accounts. No third party (bank) is involved.

Account Party – The party, usually the buyer, who instructs the bank to open a letter of credit and on whose behalf the bank agrees to make payment.

Ad Valorem – A term meaning *according to value*, used for assessing customs duties that are fixed as a percentage of the value stated on an invoice.

American Depository Receipt (ADR) – ADRs are depository receipts for shares of stock in a foreign company held in safekeeping by a U.S. bank. The ADRs are purchased and sold through listed exchanges.

Advance Against Documents – An advance made on the security of the documents covering a shipment.

After Sight – When a draft bears this name, the time to maturity begins at its presentation or acceptance.

Agent Bank – The bank that leads and documents a syndicated loan.

Allocated Transfer-risk Reserve (ATRR) – A special reserve established and maintained for specified international assets pursuant to the International Lending Supervision Act of 1983 to cover country risk. At least annually, the OCC, FRB, and FDIC determine which international assets are subject to transfer risk, the amount of ATRR for the special assets, and whether an ATRR previously established for specified assets may be reduced.

Anticipation – A deposit of funds to meet the payment of an acceptance prior to the maturity date. Should be applied to reduce customer's liability on acceptances.

Amortizing Swap – A transaction in which the notional value of the agreement declines over time.

Arbitrage – Simultaneous buying and selling of foreign currencies, or securities and commodities, to realize profits from discrepancies between exchange rates prevailing at the same time in different markets, between forward margins for different maturities, or between interest rates prevailing at the same time in different markets or currencies.

Article IV – To facilitate the exchange of goods, services, and capital between countries, members of the IMF (International Monetary Fund) signed the Articles of Agreement. Article IV identifies members' obligations regarding exchange arrangements. To promote stable exchange rates, members agree to foster orderly economic growth with reasonable price stability, to promote economic and financial conditions that do not tend to create erratic disruptions, to avoid exchange rate or international monetary system manipulation, and to follow exchange rates compatible with these goals. Under Article IV, an IMF member country notifies the IMF of its exchange arrangement. The member country has three exchange rate options. First, the country can select an exchange rate in terms of special drawing rights, gold, or some other denominator. Second, the member, by cooperative arrangement, can peg the value of their currency to the currency of another member. Typically, the country will pick its major trading partner's currency. Third, the country can select another exchange arrangement of the member's choice. The member country must notify the IMF of its selected exchange arrangement. Article IV also allows the IMF to conduct surveillance of the member country's exchange rate policies and to offer suggestions for improvement under principles of guidance. Members agree to provide the information necessary to the IMF to conduct this surveillance.

Article IV Consultations – Under the Articles of Agreement, the IMF holds discussions with member countries at least once per year. The IMF typically sends a team of experts to collect various financial and economic information. The IMF staff then discusses its findings with the member country and prepares a consultation report for the IMF's Executive Board. The Article IV Consultation report is returned to the member country and certain aspects of these reports are made publicly available on the IMF's website.

At Sight – A term indicating that a negotiable instrument is payable upon presentation or demand.

Authority to Pay – An advice from a buyer, sent by their bank to the seller's bank, authorizing the seller's bank to pay the seller's (exporter's) drafts up to a fixed amount. The seller has no protection against cancellation or modification of the instrument until the issuing bank pays the drafts drawn on it, in which case the seller is no longer liable to its bank. These instruments are usually not confirmed by the seller's U.S. bank.

Authority to Purchase – Similar to an authority to pay, except that drafts under an authority to purchase are drawn directly on the buyer. The correspondent bank purchases them with or without recourse against the drawer and, as in the case of the authority to pay, they are usually not confirmed by a U.S. bank. This type of transaction is unique to Far Eastern trade.

Baker Plan – Proposed in 1985, this initiative encouraged banks, the International Monetary Fund, and the World Bank to jointly increase lending to less developed countries that were having difficulty servicing their debt, provided the countries undertook prudent measures to increase productive growth.

Balance of Payments – The relationship between money flowing into and out of a country for a given period of time. Directly affected by the country's foreign trade position, capital inflows and outflows, remittances into and out of the country, grants and aid, and tourism. A deficit balance occurs when outflows exceed inflows with the converse situation reflecting a balance of payments surplus.

Balance of Trade – The difference between a country's total imports and total exports for a given period of time. A favorable balance of trade exists when exports exceed imports. An unfavorable trade balance is reflected when imports exceed exports.

Band – The maximum range that a currency may fluctuate from its parity with another currency or group of currencies by official agreement.

Bank for International Settlements (BIS) – Established in 1930 in Basel, Switzerland, the BIS is the oldest functioning international financial organization. It provides a forum for frequent consultation among central bankers on a wide range of issues. The BIS board consists of representatives from the G-10 countries.

Basel Capital Accords – An agreement among the central banks of leading industrialized countries, including those of Western Europe, Canada, the U.S., and Japan, to impose common capital requirements on their internationally active banks.

Basel Committee on Bank Supervision (BCBS) – The Committee was established by the central bank Governors of the G-10 countries in 1975. Its members include senior representatives from banking supervisory authorities and the central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, the U.S., and other countries. The Committee usually meets at the BIS in Basel, where its permanent Secretariat is located.

The BCBS provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.

The Committee has developed international regulatory capital standards through a number of capital accords and related publications that have collectively been in effect since 1988. In June 2010, the Committee published a comprehensive reform package known as Basel III (or the Third Basel Accord), which is a global, voluntary and comprehensive set of reform measures designed to improve regulation, supervision and risk management within the banking sector. BASEL III aims to establish a global regulatory standard on bank capital adequacy, stress testing, and liquidity risk.

Beneficiary – The person or company in whose favor a letter of credit is opened or a draft is drawn. In a documentary letter of credit or acceptance, beneficiary may also be referred to as exporter or seller of goods.

Bid-ask Spread – The difference between a bid and the ask price, for example, the difference between 0.4210 and 0.4215 would be a spread of 0.0005 or 5 points.

Bid Price – A buyer's quote for the purchase of a trading unit from a prospective seller.

Bid Rate – The price at which the quoting party is prepared to purchase a currency or accept a deposit. If the bid rate is accepted by the party to whom it was quoted, then that party will sell currency or place or lend money at that price. The opposite transaction takes place at the offer rate.

Bilateral Trade – Commerce between two countries, usually in accordance with specific agreements on amounts of commodities to be traded during a specific period of time. Balances due are remitted directly between the two nations.

Bill of Exchange – An instrument by which the drawer orders another party (the drawee) to pay a certain sum to a third party (the payee) at a definite future time. The terms *bill of exchange* and *draft* are generally used interchangeably.

Bill of Lading – A receipt issued by a carrier to a shipper for merchandise delivered to the carrier for transportation from one point to another. A bill of lading serves as a receipt for the goods, a document of title, and a contract between the carrier and the shipper, covering the delivery of the merchandise to a certain point or to a designated person. It is issued in two primary forms: an *order bill of lading*, which provides for the delivery of goods to a named person or to their order (designee) but only on proper endorsement and surrender of a bill of lading to the carrier or its agents; and a *straight bill of lading*, which provides for delivery of the goods to the person designated by the bill of lading and no other.

Blocked Currency – A currency that is prohibited by law from being converted into another foreign currency.

Blocked Exchange – Exchange that cannot be freely converted into other currencies.

Brady Plan – Proposed in 1989 and named after then U.S. Treasury Secretary Nicholas Brady, the Brady Plan sought to reduce the debt-service requirements of various developing countries and to provide new loans (Brady bonds) to service existing obligations.

Break-even Exchange Rate – The particular spot exchange rate that must prevail at the maturity of a deposit or debt in a foreign currency, which has not been covered in the forward market, so that there will be no advantage to any party from interest rate differentials.

Buyer's Option Contract – When the buyer has the right to settle a forward contract at their option any time within a specified period.

Buying Rates – Rates at which foreign exchange dealers will buy a foreign currency from other dealers in the market and at which potential sellers are able to sell foreign exchange to those dealers.

Capital Controls – Governmental restrictions on the acquisition of foreign assets or foreign liabilities by domestic citizens or restrictions on the acquisitions of domestic assets or domestic liabilities by foreign citizens.

Capital Flight – A transfer of investors' funds from one country to another because of political or economic concerns about the safety of their capital.

Central Bank Intervention – Direct action by a central bank to increase or decrease the supply of its currency to stabilize prices in the spot or forward market or move them in a desired direction to achieve broader economic objectives (e.g., weaken currency to a given point in order to boost export activity). On occasion, the announcement of an intention to intervene might achieve the desired results.

Certificate of Inspection – A document often required for shipment of perishable goods in which certification is made as to the good condition of the merchandise immediately before shipment.

Certificate of Manufacture – A statement, sometimes notarized, by a producer who is usually also the seller of merchandise that manufacture has been completed and that goods are at the disposal of the buyer.

Certificate of Origin – A document issued by the exporter certifying the place of origin of the merchandise to be exported. The information contained in this document is needed primarily to comply with tariff laws that may extend more favorable treatment for products from certain countries.

Chain – A method of calculating cross rates. For example, if a foreign-exchange trader knows the exchange rate for euros against U.S. dollars and for Mexican pesos against U.S. dollars, the *chain* makes possible the calculation of the cross rates for euros against Mexican pesos.

Charter Party – A contract, expressed in writing on a special form, between the owner of a vessel and the one (the charterer) desiring to employ the vessel setting forth the terms of the arrangement such as freight rate and ports involved in the trip.

Clean Bill of Lading – A bill of lading in which the described merchandise has been received in *apparent good order and condition* and without qualification.

Clean Collection – A collection in which a draft or other demand for payment is presented without additional attached documentation.

Clean Draft – A sight or time draft to which no other documents such as shipping documents, bills of lading, or insurance certificates are attached. This is to be distinguished from a documentary draft.

Clean Risk at Liquidation – A type of credit risk that occurs when exchange contracts mature. There may be a brief interval (usually no more than a few hours) during which one of the parties to the contract has fulfilled its obligations, but the other party has not. During this period, the first party is subject to a 100 percent credit risk, on the chance that, in the interval, an event may prevent the second party from fulfilling its obligations under the contract.

Clearinghouse – A subdivision of an exchange or an independent corporation through which all trades must be confirmed, matched, and settled daily until offset.

Clearinghouse Funds – Funds used in settlement of a transaction that are available for use or that become good funds after one business day.

Closing a Commitment – Allowing a covered foreign-exchange position to expire on maturity or reversing it before maturity by a swap operation.

Combined Transport Document – A through bill of lading that applies to more than one mode of transport.

Commodity Credit Corporation – An agency of the U.S. Department of Agriculture that promotes the export of U.S. surplus agricultural commodities. It provides the necessary financial services to carry forward the public price-support activities, including government lending, purchasing, selling, storing, transporting, and subsidizing certain agricultural commodities.

Consortium Banks – A group of banks forming a joint alliance to enter a new market, in order to reduce the capital requirements and risks involved in new ventures. While they were popular in the 1970s, they have since fallen into disfavor.

Consular Documents – Bills of lading, certificates of origin, or special forms of invoice that carry the official signature of the consul of the country of destination.

Consular Invoice – Detailed statement regarding the character of goods shipped which is duly certified by the consul at the port of shipment. Required by certain countries, including the U.S., its principal function is to record accurately the types of goods and their quantity, grade and value for import duty, balance of payments, and other statistical purposes.

Convertibility – Freedom to exchange a currency, under certain circumstances, without government restrictions or controls.

Core Principles for Effective Bank Supervision (also known as the Core Principles Methodology) – A summary of 25 principles for prudential regulation and supervision prepared by the Basel Committee on Banking Supervision. This document benchmarks the best practices for effective bank supervision. Countries are expected to use the Core Principles Methodology to assess their current bank supervisory environments to identify weaknesses that need to be addressed. The IMF utilizes the Core Principles Methodology when assessing bank regulation and supervision during its Article IV surveillance.

Cost, Insurance, and Freight. (**C.I.F.)** – A price quotation under which the seller defrays all expenses involved in the delivery of goods.

Counterpart Funds – Local currencies deposited in a special account by recipient governments that represent grant aid extended by another government. Those funds, while remaining the property of the recipient government, can generally be used only by agreement of the donor government.

Countertrade – A system of trade, like bartering, when goods or services are accepted in lieu of payment in currency for the purchase of goods or services. Such trade schemes are attractive in developing countries to promote reciprocal trade in a nation's local products as a precondition for consummating an international transaction. Countertrade was popular in East-West dealings during the Cold War and in defense and aerospace contracts. Countertrade may also be useful where foreign exchange is limited or unavailable. The quality and marketability of the goods traded can be a real concern. Other risks involved in countertrade include government intervention, cancellation of contract, and seller insolvency**.**

Country Exposure – A measurement of the volume of assets and off-balance sheet items considered to be subject to the risk of a given country. This measurement is based, in part, on identifying the country of domicile of the entity ultimately responsible for the credit risk of a particular transaction.

Country Risk – Refers to the spectrum of risks arising from the economic, social, and political environment of a given foreign country, which could have favorable or adverse consequences for foreigners' debt and/or equity investments in that country.

Cover – The execution of an offsetting foreign exchange trade to close or eliminate an open exposure.

Covered Interest Arbitrage – The process of taking advantage of a disparity between the net accessible interest differential between two currencies and the forward exchange premium or discount on the two currencies against each other.

Crawling Peg System – An exchange rate system in which the exchange rate is adjusted every few weeks, usually to reflect prevailing inflation rates.

Credit Risk – The possibility that the buyer or seller of a foreign exchange or some other traded instrument may be unable to meet their obligation at maturity.

Cross-border Exposure – The risk that arises when an office of a bank, regardless of its location or currency, extends credit to a borrower that is located outside the booking unit's national border.

Cross-currency Risk – The risk associated with maintaining exchange positions in two foreign currencies as the result of one transaction. For example, if a U.S. operator borrows Swiss francs at 5 percent and invests the proceeds in British pounds at 12 percent, the cross-currency risk is the chance that the pounds will depreciate in values against the Swiss francs to such an extent that there will be a loss on the transactions in spite of the favorable interest-rate differential.

Cross Rate – The ratio between the exchange rate of two foreign currencies in terms of a third currency.

Current Account – Those items in the balance of payments involving imports and exports of goods and services as well as unilateral transfers. Includes trade, travel, military spending and other short-term financial flows. Short- and long-term capital flows are excluded, as they are included in the capital account balance. A surplus or deficit in the current account is commonly referred to as a trade deficit or surplus.

Customs Union – An agreement between two or more countries in which they arrange to abolish tariffs and other import restrictions on each other's goods and to establish a common tariff for the imports of all other countries.

Date Draft – A draft drawn to mature on a fixed date, irrespective of acceptance.

Demand Draft – Draft payable immediately upon presentation to the drawee. Also called a *sight* or *presentation* draft.

Depth of the Market – The amount of currency that can be traded in the market at a given time without causing a price fluctuation. Thin markets are usually characterized by wide spreads and substantial price fluctuations during a short period of time. Strong markets tend to be characterized by relatively narrow spreads of stable prices.

Devaluation – An official act wherein the official parity of a country's currency is adjusted downward to the dollar, gold, special drawing rights, or a currency. After devaluation, there are more devalued currency units relative to the dollar, gold, special drawing rights, or other currency.

Direct Quote – The method of quoting fixed units of foreign exchange in variable numbers of the local currency unit. Also called a *fixed* or *certain* quotation.

Dirty Float – A floating exchange-rate system in which some government intervention still takes place. A government may announce that it will let its currency float, that is, it will let the currency's value be determined by the forces of supply and demand in the market. But, the government may secretly allow its central bank to intervene in the exchange market to avoid too much appreciation or depreciation of the currency.

Discount – In foreign exchange, the amount by which the forward exchange rate of one currency against another currency is less than the spot exchange rate between the two currencies. If a dealer quotes $2.40 and $2.45 (bid and asked) for sterling and the discounts for six months forward are .0300 and .0275, the forward quotes would be adjusted to $2.3700 and $2.4225. This discount usually represents differences between interest rates in the U.S. and Britain. In periods of crisis, the discount for a currency can represent market anticipation of a lower price.

Documentary Credit – A commercial letter of credit providing for payment by a bank to the named beneficiary, who is usually the seller of the merchandise, against delivery of documents specified in the credit.

Documentary Draft – A draft with documents attached delivered to the drawee when it accepts or pays the draft, and which ordinarily controls title to the merchandise.

Documents – Shipping and other papers attached to foreign drafts, consisting of ocean bills of lading, marine insurance certificates, and commercial invoices. Certificates of origin and consular invoices may also be required.

Documents Against Acceptance (D/A) – Instructions given by an exporter to a bank that the documents attached to a draft for collection are deliverable to the drawee only against their acceptance of the draft.

Documents Against Payment (D/P) – Instructions given by an exporter to their bank that the documents attached to a draft for collection are deliverable to the drawee only against their payment of the draft.

Dollar Exchange Acceptance – Time draft drawn by central banks in specific foreign countries and accepted by banks in the U.S. for the purpose of furnishing foreign exchange. These instruments do not arise from specific commercial transactions, rather they are designed to alleviate shortages of dollar exchange for certain countries specified in a list published by the Federal Reserve System. It is anticipated that the acceptance will be liquidated subsequently from dollar funds acquired by the central bank. Limits are placed on initial maturity of drafts (three months). Member banks may not accept drafts in an amount exceeding 50 percent of paid-in and unimpaired capital and surplus.

Domicile – Place where a draft or acceptance is made payable.

Draft – A draft is an order in writing signed by one party (the drawer) requesting a second party (the drawee) to make payment in lawful money at a determinable future time to a third party (the payee). Drafts occasionally may be written to be non-negotiable, in that they will not meet all the requirements of the Uniform Negotiable Instruments Act. Drafts generally arise from a commercial transaction, whereby the seller makes an agreement with a buyer in advance for the transfer of goods. It may be accompanied by a bill of lading, which the bank will surrender to the buyer upon payment of the draft. The buyer may then claim the goods at the office of the carrier who transported them to the buyer's place of business. Drafts may be classified as to time element, such as sight or presentation drafts. A time draft is presented at sight, accepted, and then paid on the agreed upon date which may be 30, 60, 90 days or longer after presentation and acceptance.

Drawee – The addressee of a draft, that is, the person on whom the draft is drawn.

Drawer – The issuer or signer of a draft.

Eligible Acceptance – A bankers acceptance that meets Federal Reserve requirements related to its financing purpose and term.

Embargo – A partial or total prohibition on trade initiated by the government of one country against another for political or economic reasons.

Eurobank – A bank that regularly accepts foreign currency denominated deposits and makes foreign currency loans.

Eurobond – A medium or long-term debenture underwritten by an international syndicate that is denominated in a currency other than that of the country of origin. Usually, a bond issued by a non-European entity (Sovereign, large multinational company, or bank) for sale in Europe. Instrument may also be called a global bond.

Eurocurrency – Currency deposited in banks outside the home country.

Eurodollars – Dollar deposit claims on U.S. banks that are deposited in banks located outside the U.S., including foreign branches of U.S. banks. These claims, in turn, may be redeposited with banks or lent to companies, individuals, or governments outside the U.S.

Eurodollar Bond – A Eurobond denominated in U.S. dollars.

European Central Bank (ECB) – The ECB is the central bank for the Euro. Collectively, the ECB and member national central banks (NCBs) constitute the Eurosystem. The main function of the Eurosystem is to maintain price stability while supporting the general economic practices of the EU members. Together the ECB and NCBs conduct monetary policy, foreign exchange operations, and maintain the EU payment systems for the Eurozone. The ECB is headed by the Governing Council (composed of the Executive Board and the governors of each of the NCBs).

Exchange Contracts – Documents issued by foreign exchange dealers, by banks dealing in foreign exchange, and by foreign exchange brokers confirming foreign exchange transactions.

Exchange Control or Restrictions – Limits on free dealings in foreign exchange or of free transfers of funds into other currencies and other countries.

Exchange Control Risk – The possibility of defaults on obligations by the imposition of exchange control or restrictions.

Exchange Rates – The price of a currency in terms of another.

Exchange Reserves – The total amount of foreign assets (generally currencies) held by a country's central bank.

Exchange Risk – The risk of market fluctuation of an asset or liability denominated in a foreign currency, such as the ownership of a currency (spot or forward) or trade accounts payable in foreign currency.

Export Credit Insurance – A system to insure the collection of credits extended by exporters against various contingencies. In some countries, only non-commercial risks can be insured.

Export-Import Bank of the U.S. (Ex-Im Bank) – Established in 1934 as an independent federal agency, the Ex-Im Bank provides intermediate and long-term nonrecourse financing for U.S. exports when such facilities are not available from commercial banks. Ex-Im Bank guarantees working capital and other loans for U.S. exporters. Ex-Im Bank also offers other programs such as export credit insurance.

Export Management Company – A domestic firm that provides marketing, distributing, and other international business services for exporters in overseas markets through established networks or contacts in the targeted country.

Export Trading Company (ETC) – A company organized under the Export Trading Company Act of 1982 that facilitates U.S. exports. An ETC may be an affiliate of a bank holding company. ETCs offer a wide range of export-related services such as consulting, international market research, advertising, marketing, insurance, transportation, freight forwarding, and warehousing. This is not an actively used vehicle. Subpart C of Regulation K provides guidance and restrictions for these companies.

External Debt – Total debt owed to creditors outside the country, including both private and public sector debt. In some emerging market countries, this debt may be issued under foreign law (American or English) and payable in foreign currencies.

Financial Stability Board – Established by the G-20 countries to coordinate the development of financial regulatory policies between international standard setters, multilateral organizations, and members' national authorities for financial regulation.

Fixed Exchange Rate System – A system in which the exchange rate of a country's currency is tied to one major currency, such as the U.S. dollar.

Fixed Rate of Exchange – A rate of exchange set by a foreign government relative to the dollar, gold, another currency, or perhaps special drawing rights. It remains in effect as long as that government is willing and/or able to buy or sell exchange at the set rates.

Flexible Rate of Exchange – A rate of exchange subject to relatively frequent changes. It is determined by market forces but subject to various floors or ceilings relative to the dollar, gold, special drawing rights, or another currency when the rate fluctuates beyond certain parameters.

Floating Exchange Rate System – A system in which the values of the currencies of various countries relative to each other are established by supply and demand forces in the market without government intervention.

Floating Rate – A rate of exchange that is determined completely by market forces with no floor or ceiling in relation to the dollar, gold, special drawing rights or any other currency.

Force Majeure – A standard insurance clause in a marine contract that relieves the parties from nonfulfillment of their obligations due to circumstances beyond their control such as earthquakes, floods, or war.

Foreign Bonds – Bonds issued by nonresidents but underwritten primarily by banks registered in the country where the issue is made.

Foreign Deposits – Those deposits that are payable at a financial institution outside the jurisdiction of the U.S. government and in the currency of the country in which the depository is located. See also Nostro Account.

Foreign Draft – An official bank order drawn on a foreign correspondent bank to pay on demand to a designated payee a specific sum of foreign money or U.S. dollars at the drawee's buying rate.

Foreign Exchange – The trading or exchange of a foreign currency in relation to another currency.

Foreign Exchange Rationing – A government requirement that all holders of bills of exchange relinquish them at a stipulated rate.

Foreign Exchange Reserves – The reserves maintained by a central bank that should only include foreign currency deposits and bonds; however, in popular usage may include gold, special drawing rights, and IMF Reserve positions. This larger figure is referred to as International Reserves.

Foreign Exchange Risk – The risk associated with exposure to fluctuation in spot exchange rates.

Foreign Investment Advisory Service (FIAS) – Established in 1986, FIAS counsels developing countries on attracting foreign capital. FIAS operates under the aegis of the World Bank and its affiliates the International Finance Corporation and the Multilateral Investment Guarantee Agency.

Foreign Trade Zone – An area where goods may be received and stored without entering a country's customs jurisdiction and without paying duty. Sometimes called a *free trade zone*.

Forward Book – The aggregate of all forward contracts for a given currency or all currencies.

Forward Exchange – Foreign currency traded for settlement beyond two working or business days from today.

Forward Exchange Position – The long or short position that a dealer may have in the forward market, as compared to spot dealing.

Forward Exchange Risk – The possibility of a loss on a covered position as a result of a change in the swap margin.

Forward-Forward Dealing – The simultaneous purchase and sale of a currency for different forward dates.

Forward Premium – A phrase used to describe a currency with a forward price that is more expensive than its spot price. Also referred to as *at a forward premium*.

Forward Purchase – An outright purchase of a forward contract.

Forward Rates – The rates at which foreign exchange for future delivery are quoted, bought, and sold.

Free Alongside Ship (F.A.S.) – A term for a price quotation under which the seller delivers merchandise free of charge to the steamer's side and pays shipping-related expenses up to that destination, if necessary.

Free On Board (F.O.B.) (destination) – A term for a price quotation under which the seller undertakes at their own risk and expense to load the goods on a carrier at a specified location. Expenses subsequent thereto are for account of the buyer.

Free On Board (F.O.B.) (vessel) – A term for a price quotation under which the seller delivers the goods at their own expense on board the steamer at the location named. Subsequent risks and expenses are for account of the buyer.

Free Port – A foreign trade zone open to all traders on equal terms where merchandise may be stored duty-free pending its re-export or sale within that country.

Free Trade Area – An arrangement between two or more countries for free trade among themselves, although each nation maintains its own independent tariffs toward nonmember nations. It should not be confused with free trade zone, which is synonymous with *foreign trade zone*.

Future (or Forward) Exchange Contract – A contract usually between a bank and its customer for the purchase or sale of foreign exchange at a fixed rate with delivery at a specified future time. A future contract is due later than a spot contract, which is settled in one to ten days depending on the bank or market. Future exchange contracts are generally used by the customer to avoid the risk of fluctuations in rates of foreign exchange.

G-7 (Group of Seven) – A group of industrialized countries comprising Canada, France, Germany, Great Britain, Italy, Japan, and the U.S.

G-10 Countries – The informal term for the Group of ten countries, which consists of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the U.S. Switzerland joined in 1984, but the name remains as is. Luxembourg is an associate member.

Global Bond – A temporary debt certificate issued by a Eurobond borrower, representing the borrower's total indebtedness. The global bond will subsequently be replaced by individual bearer bonds.

Global Line – A bank-established aggregate limit that sets the maximum exposure the bank is willing to have to any one customer on a worldwide basis.

Guidance Line – An authorization, unknown to the customer, or a line of credit. If communicated to the customer, the guidance line becomes an advised line of credit commitment.

Hawalas – Informal exchangers and money transmitters commonly used in Arab and other Islamic countries and in India. The system relies on dealings with a trusted party who has financial connections with another individual in another country. Because of the discreteness and informality of the dealings between the parties, hawalas represent a high risk for money laundering. Furthermore, terrorists have used these networks to transfer funds around the world.

Heavily Indebted Poor Countries (HIPCs) – A designation by the IMF to identify nations targeted that need to reduce external debt to more sustainable levels. To determine sustainability, the net value of a country's debt burden is divided into its export earnings. An HIPC is identified as a nation that has a debt to export ratio one and one-half times the amount considered by the IMF to be sustainable. Under this debt reduction initiative for these poor developing countries, the IMF, the World Bank and other multilateral organizations will get together with all of the creditors of these HIPCs. The creditor group then develops a plan to reduce the HIPC's debt to a more sustainable level. To qualify for HIPC assistance, the country must have adopted a Poverty Reduction Strategy Paper and made progress in initiating this strategy for one year. Then the HIPC must adopt adjustment and reform programs supported by the IMF and the World Bank. The IMF and World Bank will conduct periodic debt sustainability analysis to determine ongoing qualification for assistance. As of March 2015, the IMF identified 39 countries as HIPCs.

Interagency Country Exposure Review Committee (ICERC) – A nine-member joint committee of three federal regulatory agencies established to administer the country risk supervision program. ICERC determines the creditworthiness of individual countries and the proper Allocated Transfer Risk Reserve to be used by U.S. banks in mitigating cross-border exposure within a specific country.

International Banking Act of 1978 (IBA) – The principal legislation pertaining to the activities of foreign banks in the U.S. It established a regulatory framework for foreign banks operating in the U.S.

International Banking Facility – A set of asset and liability accounts segregated on the books and records of a depository institution, U.S. branch or agency or a foreign bank, or an Edge Act or agreement corporation. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. IBFs may receive certain tax advantages from individual states.

International Monetary Fund (IMF) – A specialized agency of the United Nations. It encourages monetary cooperation, establishes international standards for a currency exchange policy, promotes stable foreign exchange rates among member nations, and makes short-term advances and standby credits to members experiencing temporary payments difficulties. In some cases, the IMF advances money subject to conditions that must be met by the borrowing country. Its resources come mainly from subscriptions of members.

International Money Market of the Chicago Mercantile Exchange (IMM) – The IMM is one of the world's largest markets for foreign currency and Eurodollar futures trading.

Intervention – The actions of a central bank designed to influence the foreign exchange rate of its currency. The bank can use its exchange reserves to buy its currency if it is under too much downward pressure or to sell its currency if it is under too much upward pressure.

Intra-country Foreign Currency Position – The risk that exists whenever a subsidiary or a branch lends, invests, places, or extends credit to entities that are located within the same country as the booking unit, but in a currency different from that of the country where the borrower and booking unit are located.

Intra-day Position – The size of spot or forward positions allowed for a dealer during the business day, which may be larger than that allowed for the end of the day. Also called *daylight* limits.

Latin American Integration Association (LAIA) – The purpose of the LAIA is to reduce tariff barriers between member countries. The member countries are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela. LAIA is also known under ALADI (its Spanish Acronym).

Letters of Credit-Advised – An export letter of credit issued by a bank that requests another bank to advise the beneficiary that the credit has been opened in its favor. This occurs when the issuing bank does not have an office in the country of the beneficiary and uses the facilities of the advising bank. The advising bank is potentially liable only for its own error in making the notification.

Letters of Credit (Back-to-Back) – A letter of credit issued on the strength (or *backing*) of another letter of credit, involving a related transaction and nearly identical terms. For example, ABC company in the U.S. is designated as the beneficiary of an irrevocable letter of credit confirmed by a U.S. bank to supply XYZ company in Bolivia, whose bank issued the letter of credit, with goods to be purchased from a third company. The third company, however, will not fill ABC's order unless it receives prepayment for the goods either through cash or through some other type of financing. If ABC is unable to prepay in cash, it will request its bank to issue a letter of credit in favor of the third company. If ABC's bank agrees, the domestic credit is then *backed* by the foreign letter of credit and a back-to-back letter of credit transaction exists.

Letter of Credit (Cash) – A letter addressed from one bank to one or more correspondent banks making available to the party named in the letter a fixed sum of money up to a future specific date. The sum indicated in the letter is equal to an amount deposited in the issuing bank by the party before the letter is issued.

Letter of Credit (Commercial) – A letter of credit addressed by a bank, on behalf of a buyer of merchandise, to a seller authorizing the seller to draw drafts up to a stipulated amount under specified terms and undertaking conditionally or unconditionally to provide payment for drafts drawn.

Letter of Credit (Confirmed) – A letter of credit issued by the local bank of the importer and to which a bank, usually in the country of the exporter, has added its commitment to honor drafts and documents presented in accordance with the terms of the credit. Thus, the beneficiary has the unconditional assurance that, if the issuing bank refuses to honor the draft against the credit, the confirming bank will pay (or accept) it. In many instances, the seller (exporter) may ask that the letter of credit be confirmed by another bank when the seller is not familiar with the foreign issuing bank or as a precaution against unfavorable exchange regulations, foreign currency shortages, political upheavals, or other situations.

Letter of Credit (Deferred Payment) – A letter of credit under which the seller's draft specifies that the draft is payable at a later date, for example, 90 days after the bill-of-lading date or 90 days after presentation of the documents.

Letter of Credit (Export) – A letter of credit opened by a bank, arising from the financing of exports from a country. The issuing bank may request another bank to confirm or advise the credit to the beneficiary. If confirmed, the credit becomes a confirmed letter of credit, and, if advised, it becomes an advised (unconfirmed) letter of credit.

Letter of Credit (Green Clause) – Similar to the red clause letter of credit below, except that advance payment is made, generally upon presentation of warehouse receipts evidencing storage of the goods.

Letter of Credit (Guarantee) – A letter of credit guaranteed by the customer (applicant) and often backed by collateral security. In domestic banks, the payment of drafts drawn under this credit is frequently labeled in the general ledger asset account *Customer Liability – Drafts Paid under Guaranteed L/C.*

Letter of Credit (Import) – A letter of credit issued by a bank on behalf of a customer who is importing merchandise into a country. Issuance of an import letter of credit carries a definite commitment by the bank to honor the beneficiary's drawings under the credit.

Letter of Credit (Irrevocable) – A letter of credit that cannot be modified or revoked without the customer's consent or that cannot be modified or revoked without the beneficiary's consent.

Letter of Credit (**Negotiation)** – A letter of credit requiring negotiation (usually in the locality of the beneficiary) on or before the expiration date. The engagement clause to honor drafts is in favor of the drawers, endorsers, or bona fide holders.

Letter of Credit (Nontransferable) – A letter of credit that the beneficiary is not allowed to transfer, in whole or part, to any party.

Letter of Credit (Red Clause) – A clause permitting the beneficiary to obtain payment in advance of shipment so that the seller may procure the goods to be shipped.

Letter of Credit (Reimbursement) – A letter of credit issued by one bank and payable at a second bank that, in turn, draws on a third bank for reimbursement of the second bank's payment to the beneficiary. Those credits are generally expressed in a currency other than that of the buyer (issuing bank) or the seller, and, because of wide acceptability, many are settled in the U.S. through yet another bank as the reimbursing agent. Upon issuance, the correspondent sends the reimbursing bank an authorization to honor drawings presented by the negotiating bank.

Letter of Credit (Revocable) – A letter of credit that can be modified or revoked by the issuing bank up until the time payment is made.

Letter of Credit (**Revolving)** – A letter of credit issued for a specific amount that renews itself for the same amount over a given period. Usually, the unused renewable portion of the credit is cumulative as long as drafts are drawn before the expiration of the credit.

Letter of Credit (Standby) – A letter of credit or similar arrangement that represents an obligation to the beneficiary on the part of the issuer to repay money borrowed by or advanced to or for the account party, make payment on account of any indebtedness undertaken by the account party, or make payment on account of any default by the account party in the performance of an obligation.

Letter of Credit (Straight) – A credit requiring presentation on or before the expiration date at the office of the paying bank. The engagement clause to honor drafts is in favor of the beneficiary only.

Letter of Credit (Telegraphic Transfer Clause) – A clause in which the issuing bank agrees to pay the invoice amount to the order of the negotiating bank upon receipt of an authenticated cablegram from the latter confirming that the required documents have been received and are being forwarded.

Letter of Credit (Transferable) – A credit under which the beneficiary has the right to give instructions to the bank called upon to effect payment or acceptance to make the credit available in whole or in part to one or more third parties (second beneficiaries). The credit may be transferred only upon the express authority of the issuing bank and provided that it is expressly designated as transferable. It may be transferred in whole or in part, but may only be transferred once.

Letter of Credit (Traveler's) – A letter of credit addressed to the issuing bank's correspondents, authorizing them to negotiate drafts drawn by the beneficiary named in the credit upon proper identification. The customer is furnished with a list of the bank's correspondents. Payments are endorsed on the reverse side of the letter of credit by the correspondent banks when they negotiate the drafts. This type of letter of credit is usually prepaid by the customer.

Letter of Credit (Usance) – A letter of credit that calls for the payment against time drafts, or drafts calling for payment at some specified date in the future. Usance letters of credit allow buyers a grace period of a specified number of days, usually not longer than six months.

Local Currency Exposure – The amount of assets and off-balance sheet items that are denominated in the local currency of that country.

Lock-up – The term used to refer to procedures followed in a Eurobond issue to prevent the sale of securities to U.S. investors during the period of initial distribution.

London Interbank Offered Rate (LIBOR) – Key rate in international bank lending. LIBOR is an average of the interest rates that major international banks charge each other to borrow U.S. dollars in the London money market. Like the U.S. Treasury the CD indexes, LIBOR tends to move and adjust quite rapidly to changes in interest rates.

London International Financial Futures Exchange (LIFFE) – A London exchange where foreign currency and Eurodollar futures, as well as foreign currency options, are traded.

Long Position – An excess of assets (and/or forward purchase contracts) over liabilities (and/or forward sales contracts) in the same currency. A dealer's position when net purchases and sales result in a net-purchased position.

Loro Accounts – An account that a bank in one country maintains for a bank in another country. It usually holds foreign currency on behalf of the owner-bank's customers.

Maquiladoras – A program where imports are shipped duty and license free to Mexican firms for assembly and then exported back to the U.S.

Marine Insurance – Insurance for losses arising from specified marine casualties. Marine insurance is more extensive than other types, because it may provide for losses arising from fire, piracy, wreckage, and injuries sustained at sea.

Matched – A forward purchase is matched when it is offset by a forward sale for the same date, or vice versa. As a practical necessity, when setting limits for unmatched positions, a bank may consider a contract matched if the covering contract falls within the same week or semi-monthly period.

Maturity Date – The settlement date or delivery date for a forward contract.

Mercosur – The Mercosur was created by Argentina, Brazil, Paraguay and Uruguay in March 1991 with the signing of the Treaty of Asuncion. It originally was set up with the ambitious goal of creating a common market/customs union between the participating countries based on various forms of economic cooperation that had been taking place between Argentina and Brazil since 1986. The Treaty of Ouro Preto of 1994 added much to the institutional structure of Mercosur and initiated a new phase in the relationship between the countries, when they decided to start to implement/realize a common market. A transition phase was set to begin in 1995 and to last until 2006 with a view to constituting the common market. In 1996, association agreements were signed with Chile and Bolivia establishing free trade areas with these countries based on a *4 plus 1* formula. During this period, Mercosur also created a common mechanism for political consultations, which was formalized in 1998, in which the four countries plus Bolivia and Chile all participate as full members of the so-called *Political Mercosur*.

Multi-currency Line – A line of credit giving the borrower the option of using any readily available major currency.

Multilateral Exchange Contract – An exchange contract involving two foreign currencies against each other, for example, a contract for U.S. dollars against British pounds made in London. Also called an arbitrage exchange contract.

Nationalization – A process where a nation's central government assumes ownership and operation of private enterprises within its territory.

Net Accessible Interest Differential – The difference between the interest rates that can actually be obtained on two currencies. This difference is usually the basis of the swap rate between the two currencies and, in most cases, is derived from external interest rates rather than domestic ones. These external rates or Euro-rates are free from reserve requirements, which would increase the interest rate, and from exchange controls, which would limit access to the money.

Net Exchange Position – An imbalance between all the assets and purchases of a currency, and all the liabilities and sales of that currency.

Net Position – A bank has a position in a foreign currency when its assets, including future contracts to sell, in that currency are not equal. An excess of assets over liabilities is called a net *long* position and liabilities in excess of assets result in a net *short* position. A long net position in a currency that is depreciating results in a loss because, with each day, that position (asset) is convertible into fewer units of local currency. A short position in a currency that is appreciating represents a loss because, with each day, satisfaction of that position (liability) costs more units of local currency.

Netting Arrangement – Arrangement by two counterparties to examine all contracts settling in the same currency on the same day and to agree to exchange only the net currency amounts. Also applies to the net market values of several contracts.

Non-tariff Trade Barriers – Barriers other than tariffs that tend to restrict trade. For example, setting higher inspection standards for imports than for domestically produced items, giving preference to domestic companies in bidding on contracts, import substitution programs, import licensing requirements, additional product labeling requirements, export subsidizing, inadequate protection of intellectual property rights, or limitations on services.

North American Free Trade Agreement (NAFTA) – A free trade area consisting of Canada, Mexico, and the U.S. The goal is to reduce trade barriers between the member countries thereby creating jobs and economic prosperity for the citizens of all three countries.

Nostro Accounts – Demand accounts of banks with their correspondents in foreign countries in the currency of that country. These accounts are used to make and receive payments in foreign currencies for a bank's customers and to settle maturing foreign exchange contracts. Also called *due from foreign bank - demand accounts*, *our balances with them*, or *due from balances*.

Ocean Bill of Lading – A document signed by the captain, agents, or owners of a vessel furnishing written evidence for the conveyance and delivery of merchandise sent by sea. It is both a receipt for merchandise and a contract to deliver it as freight.

Odd Dates – Deals within the market are usually for spot, one month, two months, three months or six months forward. Other dates are odd dates, and prices for them are frequently adjusted with more than a mathematical difference. Hence, most market deals are for regular dates, although commercial deals for odd dates are common.

Offer Rate – The price at which a quoting party is prepared to sell or lend currency. This is the same price at which the party to whom the rate is quoted will buy or borrow if it desires to do business with the quoting party. The opposite transactions take place at the bid rate.

Official Rate – The rate established by a country at which it permits conversion of its currency into that of other countries.

Offshore Branch – Banking organization designed to take advantage of favorable regulatory or tax environments in another country. Many of these operations are shell branches with no physical presence.

Offshore Dollars – Same as Eurodollars, but encompassing the deposits held in banks and branches anywhere outside of the U.S., including Europe.

Open Contracts – The difference between long positions and short positions in a foreign currency or between the total of long and short positions in all foreign currencies. Open spot or open forward positions that have not been covered with offsetting transactions.

Open Market Operations – Purchases or sales of securities or other assets by a central bank on the open market.

Open Position Limit – A limit placed on the size of the open position in each currency to manage off-balance sheet items.

Order Bill of Lading – A bill of lading, usually drawn to the order of the shipper that can be negotiated like any other negotiable instrument.

Order Notify Bill of Lading – A bill of lading usually drawn to the order of the shipper or a bank with the additional clause that the consignee is to be notified upon arrival of the merchandise. The mention of the consignee's name does not confer title to the merchandise.

Organization for Economic Cooperation and Development (OECD) – An organization of 34 countries that fosters democracy and free market development throughout the world. The OECD also researches issues having international implications. The OECD publishes its research findings and international statistics on various countries at its website at http://www.oecd.org. The OECD also benchmarks best practices on economic, social, and governance issues. The OECD supports other international groups such as the FATF that have similar goals.

Outright – Forward exchange bought and sold independently from a simultaneous sale or purchase spot exchange.

Outright Forward Rate – A forward exchange rate that is expressed in terms of the actual price of one currency against another, rather than, as is customary, by the swap rate. The outright forward rate can be calculated by adding the swap premium to the spot rate or by subtracting the swap discount from the spot rate.

Override Limit – The total amount of money measured in terms of a bank's domestic currency that the bank is willing to commit to all foreign exchange net positions.

Parallel Banking Organizations – A PBO exists when a U.S. depository institution and a foreign bank are controlled, either directly or indirectly, by an individual, family, or group of persons with close business dealings, or that are otherwise acting in concert.

Parity – A term derived from par, meaning the equivalent price for a certain currency or security relative to another currency or security, or relative to another market for the currency or security after making adjustments for exchange rates, loss of interest, and other factors.

Parity Grid – The system of fixed bilateral par values in the European Monetary System. The central banks of the countries whose currencies are involved in an exchange rate are supposed to intervene in the foreign exchange market to maintain market rates within a set range defined by an upper and lower band around the par value.

Par Value – The official parity value of a currency relative to the dollar, gold, special drawing rights, or another currency.

Payable Through Accounts – Accounts used directly by customers of a correspondent bank to transact business on their own behalf.

Placement Memorandum – A document in a syndicated Eurocredit that sets out details of the proposed loan and gives information about the borrower.

Political Risk – Political changes or trends often accompanied by shifts in economic policy that may affect the availability of foreign exchange to finance private and public external obligations. The banker must understand the subtleties of current exchange procedures and restrictions as well as the possibilities of war, revolution, or expropriation in each country with which the bank transacts business, regardless of the actual currencies involved.

Position – A situation created through foreign exchange contracts or money market contracts in which changes in exchange rates or interest rates could create profits or losses for the operator.

Position Book – A detailed, ongoing record of an institution's dealings in a particular foreign currency or money market instrument. Also known as position sheet.

Position Limits – The maximum net debit or credit foreign currency balance either during the day (daylight limits) or at close of business (overnight limits) as stipulated by bank management.

Premium – The adjustment to a spot price that is made in arriving at a quote for future delivery. If a dealer were to quote $2.00 and $2.05 (bid and asked) for sterling and the premiums for six months forward are .0275 and .0300, the forward quotes would be adjusted to $2.0275 and $2.0800. The premium usually represents differences in interest rates for comparable instruments in two countries. In periods of crisis for a currency, the premium may represent the market anticipation of a higher price.

Price Quotation System – A method of giving exchange rates in which a certain specified amount of a foreign currency (1 or 100, usually) is stated as the corresponding amount in local currency.

Privatization – The selling of a government owned business (power, gas, communications) to the public. Governments privatize businesses to raise money for fiscal operations or to improve the efficiency of a firm.

Quota – A government-imposed restriction on the quantity of a specific imported good.

Rate Risk – In the exchange market, the chance that the spot rate may rise when the trader has a net oversold position (a short position), or that the spot rate may go down when the operator has a net overbought position (a long position).

Reciprocal Rate – The price of one currency in terms of a second currency, when the price of the second currency is given in terms of the first.

Representative Office – A facility established in the U.S. or foreign markets by a foreign bank to sell its services and assist clients. In the U.S., these offices cannot accept deposits or make loans.

Reserve Account – Those items in the balance of payments that measure changes in the central bank's holdings of foreign assets (such as gold, convertible securities, or special drawing rights).

Reserve Currency – A foreign currency held by a central bank (or exchange authority) for the purposes of exchange intervention or the settlement of intergovernmental claims.

Revaluation – An official act wherein the official parity of a currency is adjusted relative to the dollar, gold, special drawing rights, or another currency, resulting in less revalued units relative to those currencies. Also, the periodic computations of the current values (reevaluations) of ledger accounts and unmatured, future purchase and sales contracts.

Rollover – The process of extending a maturing forward foreign exchange contract.

Sanctions – A coercive governmental action that restricts trade with a specific country (e.g., embargo) for a political purpose rather than for an economic need.

Seller's Option Contract – When the seller has the right to settle a forward contract at their option anytime within a specified period.

Shell Branch – See *Offshore Branch*.

Short Position – An excess of liabilities (and/or forward sale contracts) over assets (and/or forward purchase contracts) in the same currency. A dealer's position when the net of purchases and sales leaves the trader in a net-sold or oversold position.

Sight Draft – A draft payable upon presentation to the drawee or within a brief period thereafter known as *days of grace*.

Society for Worldwide Interbank Financial Telecommunications (SWIFT) – A telecommunications network established by major financial institutions to facilitate messages among SWIFT participants. These messages typically result in a monetary transaction between institutions. The network is based in Brussels.

Soft Currency – A currency that is not freely convertible into other currencies.

Soft Loans – Loans with exceptionally lenient repayment terms, such as low interest, extended amortization, or the right to repay in the currency of the borrower.

Sole of Exchange – A phrase appearing on a draft to indicate that no duplicate is being presented.

Sovereign Risk – The risk that the government of a country may interfere with the repayment of debt.

Space Arbitrage – The buying of a foreign currency in one market and selling it for a profit in another market.

Special Drawing Rights – International paper money created and distributed to governments by the IMF in quantities dictated by special agreements among its member countries. The value of special drawing rights is determined by the weighted value of a *basket* of major currencies.

Spot Contract – A foreign exchange contract traded in the interbank market in which the value date is two business days from the trade date.

Spot Exchange (or Spot Currency) – Foreign exchange purchased or sold for immediate delivery and paid for on the day of delivery. Immediate delivery is usually considered delivery in one or two business days after the conclusion of the transaction. Many U.S. banks consider transactions maturing in as many as ten business days as spot exchange. Their reasons vary but are generally to facilitate reevaluation accounting policies and to initiate final confirmation and settlement verification procedures on future contracts nearing maturity.

Spot Transaction – A transaction for spot exchange or currency.

Spread – The difference between the bid rate and the offer rate in an exchange rate quotation or an interest quotation. This difference is not identical with the profit margin because traders seldom buy and sell at their bid and offer rates at the same time.

Square Exchange Position – To make the inflows of a given currency equal to the outflows of that currency for all maturity dates. This produces a square exchange position in that currency.

Sterilization – Intervention in the foreign exchange market by a central bank in which the change in the monetary base caused by the foreign exchange intervention is offset by open market operations involving domestic assets.

Stale Bill of Lading – A bill of lading that has not been presented under a letter of credit to the issuing bank within a reasonable time after its date, thus precluding its arrival at the port of discharge by the time the ship carrying the related shipment has arrived.

Straight Bill of Lading – A bill of lading drawn directly to the consignee and therefore not negotiable.

Swap – The combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another; merely trading one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures.

Swap Arrangement (Reciprocal) – A bilateral agreement between the central banks enabling each party to initiate swap transactions up to an agreed limit to gain temporary possession of the other party's currency.

Swap Cost or Profit – In a swap transaction, the cost or profit related to the temporary movement of currency into another currency and back again. That exchange cost or profit must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. Furthermore, the true trading profits or losses generated by the foreign exchange trader cannot be determined if swap profits or costs are charged to the exchange function rather than being allocated to the department whose loans or investments the swap actually funded.

Swap and Deposit – A combination of swap transactions that enable the borrower to have use of both currencies for the duration of the transaction.

Swap Position – A situation where the scheduled inflows of a given currency are equal to the scheduled outflows, but the maturities of those flows are purposely mismatched. The expectation in a swap position is that the swap rate will change and that the gap can be closed at a profit.

Swap Rate – The difference between the spot exchange rate of a given currency and its forward exchange rate.

Swap Swap – A swap transaction involving one forward maturity date against another forward maturity date.

Swaption – An option on a swap. It gives the buyer the right, but not the obligation, to enter into an interest-rate swap at a future time period.

Telegraphic Transfer (TT) Rate – The basic rate at which banks buy and sell foreign exchange. Buying rates for mail transfers, foreign currency drafts, traveler's checks, and similar instruments are all based on the TT rate. The TT rate may be slightly less favorable than other rates because of the time required for collection.

Telex – Direct communication between two banks or companies and organizations via satellite or underwater cable.

Terms of Trade – Relative price levels of goods exported and imported by a country.

Test Key – A code used in transferring funds by cable or telephone so that the recipient may authenticate the message. For example, a test key may consist of a series of numbers, including a fixed number for each correspondent bank; a number for the type of currency, a number for the total amount; and, possibly, numbers for the day of the month and day of the week. A single number code indicates whether the total amount is in thousands, hundreds, tens, or digits. To arrive at a test number, the indicated numbers are totaled, and the total amount usually precedes the text of the message.

Third Country Bills – Bankers acceptances issued by banks in one country that finance the transport or storage of goods traded between two other countries.

Through Bill of Lading – A bill of lading used when several carriers are used to transport merchandise, for example, from a train to a vessel or vice versa.

Tied Loan – A loan made by a governmental agency that requires the borrower to spend the proceeds in the lender's country.

Time Draft – A draft drawn to mature at a fixed time after presentation or acceptance.

Tomorrow Next – The simultaneous purchase and sale of a currency for receipt and payment on the next and second business day, respectively, or vice versa.

Tradable Amount – The minimum amount accepted by a foreign exchange broker for the interbank market, for example, 100,000 Canadian dollars or 50,000 pounds sterling.

Trade Acceptance – A draft drawn by the seller (drawer) on the buyer (drawee) and accepted by the buyer. Also called a trade bill, customer acceptance, and two-name trade paper.

Trade Accounts – Those parts of the balance of payments that reflect money spent abroad by the citizens of a country on goods and services and the money spent by foreigners in the given country for goods and services.

Trader's Ticket or Dealer's Slip – The handwritten record of a foreign exchange trade and/or placing and taking of deposits that is written by the dealer who executed the transaction.

Trading Position Worksheet – A record of incomplete transactions in a particular currency.

Tranche – A term sometimes used when referring to the number of drawings of funds by a borrower under a term loan.

Transfer Risk – The risk arising when a borrower incurs a liability in a currency that is not the currency in which revenues are generated. The borrower may not be able to convert its local currency to service an international loan if foreign exchange is not generated.

Trust Receipt – Used extensively in letter of credit financing, this is a document or receipt in which the buyer promises to hold the property received in the name of the releasing bank, although the bank retains title to the goods. The merchant is called the trustee and the bank the entruster. Trust receipts are used primarily to allow an importer to take possession of the goods for resale before paying the issuing bank.

Two-way Quotation – A simultaneous quotation of foreign exchange buying and selling rates implying the willingness of the bank to deal either way.

Two-way Rate – An exchange rate or an interest rate quotation that contains both a bid rate and an offer rate. The size of the spread between the two rates indicates the relative quality of the quotation.

Unclean Bill of Lading – A bill of lading across the face of which exceptions to the receipt of goods ''in apparent good order'' are noted. Examples of exceptions include burst bales, rusted goods, and smashed cases.

Undervalued – Decline in the spot rate below purchasing power parities, so that goods of one country are cheaper than in another country. In relation to foreign exchange, *undervalued* means that forward premiums are narrower or forward discounts are wider than the interest parities between the two financial centers.

Uniform Customs and Practices for Documentary Credits – Sets of rules governing documentary letters of credit formulated by the International Chamber of Commerce. Includes general provisions, definitions, forms, responsibilities, documents, and the transfer of documentary letters of credit.

Unmatched – A forward purchase is unmatched when a forward sale for the same date has not been executed or vice versa.

Usance – The period of time between presentation of a draft and its maturity.

Value Date – The date on which foreign exchange bought and sold must be delivered and on which the price for them in local currency must be paid.

Value-impaired – A category assigned by ICERC that indicates a country has protracted debt problems.

Value Today – An arrangement by which spot exchange must be delivered and paid for on the day of the transaction instead of two business days later.

Value Tomorrow – An arrangement by which spot exchange must be delivered and paid for on the business day following the transaction instead of two business days later.

Volume Quotation System – A method of giving exchange rates in which a certain specified amount of local currency (usually 1 or 100) is stated as the corresponding amount in foreign currency.

Vostro Account – A demand account maintained for a bank by a correspondent bank in a foreign country. The nostro account of one bank is the vostro account of the other bank. See also nostro account.

Warehouse Receipt – An instrument that acknowledges the deposit of goods or commodities in the warehouse that issues the receipt. These receipts may be negotiable or non-negotiable. A negotiable warehouse receipt is made to the *bearer*, and a non-negotiable warehouse receipt specifies precisely to whom the goods shall be delivered. There are several alternatives for releasing goods held under warehouse receipts: (1) the delivery of goods may be allowed only against cash payment or substitution of similar collateral; (2) some or all of the goods may be released against a trust receipt without payment; or (3) a warehouseman may release a stipulated quantity of goods without a specific delivery order. Banks will accept a warehouse receipt as collateral for a loan only if the issuer of a receipt is a bonded warehouseman. The bank must have protected assurances for the authenticity of the receipt and the fact that the commodities pledged are fully available as listed on the warehouse receipt.

Within-line Facility – Subfacilities of the line of credit that establish parameters, terms, and conditions of various other facilities available for specific additional purposes or transactions. The aggregate sum of all outstanding amounts under within-line facilities must not exceed the total of the overall line of credit.

World Bank – An international financial organization whose purpose is to aid the development of productive facilities in member countries, particularly in developing countries. The chief source of funds is capital contributions made by member countries, which vary with the financial strength of the country. Another funding source is the sale of long-term bonds.

Yankee Bond – A U.S. dollar-denominated foreign bond issued in the U.S. market.

Effective October 1, 1998, the FDIC made substantial revisions to Part 303 of the FDIC's Rules and Regulations, which governs the filing and processing of various applications. One of the most significant features of this revised regulation is that of expedited processing that is now available for "eligible depository institutions."

Eligible depository institutions are defined in the regulation as those which meet the following criteria:

- Received a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System (UFIRS) as a result of its most recent federal or state examination.
- Received a satisfactory or better Community Reinvestment Act (CRA) rating from its primary federal regulator at its most recent examination, if subject to CRA
- Received a compliance rating of 1 or 2 from its primary federal regulator at its most recent examination
- Is well-capitalized as defined in the appropriate capital regulation and guidance of the institution's primary federal regulator; and
- Is not subject to a cease and desist order, consent order, prompt corrective action directive, written agreement, memorandum of understanding, or other administrative agreement with its primary federal regulator or chartering authority.

APPLICATIONS FOR DEPOSIT INSURANCE

Introduction

The granting of deposit insurance confers a valuable status on an applicant institution; its denial, on the other hand, may have seriously adverse competitive consequences, and, in the case of a new institution, may effectively preclude entrance into the banking/thrift business. Obviously, the role of the FDIC, in acting upon such applications, involves important responsibilities and the exercise of sound discretion in the public interest.

Sections 5 and 6 of the Federal Deposit Insurance Act specifically deal with deposit insurance. Under Section 5, the FDIC must determine as a threshold matter that an applicant is a "depository institution which is engaged in the business of receiving deposits other than trust funds. If an institution does not satisfy that threshold requirement as codified under Part 303 of the FDIC Rules and Regulations. Additionally, Section 5 states that before approving an application, consideration shall be given to the factors enumerated in Section 6. Those factors are: the financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, the risk presented to the insurance fund, the convenience and needs of the community to be served, and whether or not its corporate powers are consistent with the purposes of the Act.

Subpart B of Part 303 of the FDIC's Rules and Regulations implements the basic statutory provisions and governs the administrative processing of applications for deposit insurance. For those filings subject to a public notice requirement, any person may inspect or request a copy of the non-confidential portions of a filing (the public file) until 180 days following the final disposition of the filing.

Rights of Applicants

An applicant has a statutory right to apply for deposit insurance and to obtain full consideration of its application by the FDIC in light of all relevant facts and without prejudice. If all of the seven statutory factors are resolved favorably, the applicant is entitled to receive deposit insurance coverage. In the event an application is disapproved, an applicant has a right to be informed by the FDIC of the reasons for disapproval.

Obligations of the FDIC

Under applicable law, the FDIC is obligated to consider the seven factors enumerated in Section 6 of the FDI Act in connection with every application for deposit insurance. As a measure of protection against unwarranted and unjustified risks, a full and thorough examination or investigation of each application is conducted. The FDIC has formulated certain guidelines for admission, which are designed to ease administrative problems, aid in preventing arbitrary judgment, and assist in assuring uniform and fair treatment to all applicants. These guidelines must, however, be administered in a manner consistent with the spirit of the Act, and the maintenance of a competitive and free enterprise banking/thrift system. Although applicants are largely required to satisfy criteria under each of the seven statutory factors, in a newly organized institution the FDIC views management and capital adequacy as the most important. The FDIC believes active competition between banks, thrifts and other financial institutions, when conducted within applicable law and in a safe and sound manner, is in the public interest.

Examiner's Responsibility

Whether the applicant is a proposed or newly organized institution or an existing institution, a formal application for deposit insurance coverage must be filed with the FDIC. A copy of the formal application will be made available to an examiner for use in the investigation. Although the application contains data on each of the seven factors enumerated under Section 6 of the Act, reports of investigation are not to be limited to material supplied by the applicant. Reports should be factual as to necessary information and represent the independent and unbiased findings of the examiner. The examiner should in no way indicate to an applicant the probable nature of his recommendations or discuss the applicant's chance of gaining admission to the insurance system unless specifically authorized to do so by the Regional Director. Considerable reliance is placed upon impartial reports by examiners in connection with admission procedures.

The report should detail the relevant facts and data pertinent to each of the seven statutory factors, and under a separate topical heading, an opinion as to whether the FDIC's criteria under each of the statutory factors have been met. A negative opinion on one or more of the statutory factors must be fully explained and supported and, where possible, it should be indicated whether and how the situation may be corrected. The report should also include a general recommendation relative to admission and, if appropriate, a list of conditions which should be imposed. As a rule, the FDIC requires applicants to satisfy all criteria under each of the seven statutory factors. In some cases, however, minor deficiencies in certain factors may be excused when they are more than balanced by conspicuous merits in others.

The seven factors enumerated in Section 6 of the FDI Act which are the criteria used by the FDIC to determine eligibility for deposit insurance are discussed below. The FDIC's admission criteria for proposed or newly organized institutions and existing institutions are generally the same; however, pertinent aspects specifically applicable to admission of existing institutions are covered later in this Section.

Statutory Factors, Proposed or Newly Organized Institutions

Financial History and Condition - Proposed and newly organized institutions have no financial history to serve as a basis for determining qualification for deposit insurance. Some consideration may be given to the history of other institutions presently and formerly operating in the area of the applicant, if pertinent. The ability of the proponents to provide financial support to the new institution should be evaluated under this factor. Past institution failures in a community should not be a prominent consideration in acting upon the application of a new institution. New institution applications are to be judged as far as possible upon their own merits relative to capital, management, and the other factors enumerated in Section 6 of the Act.

The investigation report should include a pro forma statement of the proposed institution for the first three years of operation. The asset and liability projections and composition should be reasonable in relation to the proposed market. Major assets with which the proposed institution intends to begin business, should be fairly valued and supported with appraisals.

Fixed assets are of primary concern in analyzing the asset condition of a proposed or newly organized financial institution. The applicant’s aggregate direct and indirect fixed asset investment, must be reasonable in relation to its projected earnings capacity, capital and other pertinent matters of consideration. Significant assets should be described in detail. For example, the following elements are pertinent to an adequate description and evaluation of applicant's realty interests: the original cost of the premises at time of construction with a breakdown between land and building, original cost to applicant, date of construction, reasonableness of purchase price, from whom purchased, insurance to be carried, assessed value, prospective or immediate repairs or alterations, estimated useful life of the building as of the beginning of business, outstanding liens, tax status, completeness of title papers, desirability of the location, and prospective annual income and expenses if the building is to be other than a one-purpose structure.

The relationship between the applicant's total investment in fixed assets and capital structure should receive comment.

If the leasing of premises is contemplated either through a real estate subsidiary of the proposed institution or otherwise, the terms of the lease are to be outlined in some detail, including a description and estimated cost of any leasehold improvements. In such cases, the lease agreement should contain a termination clause, acceptable to the FDIC. Lease transactions shall be reported in accordance with Financial Accounting Standards Board Statement 13 (Accounting for Leases). Applicants are cautioned against purchasing any fixed assets or entering into any noncancelable construction contracts, leases, or other binding arrangements related to the proposal unless and until the FDIC approves the application.

Any financial arrangement or transaction involving the applicant, its organizers, directors, officers, 10% or more shareholders, or their associates (insiders) should be avoided. If there are any such arrangements or transactions, it must be determined that they are fair and on substantially the same terms as those prevailing at the time for comparable transactions with noninsiders and must not involve more than normal risk or present unfavorable features. Full disclosure of any arrangements with insiders must be made to all proposed directors and prospective shareholders.

An evaluation and comment should be made as to whether the new institution will provide procedures, security devices, and safeguards which will at least be equivalent to the minimum requirements of the Bank Protection Act of 1968 and Part 326 of the Rules and Regulations of the FDIC. In addition, if the new institution plans to utilize electronic data processing services for some or all of its accounting functions, proponents should be apprised of the need to furnish notification in the form prescribed in Part 304.

In applications anticipating the use of temporary quarters pending construction or renovation of permanent facilities, details should be provided regarding the location of the site in relation to the permanent location, the exact address, the rental arrangement, the leasehold improvements, and estimated nonrecoverable costs upon abandonment.

Considerations required by the National Historic Preservation Act and the National Environmental Policy Act of 1969 must also be favorably resolved and the applicant is generally requested to submit data in this regard for evaluation.

Applicants often employ professional assistance, such as attorneys, economic researchers, and other specialists to assist in the preparation and filing of an application for deposit insurance coverage. The revised Statement of Policy on “Applications for Deposit Insurance” was adopted by the Board of Directors of the FDIC effective October 1, 1998, requires that legal fees and all other organizational expenses be reasonable and fully supportable. Expenses for professional or other services rendered by insiders will receive special review for any indication of self-dealing to the detriment of the institution and its other shareholders. The FDIC expects full disclosure to all directors and shareholders of any arrangement with an insider. In no case will a deposit insurance application be approved where the payment of a fee, in whole or in part is contingent upon any act or forbearance by the FDIC or by any other state or federal agency.

Adequacy of the Capital Structure – Normally, the initial capital of a proposed depository institution should be sufficient to provide a Tier 1 capital to assets leverage ratio (as defined in the appropriate capital regulation of the institution’s primary federal regulator) of not less than 8.0% throughout the first three years of operation. Initial capital should normally be in excess of $2 million net of any pre-opening expenses that will be charged to the institution’s capital after it commences business. In addition, the depository institution must maintain an adequate allowance for loan and lease losses.

If the applicant is being established as a wholly owned subsidiary of an eligible holding company (as defined in Part 303), the FDIC will consider the financial resources of the parent organization as a factor in assessing the adequacy of the proposed initial capital injection. In such cases, the appropriate regional director (DOS) may find favorably with respect to the adequacy of capital factor when the initial capital injection is sufficient to provide for a Tier 1 leverage capital ratio of at least 8% at the end of the first year of operation, based on a realistic business plan, or the initial capital injection meets the $2 million minimum capital standard set forth in the FDIC Statement of Policy on Applications for Deposit Insurance, or any minimum standards established by the chartering authority, whichever is greater. The holding company shall also provide a written commitment to maintain the proposed institution’s Tier 1 leverage capital ratio at not less than 8% throughout the first three years of operation.

The adequacy of the capital structure of a newly organized financial institution is closely related to its risk appetite, deposit volume, fixed asset investment, and the anticipated future growth in liabilities. Deposit projections made by the applicant must, therefore, be fully supported and documented. Projections should be based on established growth patterns in the specific market, and initial capitalization should be provided accordingly. Special purpose depository institutions (such as credit card banks) should provide projections based on the type of business to be conducted and the potential for growth of that business.

In most cases, the first three years of operation is a reasonable time frame for measuring deposit growth in newly organized institutions. Accordingly, in assessing the adequacy of initial capital as related to prospective deposit volume, the examiner should develop a reasonable estimate of the deposit volume a new financial institution may generate in each of the first three years of operation, which may differ considerably from the estimates provided in the proponents' application, feasibility study, or economic survey. It is not unusual to find that the proponents' deposit projections and feasibility study are influenced by the proposed capital structure. The proponents' deposit projections may also be out-of-date or not fully supportable due to lack of adequate information and documentation. The best sources of information to assist in formulating reasonable estimates are local economic indicators, population data, deposit and loan growth in other financial institutions in the area, comments and observations of

depository institution managers in the area, the competitive impact of other financial institutions, and the ability of the proponents to generate business in the trade area. In the final analysis, the estimated deposit volume for a new institution's third year of operation is highly significant because it serves the dual purpose of measuring earnings capability as well as capital adequacy after projecting a reasonable operating period.
The number of shares of stock and its par value as of the commencement of business should be scheduled. The per share price of the stock should be stated, and, in cases where an additional amount per share is assessed to cover organizational and preopening expenses, that amount should also be identified. The components of the beginning capital structure can then be allocated to capital stock, surplus, other segregations, and the organizational expense fund. It should be ascertained whether or not the State or Office of Thrift Supervision statutory minimum capital requirements are met and how evidence will be provided to the FDIC that capital funds are fully paid in prior to opening for business. If it appears the proposed capital structure will not meet the FDIC's criteria, the investigation report should reflect fully the extent of and reasons for the inadequacy and recommend to the FDIC an amount which would be acceptable. Should the attitude of the proponents be receptive to a request for supplying additional capital, it should be so indicated.

All stock of a particular class in the initial offering should be sold at the same price, and have the same voting rights. Proposals which allow the insiders to acquire a separate class of stock with greater voting rights are generally unacceptable. Insiders should not be offered stock at a price more favorable than the price for other subscribers. Price disparities provide insiders with a means to gain control disproportionate to their investments.

When securities are sold to the public, the disclosure of all material facts is essential. The FDIC's Statement of Policy regarding use of Offering Circulars in connection with Public Distribution of Bank Securities (dated September 5, 1996) provides additional guidance. A copy of the offering circular prepared by the applicant, the stock solicitation material, and the subscription agreement should be submitted to the FDIC when they become available.

Future Earnings Prospects - Allowing a new institution to commence operations without some indication that it can be operated profitably not only creates a potentially unsatisfactory situation, but could also have a detrimental effect on other competing financial institutions. Usually the operations of a new institution are not profitable for at least the first year. Estimates of operating income and expenses for the first three years of operation should be made using, among other things, the projections of loan and deposit volume made in connection with the "Adequacy of the Capital Structure" factor.

In determining future earnings prospects, the probable income from loans and discounts, bonds and securities, service charges and commissions, and other sources of income must be estimated. Assistance in this task may be obtained from evaluating the applicant's projections, the demand for loans in the area and types thereof, the probable nature of the institution's investment policy, the amount of time and demand deposits likely to be acquired, the probable competitive reaction from existing depository institutions, the economic conditions in the community, the possibility of future development or retrogression in the area, the apparent moneymaking ability of the institution's management, and the FDIC's statistical data for depository institutions operating in the same general area. In addition, estimates must be made for expenses such as salaries and other employee benefits, interest, occupancy and equipment outlays, electronic data processing service costs, and other current operating expenses. Assistance in making these projections may generally be obtained from the same sources used in projecting the various income categories. A review and comparison of original projections and actual data for other recently organized operating financial institutions in the same or comparable areas may be of assistance in projecting earnings and expense data. Applicants need to demonstrate through realistic and supportable estimates that, within a reasonable period (normally three years); the earnings will be sufficient to provide an adequate profit.

The report of investigation should pinpoint any marked divergence between the examiner's findings and those presented in the application and the reasons for such variances. Comment should also be made on the proponents' plans for payment of cash dividends, bonuses, directors' fees, retainer fees, etc, and the accounting system to be used. During the first three years, dividends shall be paid only from net operating income after tax and not until an appropriate allowance for loan and lease losses has been established and overall capital is adequate. In regard to accounting systems, the FDIC requires use of the accrual method from the outset of operations.

As indicated previously, this portion of the investigation report is, by reason of Part 303 of the FDIC's Rules and Regulations, available for public inspection.

General Character of the Management - The quality of an institution's management is vital and perhaps the single most important element in determining the applicant's acceptability for deposit insurance. To satisfy the FDIC's criteria under this factor, the evidence must support a management rating which in an operating institution would be tantamount to a rating of "2" or better. In most instances, the management of a proposed or newly organized institution will not have an operating record as a functioning unit to assist in forming a judgment; therefore, the management rating essentially becomes a question of directly evaluating the individual directors and officers and then making a composite overall rating premised upon the individual analyses.

In general, the individual directors and officers will be evaluated largely on the basis of the following:

- Financial institution and other business experience;
- Duties and responsibilities in the proposed depository institution;
- Personal and professional financial responsibility;
- Reputation for honesty and integrity; and
- Familiarity with the economy, financial needs, and general character of the community in which the depository institution will operate.

The report of investigation should, therefore, contain a schedule giving the name, address, approximate age, total liabilities, and net worth of each director and officer. In addition, for each proposed member of the management team comments should be included that detail present occupation or profession and past banking, thrift, business, farming, or other experience; including observations as to how successful the individuals have been in their present and past activities and whether they have been asked to resign from a position or positions held or have been associated with serious business failures or debt compromises. As a rule of thumb, success of the majority of an applicant's management in their present business endeavors is some evidence of their ability to manage successfully the affairs of the proposed institution.

In addition, all firms, companies, corporations, and organizations in which a given director or officer is substantially interested should be indicated. If the facts denote that the institution is being organized primarily to finance the businesses or personal interests of certain officers and directors, particularly when the assets related thereto are likely to be of dubious quality, the relevant facts should be fully covered.

Duties and responsibilities as well as the title of each proposed officer and director should be outlined. If the proposed duties and responsibilities are regarded as beyond the capabilities of a particular officer or some other distribution of duties and responsibilities among officers would be more effective than that contemplated, the opinions and reasons therefore should be indicated.

Net worth figures on each director and officer will be available from financial reports filed with the application. In listing net worth figures in the report of investigation, an opinion as to the validity of the figures and any pertinent information relating to sizable liabilities may be made.

Stock holdings of each director and officer are to be indicated. Successful operation of a financial institution requires a real interest in its welfare as well as a willingness to devote a substantial amount of time to its affairs. When directors and officers have a significant financial investment, genuine and continuing interest is more likely.

Section 19 of the FDI Act prohibits, without the prior written consent of the FDIC, a person convicted of criminal offense involving dishonesty, breach of trust, money laundering, or who has entered into a pretrial diversion or similar program in connection with a prosecution for such offense, from becoming or continuing as an institution-affiliated party, owning or controlling, directly or indirectly an insured institution, or otherwise participating, directly or indirectly, in the conduct of the affairs of an insured depository institution. If an employee, officer, or director is involved in a criminal conviction, or fidelity insurance has been denied with respect to any employee, officer, or director, a thorough investigation of the circumstances should be conducted. If the facts of the investigation dictate, the institution may be required to file an application pursuant to Section 19 of the FDI Act.

Length of residence in the community or trade area of the proposed institution and degree of familiarity with the major activities of the locale should be indicated with respect to each director and officer.

The above information should be particularly complete with respect to individuals who are likely to dominate the policies and operations of the institution. In addition, comparable information should be included on any shareholder (other than a proposed director or officer) who is subscribing to 10% or more of the aggregate par value of stock to be issued. Examiners should also include in their report any information that may come to their attention concerning possible changes that may be made in the institution's management after commencement of operations. In addition, the FDIC has found that on occasion, subsequent to approval of an application for deposit insurance and prior to the actual opening of a proposed new institution, changes have occurred in the management or ownership. In order to monitor such changes, the FDIC requires that the prospective incorporators advise the Regional Director in writing if changes in the directorate, active management, or in the ownership of stock of 10% or more of the total are made prior to opening. When conducting investigations, this notification should be stressed in any discussions with the proponents.

Certain other information relative to the sale and purchase of the proposed institution's stock and the exercise of voting rights may also reflect on the general quality and character of management. While these matters may also relate to the "Adequacy of Capital Structure" factor, on balance they are more appropriately treated herein. Stock financing arrangements by proposed officers, directors and 10% shareholders of their investments in stock of the proposed depository institution will be carefully reviewed. Such financing will be considered acceptable only if the party financing the stock can demonstrate the ability to service the debt without reliance on dividends or other forms of compensation from the applicant. When stock financing arrangements are anticipated, information should be submitted with the application demonstrating that adequate alternative independent sources of debt serving are available. Direct or indirect financing by proposed officers, directors and 10% shareholders of more than 75% of the purchase price of the stock subscribed by any individual, or more than 50% of the purchase price of the aggregates stock subscribed by the proposed officers, directors and 10% shareholders as a group, will require supporting justification in the application regarding the reason that the financing arrangements should be considered acceptable. If the proposed financing arrangements are not considered appropriate, the FDIC may find unfavorably on the adequacy of the capital structure.

It should be determined whether any commissions are to be paid in connection with the sale of the stock and confirmed that no loans representing applicant stock purchases will be refinanced by the institution. Any evidence that the institution is being organized on a promotional basis should also be covered. Ownership control by several individuals or groups of shareholders as well as any contemplated or existing buy-sell, voting trust, or proxy agreements between various individuals or other entities, such as holding companies, should also receive comment and copies of any such agreements obtained from the applicant or proponents involved.

Stock Benefit Plans – Stock benefit plans, including stock options, stock warrants and other similar stock based compensation plans will be reviewed by the FDIC and must be fully disclosed to all potential subscribers. Participants in stock benefit plans may include incorporators, directors and officers. A description of any such plans proposed must be included in the application submitted to the appropriate regional director. The structure of stock benefit plans should encourage the continued involvement of the participants and serve as an incentive for the successful operation of the institution. Stock benefit plans should contain no feature that would encourage speculative or high-risk activities or serve as an obstacle to or otherwise impede the sale of additional stock to the general public. The following are the factors to use to evaluate stock benefit plans:

- The duration of rights granted should be limited and in no event should the exercise period exceed ten years;
- Rights granted should encourage the recipient to remain involved in the proposed depository institution
- Rights granted should not be transferable by the participant;
- The exercise price of stock rights shall not be less than the fair market value of the stock at the time that the rights are granted;
- Rights under the plan must be exercised or expire within a reasonable time after termination as an active officer, employee or director; and
- Stock benefit plans should contain a provision allowing the institution’s primary federal regulator to direct the institution to require plan participants to exercise or forfeit their stock rights if the institution’s capital falls below the minimum requirements, as determined by its state or primary federal regulator.

Stock benefit plans provided to directors and officers will be reviewed as part of the total compensation package offered to such individuals.

Stock benefit plans provided to incorporators will also be closely scrutinized. In reviewing such plans, the FDIC will consider the individual’s time, expertise, financial commitment and continuing involvement in the management of the proposed institution. The FDIC will also consider the amount and basis of any cash payments which will be made to the incorporator for services rendered or as a return on funds placed at risk. Plans to compensate incorporators that provide for more than one option or warrant for each share subscribed will generally be considered excessive. It is further expected that incorporators granted options or warrants at or near this level will actively participate in the management of the depository institution as an executive officer or director. On a case-by-case basis, the FDIC may not object to additional options being granted to an incorporator who will also be a senior executive officer.

The FDIC recognizes that there will be limited instances where individuals who substantially contribute to organization of a new depository institution do not intend to serve as an active officer or director after the institution opens for business. The FDIC will generally not object to awarding warrants or options to incorporators who agree to accept shares of stock in lieu of cash payment for funds placed at risk or for professional services rendered. In such instances, the FDIC defines funds placed at risk to include seed money actually paid into the organizational fund and the value of professional services rendered as the market value of legal, accounting and other professional services rendered. Generally, warrants or options for organizers who will not participate in the management of the institution will be considered excessive if the amount of options or warrants to be granted exceeds the number of shares of stock at risk and/or for professional services rendered. The granting of options to incorporators who guarantee loans to finance an institution's organization generally would not be objectionable, but options granted should be limited so that the market value of the stock subject to option does not exceed the amount of the loan guarantees (although guarantees exceeding the amount drawn or expected to be drawn will not be considered.) When continuing service is not contemplated, the FDIC will not require vesting or restrictions on transferability, but will review the duration of the rights, exercise price and exercise or forfeiture clauses in the same manner as discussed above.

In evaluating benefit and compensation plans for insiders, the FDIC will look to the substance of the proposal. Those proposals that are determined to be substantially stock based plans will be evaluated on the above stock benefit plan criteria. Stock appreciation rights and similar plans that include a cash payment to the recipient based directly on the market value of the depository institution's stock are unacceptable.

If the proposal involves the formation of a de novo holding company and a stock benefit plan is being proposed at the holding company level, that stock benefit plan will be reviewed by the FDIC in the same manner as a plan involving stock issued by the proposed depository institution.

Proponents should be made aware of the prohibition against interlocking management relations applicable to depository institutions (banks, savings and loan associations, mutual savings banks, and credit unions) and depository holding companies (banks, and savings and loan holding companies) contained in Title 11 of FIRIRCA and Part 348 of the FDIC's Rules and Regulations. The FDIC adheres to a fixed policy requiring that all applicants provide at least a five-member board of directors, even though the State law may, in some cases, permit a lesser number.

On the basis of the facts and considerations detailed in the report of investigation, examiners should state, and factually support to the greatest extent possible, their conclusions as to the management rating. A notation as to the type and amount of the insurance (fidelity, burglary, robbery, etc.) to be carried by the institution should be included in the report under the management heading. With respect to fidelity coverage, the FDIC's position is that applicants should subscribe to and maintain adequate coverage and have in force at all times a $1 million excess bank employee dishonesty bond, if primary blanket bond coverage is less than $1 million.

Applicants are expected to develop appropriate written investment, loan, funds management and liquidity policies. Establishment of an acceptable audit program is required for proposed depository institutions. Applicants are expected to commit the depository institution to obtain an audit by an independent public accountant for at least the first three years of operation.

An applicant bank or an applicant branch of a foreign bank that expects to operate an international loan department or conduct international lending and investment activities is expected to address country risk and related concentrations of credit with respect to these activities in their written policies. These factors should be segregated from other lending and investment risk criteria and addressed separately in the policies. Policy coverage should not be limited to just loans, but should also encompass securities, deposit balances, acceptances, and other activities that are expected to be included in the bank's or branch's operations. If an applicant does not intend to engage in such activity, they should specifically so state.

Risk Presented to the Insurance Fund - This factor is to be broadly interpreted and may be the most relevant in the unusual circumstance where none of the other factors is clearly identifiable as unfavorable. For example, "risk to the fund" might be resolved unfavorably and the application denied based on the applicant's unsound business plan even though all the other factors might be favorably resolved. The FDIC expects that an applicant will submit a business plan commensurate with the capabilities of its management and the financial commitment of the incorporators. Any significant deviation from the business plan within the first three years of operation must be reported by the insured depository institution to the primary federal regulator before consummation of the change. An applicant's business plan should demonstrate the following:

- Adequate policies, procedures, and management expertise to operate the proposed depository institution in a safe and sound manner;
- Ability to achieve a reasonable market share;
- Reasonable earnings prospects;
- Ability to attract and maintain adequate capital; and

- Responsiveness to community needs.

Operating plans that rely on high risk lending, a special purpose market, significant funding from other sources other than core deposits, or that otherwise diverge from conventional bank related financial services will require specific documentation as to the suitability of the proposed activities for an insured institution. Similarly, additional documentation of plans is required where markets to be entered are intensely competitive or economic conditions are marginal. Like a recommendation based on any other factor, an unfavorable finding based on "risk to the fund" must be clearly articulated.

Convenience and Needs of the Community to be Served - Generally, there is a presumptive indication of need if the directors or organizers of the applicant are a responsible group of persons willing and able to supply a substantial and adequate amount of money to back up their judgment, and if the management of the proposed institution is competent, honest, and familiar with the problems of the area to be served. However, consideration should be given to the adequacy of existing depository institution facilities in the community and in nearby rival communities, for a financial institution is unlikely to fulfill a need if it is unable to command sufficient volume to maintain profitable operations. In this connection, the Examiner should endeavor to ascertain whether or not the services rendered by existing depository institutions are satisfactory, and whether or not such institutions are meeting the legitimate credit needs of the community.

It should be noted that the provisions of the Community Reinvestment Act are especially relevant in evaluating this statutory factor.

In considering the question of need, it is important that the examiner not adopt the viewpoint of depository institutions located in the community, to the exclusion of other, equally persuasive viewpoints. As in the other lines of business, existing financial institutions may regard any new institutions as unnecessary and a potentially "harmful competitor". An unbiased conclusion in this connection requires impartial consideration of the opinions of the organizers of the applicant as well as those of the management of existing institutions. In addition, it is sometimes necessary to solicit the views of representative business and professional persons in the community, together with those of citizens of more modest means. The results of canvasses and surveys of local individual or business persons should be set forth in the report in order to assist in evaluating support for the proposed institution, the adequacy of present depository institution facilities, whether the legitimate banking needs of the community are being met, whether and to what extent the new facility would be used, and the knowledge these persons have of the proponents. In the final analysis, the value of any information so obtained will depend largely on the examiner's ability to discriminate between those views which proceed from intelligent and rational consideration of the real needs of the community and those which are mainly inspired by a false sense of community pride or selfish personal interest.

A clear definition of the proposed institution's trade area is essential in determining convenience and needs. A brief description of the general area in which the proposed institution is to be situated and its location in relation to other prominent nearby communities, developments, or other important landmarks should be initially presented. The primary trade area as described in the application should then be discussed along with an opinion as to the validity of the applicant's definition of the trade area. In some instances, the applicant may artificially draw its trade area boundaries so as to exclude factors which would be unfavorable to the proposal (nearby depository institutions, depressed areas, etc.) and include others which would increase the attractiveness of the proposed location (significant residential or commercial developments, highly concentrated population area, etc.). Any differences between the examiner's conception of the trade area and that of the proponents should be discussed fully in the report together with a description of the trade area as the examiner perceives it. Once the trade area has been defined, information regarding the following should be set forth.

The principal industrial, trade, or agricultural activity should be described and, if considered relevant, annual values of principal products indicated. The presence and source of large payrolls in the area may also be an important consideration. The number and value of residential and commercial building permits can often be of considerable value in determining the vitality of the area. Figures regarding retail sales from public sources or trade organizations are useful; however, if they are not available, it may be possible to obtain some estimates of volume in the course of conducting a survey of the locale's business establishments. Information regarding medical facilities and other professional services can be a useful indicator of the self- sufficiency of the community or trade area. Statistical information on governmental units such as; assessed valuations, tax levies, bonded indebtedness, and tax delinquencies, and data on the educational environment of the area are also valuable indicators. Reports of investigation should not, however, be filled with pages of statistics unless the figures are relevant.

Demographic figures within the trade area as well as the general surrounding areas are significant determinants in considering convenience and needs. While population as of the date of investigation is important, data which establishes population trends as well as projections for the future should be presented. In some cases it is difficult to obtain accurate population data for a particular trade area, as statistics combine portions of several census tracts. In some instances, data showing the number of household units in the area may be a more appropriate basis for assessing reasonable population estimates.

The examiner should assess the competitive dynamics of the proposed market and how the institution will compete for market share. Officials of area depository institutions should be contacted during the investigation and given an opportunity to express their attitudes on the proposal. Any formal objections to the proposal should be investigated and comments relative to discussions with the objector(s) set forth in the investigation report. The probable competitive effects of a new institution proposal should be fully weighed by the examiner. While the number of depository institutions operating in the city or area to be served is important in determining whether the addition of a new institution may result in an overbanked condition, consideration should also be given to possible procompetitive consequences flowing from the new institution proposal, such as increased customer services and banking options to residents of the area. Therefore, it is necessary to furnish complete factual data with respect to the probable impact of the proposal on existing financial institutions in the community.

The extent of new or proposed residential, commercial, and industrial development and construction is a significant secondary consideration in resolving the convenience and needs factor. Plans for the development of shopping centers, apartment complexes and other residential subdivisions, factories, or other major facilities near the proposed site should, therefore, receive comment. In certain instances, inclusion of maps may be desirable to clarify comments, showing location of competing depository institutions or branches, important buildings, offices, shopping centers, industrial parks, and the like in relation to the office site. As in the case of the "Future Earnings Prospects' factor, this portion of the investigation report is also available for public inspection under Part 303 of the FDIC's Rules and Regulations.

Consistency of Corporate Powers – Generally, the FDIC will presume that a proposed national bank’s or federal savings association’s corporate powers are consistent with the purposes of the Act. Pursuant to section 24 of the Act, no insured state bank may engage as principal in any type of activity that is not permissible for a national bank unless the FDIC has determined that the activity would pose no significant risk to the appropriate deposit insurance fund and the state bank is, and continues to be, in compliance with applicable capital standards prescribed by its primary federal regulator. Similarly, section 28 of the Act provides that a state chartered savings association may not engage in any type of activity that is not permissible for a federal savings association, unless the FDIC has determined that the activity would pose no significant risk to the affected deposit insurance fund and the savings association is and continues to be, in compliance with the capital standards for the association. Since the applicant will have agreed in its application not to exercise nonbanking powers whether granted by charter or statute, the examiner need only refer to this previously obtained agreement. Additional comments may be included if the terms of the agreement are not generally understood by the applicant or if they regard the agreement as being incomplete or amendment to the Articles of Association or Charter is necessary or desirable.

Miscellaneous - The existence of any conflicting applications to establish depository facilities in the immediate area should be indicated and receive appropriate comment in the examiner's report of investigation. If operation of a trust department is contemplated, applicant must also file with the FDIC the appropriate form covering "Application for Consent to Exercise Trust Powers". This form will provide much of the information necessary for the completion of the report of investigation with respect to this phase of the applicant's operations. If the proposed trust functions will materially affect the examiner's findings in making a recommendation on anyone of the seven factors contained in Section 6 of the Federal Deposit Insurance Act, it may be advisable to analyze the prospects for the operation of the commercial and trust departments under separate subheadings for any factor so affected.

If any of the documents essential for full consideration of the application have not been submitted to the FDIC, the proponents should be instructed to transmit such documents at the earliest practical date and a notation to that effect included in the report.

Statutory Factors, Existing Institutions

As indicated previously, the FDIC's admission criteria for proposed or newly organized institutions and for existing institutions are generally the same. Consequently, principles previously discussed in this section of the Manual are not repeated herein. Prior to processing applications for existing institutions for deposit insurance coverage, examiners should familiarize themselves not only with the following provisions but also those set forth under "Statutory Factors, Proposed or Newly Organized Institutions". In the case of an existing institution, the FDIC will conduct an examination of the ongoing institution or its predecessor institution and a report prepared on the regular printed FDIC form, with appropriate notation on the cover indicating the special purpose of the examination. Under Examiner's Comments and Conclusions of the Supervisory Section of the Report of Examination, the examiner is required to discuss separately each of the seven statutory factors.

Financial History and Condition - While the financial history of an operating institution is usually reflected in its present condition, the basic cause or causes for an institution's condition, whether satisfactory or unsatisfactory, should be analyzed and the reasons therefor ascertained. Accordingly, where the financial history of an operating institution has not been successful or is questionable, the FDIC generally requires reasonable assurance that the cause or causes of any past difficulties of a serious nature have in large measure either been overcome or ceased to exist.

Date of primary organization should be indicated. Another important feature in the financial history of an existing institution is its past attitude on the prompt recognition and current charge-off of losses and the administration of dividend policies. In addition, mergers, consolidations, recapitalizations, reorganizations, liability assumptions, deposit waivers, deposit deferments, and similar events, which are not recent, should be covered in the Report of Examination, but in less detail.

With respect to an operating institution's financial condition, the FDIC customarily requires that the general quality of its net assets be satisfactory and on a par with that of peer institutions. In appraising the value and quality of an applicant operating institution's assets, the same appraisal and classification procedures and criteria are to be followed as in regular FDIC examinations. The "Items Subject to Adverse Classification" as well as the "Items Listed for Special Mention" pages in the Report of Examination as well as the "Summary Analysis of Examination Report" (SAER) should include data on the quality of an institution's net assets. This information should be summarized in the "Examination Conclusions and Findings" under an appropriate caption. General comments on asset condition and problems should also be included, as well as a summary of "Violations of Laws and Regulations", contingent liabilities, existing litigation against the institution, dividend and remuneration policies, and other matters which could affect the institution's condition.

Adequacy of the Capital Structure - An existing institution applying for deposit insurance should have sufficient capital to support the volume, type, and character of its business, provide for losses, and meet the reasonable credit needs of the community which it serves. The process of determining the adequacy of an institution's existing capital as well as that after three years of operation (considering estimated deposit growth) begins with a qualitative evaluation of critical variables that directly bear on the institution's overall financial condition. These variables as well as all the principles set forth in the FDIC Statement of Policy on Capital (Appendix B to Part 325), are applicable here. The Statement, setting forth various levels for adjusted equity capital, only provides a benchmark for evaluating capital adequacy. Although it establishes uniform standards for capital levels among depository institutions regardless of size, the ratios set forth therein are, however, only starting points since such ratios are not in themselves determinative and must be integrated with all other relevant factors such as character of management, quality of assets, and so on. In the final analysis, each case must be judged on its own merits. It should be recognized that various State banking departments may impose more stringent capital requirements than those set forth in the FDIC Statement of Policy on Capital.

The Report of Examination should include some of the data necessary for determining whether the applicant's capital is adequate. The data should also be summarized and augmented in the Examiner's Conclusions and Recommendations of the Supervisory Section under the caption "Adequacy of Capital Structure". If for any reason a substantial increase in deposits is anticipated, or any plans of the applicant with respect to the institution's capital structure are contemplated, or if the proponents appear receptive to a request for supplying additional capital, it should be so indicated in the Report of Examination. It is desirable to include under this caption, or as a supplemental page to the Report of Examination, a complete or reasonably complete list of all shareholders, their holdings, and related interests.

Future Earnings Prospects - The earnings capability of an existing institution is reflected in its earnings record. Ordinarily, an operating institution's earnings record should indicate ability to pay all operating expenses with a safe margin for the absorption of losses and for the payment of reasonable dividends. For comparative purposes, current earnings ratios may be obtained from various data prepared by the FDIC. If earnings have not been sufficient, areas where income may be improved or expenses reduced should be noted. The principles described in the Earnings Section of this Manual are applicable here. The income and expense figures reflected in the Report of Examination are book figures. If the examiner regards these figures as incorrect or misleading because of improper accounting for unearned discounts, failure to charge off losses, failure to properly depreciate fixed assets, or similar deviations from accepted practices, the matter should be fully discussed in the presentation of earnings data in the Supervisory Section. The examiner should also comment on the effect deposit insurance coverage might have on the institution's income and expenses in the future.

General Character of Management - In the case of an existing institution, management may be evaluated both from the standpoint of the institution's condition and the vantage point of management's past performance as reflected in the books and records of the institution, previous Reports of Examination and correspondence from other regulators, and internal records, such as committee and board of directors' minutes. A management rating of "2" or better is necessary to satisfy the requirements of this statutory factor. The rating of management is discussed in the Management Supervision, Administration and Control Section of this Manual.

Complete information on management will be included in the report. In addition, a summary discussion of important aspects of this information, together with information on director and officer indebtedness to the institution, should be included under this caption in the "Examiner's Conclusions and Recommendations" of the Supervisory Section. If management is not regarded as warranting a rating of "2" or better, it should be indicated what changes are believed essential to warrant such a rating. Fidelity insurance on active officers and employees and other indemnity protection should receive comment to the extent necessary under this captioned statutory factor.

Risk Presented to the Insurance Fund - Analysis of this factor is the same as previously described for proposed new institutions.

Convenience and Needs of the Community - The FDIC's criteria under this statutory factor are closely related to those outlined with respect to the "Future Earnings Prospects" factor. A going institution which is being successfully and profitably operated, and which has a recognized place and established customer relationships in its community, is for self-evident reasons convenient to and fulfilling the needs of the community it serves. An institution may, however, have had inferior earnings in the past and nevertheless qualify under this statutory factor. Any pertinent information with respect to local economic conditions, population trends, or unusual circumstances which have affected or may affect the community and the applicant should be commented on under this caption. It should be noted that the provisions of the Community Reinvestment Act are relevant in evaluating this statutory factor.

Consistency of Corporate Powers - Nonbanking powers and certain saving associations activities, other than trust powers, are regarded by the FDIC as inconsistent with the purposes of the Act. In some states, institutions have been granted the right under their charters or by statute to engage in certain nonbanking activities. Section 24 of the Act limits the powers of insured state banks and section 28 of the Act limits the powers of state chartered savings associations. If the institution is exercising any powers not authorized under the applicable statute, the application should contain an agreement and plan for eliminating the activity as soon as possible, or a separate application should be submitted seeking the FDIC’s consent to continue the activity.

Miscellaneous - If the applicant operates a trust department, an examination will be conducted and a Report of Examination compiled. The examiner should consider the condition and the prospects of the trust department in developing the conclusion for each factor enumerated under Section 6 of the Act. Should trust department operations be of sufficient influence in the final determination of the examiner's findings on any of the factors, it may be advisable to analyze the commercial and the trust operations under appropriate subheadings. The examiner should indicate the number of tellers' windows at which insured deposits will be received. If any of the documents essential for full consideration of the application have not been submitted to the FDIC, the proponents should be instructed to transmit such documents at the earliest practical date and a notation to that effect included in the report.

Examiners should indicate in their reports the sources of information on significant points covered in their comments. During the examination, the examiner should review reports of examination of other supervisory authorities and correspondence from these authorities.

Deposit Insurance Applications from Proposed Publicly Owned Depository Institutions

An application for deposit insurance from a depository institution which would be owned or controlled by a domestic governmental entity (such as, for example, a state, county or a municipality) will be reviewed very closely. The FDIC is of the opinion that due to their public ownership, such depository institutions present unique supervisory concerns that do not exist with privately owned depository institutions. For example, because of the ultimate control by the political process, such institutions could raise special concerns relating to management stability, their business purpose, and their ability and willingness to raise capital. On the other hand, such institutions may be particularly likely to meet the convenience and need of their local community, particularly if the local community is currently un- or under- served by depository institutions.

APPLICATIONS TO ESTABLISH A BRANCH OR TO MOVE MAIN OFFICE OR BRANCH

Provisions of Law

Under the provisions of Section 18(d) of the Federal Deposit Insurance Act (the "Act"), no State nonmember insured bank may establish and operate any new branch, or change the location of any existing branch, or move its main office, unless it obtains the prior written consent of the FDIC. The factors to be considered in granting or withholding such consent are those enumerated in Section 6 of the Act. Also included in Section 18(d) of the Act, no state nonmember insured bank shall establish or operate any foreign branch, except with the prior written consent of the FDIC. There are further restrictions detailed below concerning either establishment or relocation of branches in states other than the applicant's home state. Subpart C of Part 303 of the FDIC's Rules and Regulations governs the administrative handling of applications to establish a branch or to relocate an office.

Filing Procedures for Branch Applications

In applying to establish a branch or to relocate an existing office, State nonmember insured banks must file an application in letter form with the FDIC. A complete letter application shall include:
(1) a statement of intent to establish a branch or to relocate the main office or a branch;
(2) the exact location of the proposed site including the street address; and
(3) details concerning any involvement in the proposal by an insider of the bank;
(4) a statement on the impact of the proposal on the human environment, including information on compliance with the provisions of the NEPA (National Environmental Protection Act);
(5) a statement as to whether or not the site is eligible for inclusion in the National Register of Historic Places for purposes of complying with the applicable portions of NHPA (National Historic Preservation Act);
(6) comments on any changes in services to be offered, the community to be served, or any other effect the proposal may have on the applicant's compliance with the Community Reinvestment Act;
(7) a copy of each newspaper publication required; and
(8) when an application is submitted to relocate the main office of the applicant from one state to another, a statement of the applicant's intent regarding retention of branches in the state where the main office exists prior to relocation.

Expedited processing per Part 303 is available for eligible depository institutions. For those applications which are not processed pursuant to the expedited procedures, preliminary consideration will be given in the Regional Office to applications to determine whether an examination of the applicant bank should be ordered. In all cases, however, a Summary of Investigation Form for Branch Applications will be completed. Please refer to the Case Managers Procedures Manual for additional processing and filing information.

Interstate Banking Branch Applications

For applications to establish a de novo branch that is not in the applicant's home state and in which the applicant does not already maintain a branch, the application must comply with the state's filing requirements. The FDIC needs to determine that the applicant is adequately capitalized as of the date of the filing and will continue to be adequately capitalized and adequately managed upon consummation of the transaction; and confirmation that the host state has a law permitting state "opt-in" elections to enable interstate branching, pursuant to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

For applications where the applicant already has one or more existing branches in a state other than the applicant's home state, a determination needs to be made that the application has not failed the host state's credit needs test and that it is reasonably helping to meet the credit needs of the communities which the branches serve.

Other Considerations for Branch Applications

As in the case of applications for deposit insurance, the provisions of the Community Reinvestment Act, the National Historic Preservation Act, and the National Environmental Policy Act of 1969, must be favorably resolved.

APPLICATIONS FOR CONSENT TO EXERCISE TRUST POWERS

Introduction

1. FDIC Section 333

The FDIC does not grant trust powers, but only gives its consent to exercise such powers as granted by state authorities. Section 333.2 of the FDIC's Rules and Regulations prohibits an insured state nonmember bank from changing the general character of its business without the FDIC's prior written consent. The test to determine when a change in character of business has occurred is left to the discretion of the FDIC. For trust powers, this normally occurs when a fiduciary relationship is created under the laws of the governing state authority. Therefore, it is general policy that unless a bank is exempted through the circumstances described in the Background section below, it must file a formal application with the FDIC to obtain prior written consent before it may exercise trust powers. It should also be noted that the statute applies only to banks. Separately chartered and capitalized uninsured trust company subsidiaries of banks need not apply for FDIC consent to exercise trust powers.

2. Background

In 1958 the FDIC articulated its basis for requiring consent to exercise trust powers (refer to page C-41 of the FDIC Trust Examination Manual), and established conditions for grandfathering consent. Banks granted trust powers by state statute or charter prior to December 1, 1950, regardless of whether or not such powers have ever been exercised, are not required to file an application with the FDIC for consent to exercise trust powers. Such consent is grandfathered with the approval for Federal deposit insurance.

Banks approved for Federal deposit insurance after December 1, 1950, are required to file an application to exercise trust powers, unless such filing was made simultaneously with the application for Federal deposit insurance.

3. Applications for Consent

Part 303 of the FDIC's Rules and Regulations governs the administrative handling of applications for consent to exercise trust powers. Application procedures are set forth in both Part 303 and the Case Managers Procedures Manual. Banks eligible for expedited processing under Part 303 (as defined therein) may file an abbreviated application. Application forms for both expedited and non-expedited processing are available at Regional Offices. Applications are reviewed in the context of the financial institution's ability to satisfactorily perform trust activities. In reviewing any such application, the statutory factors set forth in Section 6 of the Federal Deposit Insurance Act are also considered. Other factors which examiners should be aware of include:

a. Statement of Principles of Trust Department Management

The FDIC's "Statement of Principles of Trust Department Management" outlines minimum requirements for the sound operation of a trust department. Before final approval of any application for consent to exercise trust powers may be given, the applicant's board of directors is required to adopt the minimum requirements set forth in the "Statement".

b. Management Adequacy

To approve any application for consent to exercise trust powers, it must be concluded that management of the contemplated trust operation is capable. By adopting the "Statement of Principles of Trust Department Management", the applicant bank resolves to provide sufficient staff and facilities to meet minimum standards of competency in trust matters. Applications submitted for consent to exercise full trust powers by banks having inexperienced trust management, or management which is considered incapable of administering trust activities other than routine matters, should not be approved. Such applications should not be accepted for processing, but returned to the bank for resubmission at a later time. Where limited powers will suffice, the bank should be encouraged to amend its application for specified limited powers. Otherwise, the board of directors should be requested to seek qualified trust management if it wishes to obtain consent to exercise full trust powers. Nevertheless, Regional Directors may, when warranted, approve an application conditioned on the bank's hiring of qualified trust management which is acceptable to the FDIC.

c. Limited Trust Powers

Banks will sometimes be granted limited trust powers, usually confined to a few specific functions such as agent for employee benefit accounts, guardian of the property of minors, or capacities not requiring extensive expertise. In processing an application for consent to exercise limited trust powers, applicants should be required to specify the exact functions to be performed. At
examinations of banks having limited trust powers, the examiner should determine that only authorized activities are being performed.

d. Unauthorized Trust Activities

Commercial banks may be found performing fiduciary services without having obtained full or limited trust powers, or the FDIC’s consent to exercise such powers. In these cases, the examiner should determine what services are being performed, and review all written customer agreements. If a bank is acting in any capacity requiring trust powers, the examiner should:

(1) cite a violation of state law for performing fiduciary services without trust powers (if applicable);
(2) cite a violation of FDIC Section 333.2 for changing the character of its business without the FDIC's prior written consent;
(3) advise management:
(a) it must discontinue accepting any additional appointments;
(b) it should (upon advice of counsel) discontinue performing fiduciary services, if it can do so without jeopardizing its accounts or incurring additional liability upon itself;
(c) that it must apply to its state authority for trust powers (if applicable); and
(d) that it must also apply to the FDIC for consent to exercise the powers.

If a bank is acting in an agency capacity, the examiner should make a determination of the bank's duties and responsibilities.

Particular attention should be given to the degree of discretionary authority exercised. It should also be determined whether the bank is required to manage the assets, or to simply hold them subject to customer direction. If the bank's duties are those which require trust powers, the examiner should follow the procedures outlined in the preceding paragraph. Applications for consent to exercise trust powers subsequent to the discovery of unauthorized activities do not merit expedited processing. Such applications warrant consideration for approval subject to prior written conditions with management.

e. "Customer Service" versus "Fiduciary Activity"

It is not unusual for a bank to hold securities, notes, mortgages, or similar instruments in a "Customer Collections" department, collecting income and remitting it to customers. This could be considered a normal banking function not requiring trust powers. However, there have been instances where banks have entered into arrangements to make investment recommendations, buy and sell securities on their own authority, vote proxies, and otherwise deal with securities in the manner of a fiduciary. Banks have also entered into discretionary arrangements to execute repurchase agreements, or make other short-term investments using demand deposit accounts to settle transactions. Some escrow departments may hold, manage, rent, or otherwise administer real property in a manner, which reaches beyond conventional escrow relationships. All these activities constitute discretionary agencies typically requiring trust powers. Normally, the most important determining factor is the degree of discretionary authority exercised over funds and assets, with resulting exposure to contingent liabilities. Questionable cases should be submitted by the examiner to the Regional Office for determination.

f. Additional Information

Whether or not additional information is necessary to approve or recommend denial of an application for consent to exercise trust powers, is generally left to the discretion of the Regional Director. Additional information may be obtained by correspondence, telephone, or personal visit. Matters, which may be relevant in considering applications which, are not eligible for expedited processing include:

(1) Competition - If the lack of sufficient trust services in the trade area is of importance in determining a recommendation, competitive information should be secured from the Annual Report of Trust Assets of area banks.

(2) Trust Business Development - The size and scope of the proposed operation may be influenced considerably by the extent to which the applicant plans to use advertising, personal solicitation, and other public relations activities.

(3) Amount and Kind of Property and Potential Volume of Business - The sources of such data will vary. Any information as to trade area demographics, and the types of assets or property by which it is principally represented would, in some instances, prove beneficial.

(4) Deposit Structure - If collateral benefits to the bank, such as a substantial volume of new deposits in the banking department, are anticipated from the establishment of trust services, the bank may be required to provide full details. Caution is suggested in allowing too much weight in consideration for claims of collateral benefits, as these are often short-lived while the obligations of the trust services continue.

(5) Fixed Assets - If establishment of the trust department results in a significant increase in an already heavy fixed asset investment, full details should be requested.

(6) Deposit Insurance - As noted in FDIC Section 330.12, depending on the institution's Prompt Corrective Action capital category, pass-through deposit insurance may not be available on deposits of retirement and

employee benefit plans. This applies to deposits, which may obviously be made in the bank without regard to whether it has trust powers.

However, the likelihood of such deposits being made increases when banks acquire trust powers. The applicability of this section to applicants seeking consent should be ascertained. To the extent that deposits of such plans exist in the bank, or are contemplated, and pass-through deposit insurance is not available, care should be taken to ensure that procedures in both Parts 325 (Capital Maintenance) and 330 (Deposit Insurance Coverage) are being followed, and that corrective plans are in place.

C. CORPORATE STRUCTURE AND ORGANIZATION OF FIDUCIARY ACTIVITIES

1. General

The offering of trust services has long been regarded as an ancillary customer service, primarily the dominion of banks. However, toward the end of the twentieth century a number of forces have combined, with the result that fiduciary services are a dynamic and sought-after product line with significant profit potential. In the U. S., population trends have been a significant factor as the large post-World War II "baby boom" generation matures and accumulates wealth. The large size and consumer influence of this group has created much emphasis on wealth management and transfer. While this has presented trust service providers with more opportunity, it has also attracted competition from banking and non-banking industries. New delivery systems, new products, advances in technology, and consolidation within the financial industry, have all contributed to changes in how banks offer trust services. To properly evaluate these delivery systems the examiner needs an understanding of both the legal and functional organization of the bank's trust services.

The trust department, as a separate and visually distinct department of the bank, remains the most prevalent method for banks to deliver fiduciary services. However, the recent trend toward consolidation within the financial services sector has led to diverse restructuring and merger activity. In some instances, banks previously lacking trust product lines may have acquired them through mergers. In other cases, the "trust" line of business may have been purchased or sold by a bank. In some cases, trust services being provided by several individual banks owned by the same holding company may have been consolidated within one bank, or within a separately chartered trust company. In still other instances, a bank may have contracted with an unrelated outside party, to provide such services on-premises. Or conversely, the bank under examination may provide such services to other banks. In all cases, the examiner should seek to understand the organization, and review the structure of the delivery system for legality, reasonableness, and adequacy of compensation to the bank.

CHANGE IN BANK CONTROL ACT

Introduction

The Change in Bank Control Act of 1978, Title VI of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, amended Section 7(j) of the Federal Deposit Insurance Act. The amendments gave Federal banking agencies authority to disapprove changes in control of insured banks and bank holding companies. The appropriate agencies for changes in control are: the FDIC for insured nonmember banks, The Board of Governors of the Federal Reserve System for member banks and bank holding companies, the Comptroller of the Currency for national banks, and the Director of the Office of Thrift Supervision for savings associations and savings and loan holding companies. Previous reporting requirements relating to loans by banks secured by stock of other banks and management changes occurring after a change in control were retained with some modification and these requirements were extended to bank holding companies and loans secured by bank holding company stock. The FDIC's objectives in its administration of the Change in Bank Control Act are to enhance and maintain public confidence in the banking system by preventing identifiable serious adverse effects resulting from anticompetitive combinations of interest, inadequate financial support, and unsuitable management in these institutions. The FDIC will review each notice to acquire control of an insured State nonmember bank and disapprove transactions likely to have serious harmful effects.

Provisions of Law

Section 7(j) of the FDI Act; Subpart E, Section 303.80 of the FDIC's Rules and Regulations and the FDIC Statement of Policy, "Changes in Control in Nonmember Banks," set forth in detail all necessary requisites and instructions.

Procedures

Any person (broadly defined) seeking to acquire control (power to vote 25% or more of any class of voting securities) of any insured bank or bank holding company, is required to provide sixty days prior written notice to the appropriate agency. A person means an individual or a corporation, partnership, trust, association, joint venture, pool, syndicate, sole proprietorship, unincorporated organization, or any other form of entity. A Notice of Acquisition of Control form is required to be filed with the appropriate Regional Office, accompanied by a completed and signed Financial Report and Biographical Information form for each of the acquiring parties to the extent known. Certain newspaper publication requirements are also required as indicated in Part 303.

The FDIC reviews the information reported in a Notice to assess any anticompetitive or monopolistic effects of the proposed acquisition, to determine if the financial condition of any acquiring person is such as might jeopardize the financial stability of the bank or prejudice the interests of the depositors of the bank, and to determine whether the competence, experience, or integrity of any inquiring person, or any of the proposed management personnel, indicates that it would not be in the interest of the depositors of the bank, or in the interests of the public, to permit such person to control the bank.

While processing and handling of Notices may parallel the procedures related to applications for deposit insurance, new branches, relocations, etc., at least one fundamental difference is present. In the case of statutory applications, the burden of making a case in support of a proposal falls on the applicant; in considering Notices, the FDIC exercises a veto, with a burden of sustaining a disapproval falling on the FDIC. Accordingly, in evaluating Notices, the FDIC need not find favorably on the various factors; the absence of unfavorable findings approximates tacit approval.

Regional Directors are delegated, with certain exceptions, authority to issue a written notice of the FDIC's intent not to disapprove an acquisition of control. Authority to disapprove has been delegated to the Director and Deputy Director (DOS) and where confirmed in writing by the Director to an associate director. If written views of the State authority recommend disapproval, or if an acquiring party discloses a conviction or a plea of no contest to a criminal charge involving dishonesty or breach of trust, the Regional Director makes a recommendation to Washington based on the findings under the factors.

The factors considered in evaluating Notices and the basis for disapproval are, in brief: whether the proposed acquisition of control would result in a monopoly; whether the effect the proposed acquisition of control in any section of the country may be substantially to lessen competition or to tend to create a monopoly, or would in any other manner be in restraint of trade; the financial condition of the acquiring party and its potential impact on the financial stability of the bank or prejudice the interests of depositors; the competence, experience or integrity of any acquiring person or proposed management; if any acquiring party neglects, fails, or refuses to furnish all the information required by the FDIC; or the effect on the Bank Insurance Fund or Savings Association Insurance Fund is adverse.

A transaction triggering the notice requirements may not result in the acquiring party actually gaining effective control of an institution. For example, a person acquiring 25% of voting control would not gain effective control if there were an existing shareholder with 50% of voting control. Nonetheless, the transaction triggers the notice requirement and a Notice should be evaluated as if it were an actual change in effective control. After once complying, further acquisitions by the same person in the same bank do not require filing of notices. An acquiring party who continuously remains within the definition of control needs to file only one notice per bank to be in compliance.

Certain types of transactions are exempt from prior notice requirements, such as those subject to Section 3 of the Bank Holding Company Act, Section 10 of the Home Owner's Loan Act, or Section 18 of the FDI Act, since they are covered by existing regulatory approval procedures. Accordingly, changes in control due to acquisitions by bank holding companies and those resulting from mergers, consolidations, or other similar transactions are not covered. Acquisition of shares of foreign banks are exempt, however, foreign banks with insured domestic branches are subject to the after-the-fact reporting requirements. Transactions resulting in voting control of 10% or more of any class of voting securities of banks whose securities are subject to the regulation requirements of Part 335 of the FDIC's Rules and Regulations are presumed to be acquisitions of control as are similar transactions of unregistered banks resulting in 10% or more control whereby the acquiring party would become the largest shareholder. These latter two are rebuttable presumptions of control. In addition, the following types of transactions are also exempt: a foreclosure of a debt previously contracted in good faith; testate or intestate successions; a bona fide gift; and; a transaction described in Section 2(a)(5) or 3(a)(5)(A) or (B) of the Bank Holding Company Act by a person there described.

Persons acquiring control by exempt transactions while not required to give prior notice, are required to provide after-the-fact information on the transaction and other information regarding changes in management or policies of the bank. Personal financial and biographical information may be requested subsequent to changes in control of these types at the discretion of the Regional Director. Affected banks are required to report changes or replacement of chief executive officers or directors occurring within twelve months after change in control, including a statement of the past and current business and professional affiliations of the new chief executive officer or director.

Section 7(j) of the FDI Act also requires the chief executive officer of an insured bank that makes a loan secured or to be secured by 25% or more of the voting stock of another insured bank to report the facts to the appropriate regulatory agency. No report need be made where the stock is that of a newly organized bank prior to its opening. Through the definition of insured bank, the reporting requirement is extended to include loans secured by bank holding company stock.

Effective enforcement of Section 7(j) of the FDI Act requires examiners to review stockholder ledgers and records and review correspondence files to determine whether any nonexempt stock transactions have occurred which would constitute an acquisition of control, whether prior notice has been provided to the FDIC where required, and, if bank management has complied with the after-the-fact reporting requirements relating to bank stock loan reports and changes or replacement of the chief executive or directors. Review of stockholder records must be conducted with particular attention to the statutory definition of control, including the presumptions of control established in Part 303 of the FDIC's Rules and Regulations. All substantial change in ownership transactions between examinations should be reviewed, however, a relatively small transaction may trigger the notice requirements and the statutory definition of control does not necessarily imply effective control. Examiners should also be alert to the formation of voting trusts, assignments of proxies of duration beyond the customary annual meeting solicitations, and other similar arrangements which effectively transfer voting control and which may require prior notice. The statute and implementing regulations do not elaborate on what constitutes a group acting in concert. A series of transactions which are individually insignificant, but significant when aggregated, may indicate a subterfuge, particularly if the individuals or entities involved have other business or professional relationships. Consultation with the Regional Office would appear prudent should such a situation of this type be encountered.

Apparent violations regarding acquisitions consummated without filing of a prior notice should be communicated to the Regional Office by telephone and reported in the Supervisory Section of the Report of Examination. Apparent violations for failure to comply with the after-the-fact reporting requirements should be detailed in the open section of the report under Violations of Laws and Regulations since civil money penalties may be invoked (refer to the Civil Money Penalties Section of this Manual).

APPLICATIONS FOR RETIREMENT OF CAPITAL

Introduction

Refer to the current FDIC Statement of Policy on Capital in the Capital Section of this Manual. Section 303.241 of the FDIC Rules and Regulations contains the procedures to be followed when an institution seeks the FDIC’s prior approval to reduce the amount or retire any part of its common or preferred stock, or to retire any part of its capital notes or debentures.

There is concern that approval of a request to retire subordinated notes by a bank which is in danger of failure may in effect be granting preferred creditor status to the note holder. Consequently, unless a bank is in a condition which indicates it might fail within a reasonable time, the Regional Director should exercise delegated authority and approve the request.

Applicants should submit a letter application containing the following: type and amount of the proposed change to the capital structure and the reason for the change; a schedule detailing the present and proposed capital structure; the time period that the proposal will encompass; if the proposal involves a series of transactions affecting Tier 1 capital components which will be consummated in twelve months or less, the application shall certify that the insured depository institution will maintain itself as a well-capitalized institution as defined in Part 325 of the FDIC Rules and Regulations, both before and after each of the proposed transactions; if the proposal involves the repurchase of capital instruments, the amount of the repurchase price and the basis for establishing the fair market value of the repurchase price; a statement that the proposal will be available to all holders of a particular class of outstanding capital instruments on an equal basis, and if not, the details of any restrictions; and the date that the applicant’s board of directors approved the proposal. Expedited processing is available for eligible depository institutions as defined in Part 303.

Adequacy of the remaining capital is the chief factor considered in acting upon applications for capital retirement or reduction. In granting or withholding consent, the FDIC must consider the six statutory factors: the financial history and condition of the bank; the adequacy of its capital structure; its future earnings prospects; the general character of its management; the convenience and needs of the community to be served and whether or not its corporate powers are consistent with the purposes of the FDI Act.

Section 18(i) of the FDI Act deals specifically with the subject of capital retirement. The FDIC's Legal Division has ruled that the provisions of this section also apply to capital retirements or reductions relative to the following: retirements or reductions which are part of another proposal for which a current application has been filed for FDIC approval; conversion of capital notes or debentures to an equivalent amount of common stock or preferred stock; conversion of preferred stock to an equivalent amount of common stock; and repurchase and retention by a bank of its own capital as part of a stock option plan.

Capital Notes and Debentures

Insured State nonmember banks customarily seek the FDIC's consent to retire subordinated notes or debentures at the time of proposed issuance of such obligations. The Legal Division is of the opinion that where a replacement of capital issues is clearly of a formalistic nature only, without an effective reduction in the amount of the bank's capital and with no change to the governing terms and conditions of the instruments themselves, the replacement should not be deemed to come within Section 18(i)(1) of the FDI Act.

All new subordinated note and debenture agreements must contain a statement to the effect that the prior consent of the FDIC is required before any portion of the debt can be retired. The purpose of including the statement is to assure that all parties involved, including future holders of the notes, are aware of the requirements of Section 18(i)(1). Where periodic mandatory payments are required, the agreement and the notes may include the additional statement that these particular mandatory payments have already been consented to by the FDIC, if such advance consent has, in fact, been given.

APPLICATIONS FOR MERGERS

Introduction

It is the policy of the FDIC to preserve the soundness of the banking system and promote market structures conducive to competition. A proposed merger, consolidation, and purchase of assets and assumption of liabilities are all hereafter referred to collectively as "mergers."

Provisions of Law

Section 18(c) of the FDI Act (the "Act"), popularly known as the Bank Merger Act, provides that, except with the prior written approval of the FDIC, no insured depository institution may merge with any other insured depository institution, if the acquiring, assuming or resulting institution is to be a nonmember insured bank. The section also requires approval before an insured depository institution may merge with a noninsured bank or institution. The section contains special provisions for interstate merger transactions. These are subject to section 44 of the FDI Act. In addition, the FDIC will consider in evaluating merger applications the requirements of the Community Reinvestment Act. The factors to be considered in granting or withholding approval are those enumerated in Section 18(c) of the "Act". Subpart D of Part 303 of the FDIC Rules and Regulations governs the administrative handling of "merger" applications.

Paragraph (4) of Section 18(c) of the "Act" provides that, before acting on an application, the FDIC must request reports on the competitive factors involved from the Attorney General, the Comptroller of the Currency and the Board of Governors of the Federal Reserve System. These reports must ordinarily be furnished within 30 days, and the applicant will, if it so requests, be given an opportunity to submit comments to the FDIC respecting the contents of the competitive factor reports.

Paragraph (5) of Section 18(c) prohibits the FDIC from approving anticompetitive mergers. To establish that any anticompetitive effect is clearly outweighed in the public interest, the proponents must show that probable effect of the transaction in meeting convenience and needs is likely to benefit all seekers of banking services in the areas of competitive impact, rather than merely those who seek, for example, large loan and trust services, and that the expected benefit cannot reasonably be achieved through other, less anticompetitive means. The statute also requires the FDIC to consider in every case the financial and managerial resources, future prospects of the existing and proposed institutions, as well as the convenience and needs of the community to be served.

Under Section 8(q) of the "Act," whenever the liabilities of an insured depository institution are assumed by another insured depository institution; the insured status of the institution whose liabilities are assumed terminates on the date of receipt by the FDIC of satisfactory evidence of the assumptions, and separate insurance of all assumed deposits terminates at the end of six months from the date the assumption takes effect or, in the case of any time deposit, the earliest maturity after the sixth-month period.

Branch closings in connection with a merger transaction are subject to the notice requirements of Section 42 of the FDI Act, including requirements of notification to customers.

Statement of Policy - Bank Merger Transactions

The FDIC Statement of Policy on Bank Merger Transactions was revised effective October 1, 1998. The FDIC is prohibited by law from approving any merger that would tend to create or result in a monopoly, or which would further a combination, conspiracy or attempt to monopolize the business of banking in any part of the United States. Similarly, the FDIC may not approve a transaction whose effect in any section of the country may be to lessen competition substantially, or which in any other manner would be in restraint of trade. The FDIC may, however, approve any such transaction if it finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by its probable effect in meeting the convenience and needs of the community to be served, for example, where approval of the merger may prevent the probable failure of one of the banks involved. In every case, the FDIC must also consider the financial and management resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served.

In evaluating the various factors prescribed and making the necessary judgments on proposed merger transactions, it is the intent and purpose of the FDIC to foster and maintain a safe, efficient and competitive banking system that meets the needs of all elements of the communities served. With these broad goals in mind, the FDIC will apply the specific standards listed in the Policy Statement in evaluating and deciding proposed bank merger transactions.

Procedures

Banks seeking the FDIC's consent to engage in a merger transaction must file a formal application with the FDIC on the appropriate form. The FDIC will not take final action on an application until notice of the proposed transaction is published in a newspaper or newspapers of general circulation in the appropriate community or communities, in accordance with the requirements of Section 303.65 of the FDIC's Rules and Regulations.

Section 303.64 of the FDIC Rules and Regulations provides for expedited processing to eligible applications. In evaluating a merger application, the FDIC considers the following factors: the extent of existing competition between and among the merging institutions, other depository institutions, and other providers of similar or equivalent services in the relevant product markets within the relevant geographic markets. In its analysis of the competitive effects of a proposed merger transactions, the FDIC will focus particularly on the type and extent of competition that exists and that will be eliminated, reduced or enhanced by the proposed merger transaction.

In order to determine the effect of the proposed merger on competition, it is necessary to identify the relevant geographic market. The delineation of such market can seldom be precise, but realistic limits should be established so the effect of the merger upon competition can be properly analyzed. The FDIC recognizes that different banking services may have different relevant geographic markets. However, the market should not be drawn so expansively as to cause the competitive effect of the merger to seem insignificant. Conversely, the market should not be drawn so narrowly as to place competitors in entirely different markets. After the relevant geographic market has been identified, the competitive effect of the proposed merger can be analyzed. A merger not having a substantially adverse competitive effect may nevertheless be disapproved if, after considering the banking factors, the FDIC concludes that the resultant bank will have inadequate capital, unsatisfactory management, or poor earnings prospects. Refer to the policy statement for further competitive effects analytical explanation.

In addition to the competitive analysis, the FDIC will consider prudential factors. These include the existing institutions overall condition, including capital, management and earnings. Apart from competitive considerations, the FDIC normally will not approve a proposed merger transaction where the resulting institution would fail to meet existing capital standards, continue with weak or unsatisfactory management, or whose earnings prospects, both in terms of quantity and quality are weak, suspect or doubtful. In assessing capital adequacy and earnings prospects, particular attention will be paid to the adequacy of the allowance for loan and lease losses. In evaluating management, the FDIC will rely to a great extent on the supervisory histories of the institutions involved and of the executive officers and directors that are proposed for the resultant institution.

The Convenience and Needs factor is also evaluated. Under this factor, the FDIC will consider the extent to which the proposed merger transaction is likely to benefit the general public through higher lending limits, new or expanded services, reduced prices, increased convenience in utilizing the services and facilities of the resulting institution, or other means. The FDIC, as required by the Community Reinvestment Act, will also note and consider each institution's CRA performance evaluation record. An unsatisfactory record may form the basis for denial or conditional approval of an application.

The commitment to pay or payment of unreasonable or excessive fees and other expenses incident to an application reflects adversely upon the management of the applicant institution. The FDIC will closely review expenses for professional or other services rendered by present or prospective board members, major shareholders or other insiders for any indication of self-dealing to the detriment of the institution. As a matter of practice, the FDIC expects full disclosure to all directors and shareholders of any arrangement with an insider. In no case will the FDIC approve an application where the payment of a fee, in whole or part, is contingent upon any act or forbearance by the FDIC or by any other federal or state agency or official.

Where banking offices are to be closed in connection with the proposed merger transaction, the FDIC will review the merging institution's conformance to any applicable requirements of section 42 of the FDI Act concerning notice of branch closing as reflected in the interagency Policy Statement Concerning Branch Closing Notices and Policies. Although the appropriate application must be filed with the FDIC and statutory factors are considered in the case of "interim" (mergers or other transactions involving an existing bank and a newly chartered bank or corporation for the purpose of corporate reorganization) and other corporate reorganizations (transactions involving banks controlled by the same holding company or transactions involving banks or their subsidiaries), these types of transactions normally do not have any effect on competition or otherwise have significance under relevant statutory standards set forth in Section 18(c) of the FDI Act. The guidelines set forth above for "mergers" have only general applicability and may have no applicability depending on the specific circumstances involved in individual transactions.

APPLICATIONS BY UNDERCAPITALIZED DEPOSITORY INSTITUTIONS FOR A WAIVER TO ACCEPT, RENEW OR ROLLOVER BROKERED DEPOSITS

Provisions of Law

Section 224 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 added Section 29 to the FDI Act, prohibiting the acceptance, renewal or rollover of brokered deposits by any undercapitalized insured depository institution (bank or savings association) except on specific application to and waiver of the prohibition by the FDIC.

Section 337.6 of the FDIC's Rules and Regulations provides guidance and detail on when an institution is considered undercapitalized, when certain deposits are considered "brokered" for purposes of the prohibition, and the circumstances under which a waiver from the prohibition may be obtained. Section 303.243 contains the procedures to follow to file with the FDIC for a brokered deposit waiver. Expedited processing of these filings is extended to eligible depository institutions with the caveat that for purposes of this filing, eligible depository institutions may be adequately capitalized, according to the definition found in Section 325.103 of the FDIC's Rules and Regulations, rather than well-capitalized as is required for other filings.

The regulation takes a broad view of when an institution is considered undercapitalized and a narrow view of the circumstances under which a waiver may be obtained with the result and expectation that such institutions will not accept new brokered deposits and over some reasonable time frame all undercapitalized depository institutions utilizing brokered deposits will have to either meet applicable capital standards or eliminate brokered deposits from their books.

Procedures

Undercapitalized insured depository institutions may file waiver applications under section 337.6 with the Regional Office where they are headquartered. Institutions may apply for a waiver in letter form or on an optional application form. Applications should contain: the time period for which the waiver is requested, a statement of the policy governing the use of brokered deposits in the institution's overall funding and liquidity management program; the volume, rates and maturities of the brokered deposits held currently and anticipated during the waiver period sought, including any internal limits placed on the terms, solicitation and use of brokered deposits; how brokered deposits are costed and compared to other funding alternatives and how they are used in the institution's lending and investment activities, including a detailed discussion of asset growth plans; procedures and practices used to solicit brokered deposits, including an identification of the principal sources of such deposits; management systems overseeing the solicitation, acceptance and use of brokered deposits; a recent consolidated financial statement with balance sheet and income statements; and the reasons the institution believes its acceptance, renewal or rollover of brokered deposits would pose no undue risk.

Authority is delegated to Regional Directors or Deputy Regional Directors to approve or deny brokered deposit waiver applications. Based upon a preliminary review, any delegate may grant a temporary waiver for a short period in order to facilitate the orderly processing of a filing for a waiver. A waiver should be for a fixed period, generally no longer than two years, and may be revoked by the FDIC at any time by written notice to the institution.

POLICY STATEMENT ON ENCOURAGEMENT AND PRESERVATION OF MINORITY OWNERSHIP OF FINANCIAL INSTITUTIONS

Introduction

In recognition of the unique status of minority-owned depository institutions in the financial system, it is the policy of the DOS to proactively preserve minority ownership of financial institutions and to encourage minority participation in the management of financial institutions. This policy is intended to be consistent with the FDIC's broader mission of preserving the soundness of the banking system and promoting fair market structures conducive to competition and community service.

For the purposes of this policy statement, the term minority-owned institution means an FDIC-insured depository institution where more than 50% of the voting stock is owned or controlled by minority individuals or organizations, or in the case of a mutual depository institution, the majority of the Board of Directors, account holders and the community which it serves are members of a minority group. The term "minority" means any Black American, Native American, Hispanic American, or Asian American.

Statutory Requirements

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) contains several provisions relating to the preservation of minority ownership of financial institutions. These statutes provide a framework for this policy statement.

Section 13(k) of the FDI Act deals with emergency acquisitions of distressed savings associations. Section 13(k)(2)(B) addresses the acquisition of minority-controlled depository institutions by stating: "the FDIC shall seek an offer from other minority-controlled depository institutions before seeking an offer from other persons or entities.

Section 13(f)(12) of the FDI Act eliminates the $500,000,000 asset cut-off for acquisition of a distressed minority-controlled bank by an out-of-state minority-controlled depository institution or depository institution holding company.

Section 308 of FIRREA sets goals to preserve minority ownership of financial institutions. These goals are set out as:

1. Preserving the number of minority depository institutions;
2. Preserving the minority character in cases of merger or acquisition;
3. Providing technical assistance to prevent insolvency of institutions not now insolvent;
4. Promoting and encouraging creation of new depository institutions; and
5. Providing for training, technical assistance, and education programs.

Discussion

The Division of Supervision becomes involved in the creation of new minority ownership through its responsibility for acting on applications for federal deposit insurance and mergers and reviewing notices of acquisition of control. For those minority applicants who are not familiar with the required laws, procedures or forms, technical expertise and assistance should be made available through DOS Regional Offices.

One very effective method of preserving minority ownership is to maintain the health of existing minority-owned depository institutions. In this regard, DOS is committed to a program of regular examination of all banks for which it has primary supervisory responsibility. This examination program is intended to detect deteriorating trends and to work with management to correct them. Correction of any adverse trends in institutions normally is handled through regular supervisory channels. In the event that management is unable to effect correction because of a lack of resources or technical expertise, DOS will provide assistance where practical. Additionally, DOS encourages other depository institutions to be available to provide technical expertise to minority-owned institutions.

Training, education and technical assistance are available through the FDIC in such areas as call report preparation, consumer affairs and civil rights, and accounting. FDIC personnel generally are available for attendance at conferences or seminars dealing with issues of concern to minority groups.

Procedures and Related Matters

Applications - Notices of acquisition of control and applications for deposit insurance and merger from minority-owned institutions will be submitted to the appropriate regional office and processed under established procedures. Those applications which involve creation or preservation of minority ownership also will be considered in the context of the effect of the transaction on the goal of preserving minority ownership. Technical assistance in the completion of the documentation of these applications is available upon request from the regional office.

Operating Institutions in Need of Assistance - Through its normal supervision, the FDIC will be aware of institutions in need of remedial or preventative attention. Field examiners and regional office staff will make suggestions and offer assistance, which an institution is free to accept. Institutions are also urged to make their needs known to the Regional Director who will do all they can to help. To the extent possible, the FDIC will consider invitations to participate in seminars, conferences and workshops directed to minority audiences.

Request for Financial Assistance - Requests from minority groups for assistance in resolving a failing minority-owned depository institution will be considered at the same time as assistance requests or failing bank bids received from non-minority groups; however, preference generally will be given to a minority group proposal. Technical assistance in preparing these applications is available upon request.

Failing Banks - In the event a minority-owned bank deteriorates into a failing condition, a list of eligible bidders is compiled. Generally, preference will be given to qualified minority bidders located 1) in the same local market area, 2) in the same state, and 3) nationwide. Trade associations will be contacted for names of possible interested parties which may be contacted. Groups interested in becoming bidders must have appropriate clearance from other responsible regulatory agencies.

APPLICATIONS PURSUANT TO SECTION 19 OF THE FDI ACT – CRIMES INVOLVING DISHONESTY OR BREACH OF TRUST OR MONEY LAUNDERING, OR PRETRIAL DIVERSION PROGRAMS FOR SUCH OFFENSES

Provisions of Law

Section 19 of the FDI Act prohibits, without the prior written consent of the FDIC, a person convicted of any criminal offense involving dishonesty, breach of trust, money laundering, or who has agreed to enter into a pretrial diversion or similar program for such offense, from becoming or continuing as an institution-affiliated party, owning or controlling, directly or indirectly an insured depository institution, or otherwise participating, directly or indirectly, in the conduct of the affairs of an insured institution.

Section 19 imposes a duty upon the insured institution to make a reasonable inquiry regarding an applicant’s history, which consists of taking steps appropriate under the circumstances, consistent with applicable law, to avoid hiring or permitting participation in its affairs by a person who has a conviction or program entry for a covered offense. The FDIC believes that, at a minimum, each insured institution should establish a screening process that provides the insured institution with information concerning any convictions or program entry pertaining to a job applicant. This would include, for example, the completion of a written employment application (although other alternatives may be appropriate) that requires a list of all convictions and program entries. The FDIC will look to the circumstances of each situation to determine whether the inquiry is reasonable.

Upon notice of a conviction or program entry, the institution should obtain forms and instructions from, and file an application with, the appropriate FDIC Regional Director. The application must be filed by an insured depository institution on behalf of a person, unless the FDIC grants a waiver of that requirement. The FDIC will consider such waivers on a case-by-case basis where the institution shows substantial good cause for granting a waiver.

The above information represents a partial summary of the requirements of Section 19. For definitions of terms and additional guidance, examiners should refer to the FDIC Statement of Policy on Section 19 of the FDI Act.

Examiner Responsibilities

Examiners should review conformance with the FDIC Statement of Policy for Section 19 of the FDI Act during examinations of institutions where risk-scoping activities indicate a material degree of risk with respect to this area. The scope or depth of these reviews should comply with the guidelines detailed in the risk-focused supervision examination modules.

APPLICATIONS PURSUANT TO PART 362 OF THE FDIC's RULES AND REGULATIONS – ACTIVITIES AND INVESTMENTS OF INSURED DEPOSITORY INSTITUIONS

Revised Part 362 and related amendments to Part 303 became effective January 1, 1999. The revised rule provides the framework for which certain state-chartered banks or their majority-owned subsidiaries may engage in activities that are not permissible for national banks or their subsidiaries. The institution's chartering authority must permit all contemplated activities.

Under Part 362, well-capitalized, state-chartered banks or their subsidiaries may engage in certain otherwise impermissible activities without seeking specific FDIC consent if the bank complies with any limits or conditions restricting those activities. Other activities require depository institutions to submit either a notice or application to the FDIC.

The notice procedure is designed to expedite the processing of requests from banks meeting various eligibility requirements. Activities to which notice processing has been extended include securities underwriting and real estate investment activities.

OTHER APPLICATIONS

Subpart F of Part 303 – Change of Director or Senior Executive Officer

Insured state nonmember banks are to give the FDIC written notice at least 30 days prior to adding or replacing any member of its board of directors, employing any person as a senior executive officer of the bank, or changing the responsibilities of any senior executive officer so that the person would assume a different senior executive officer position if:
(1) The bank is not in compliance with all minimum capital requirements applicable to the bank
(2) The bank is in troubled condition, or
(3) The FDIC determines, in connection with its review of a capital restoration plan that such notice is appropriate

Waivers to the pre-filing requirement may be applied for and granted if delay would threaten the safety or soundness of the bank or not be in the public interest. In the case of the election of a new director not proposed by management at a meeting of the shareholders, the prior 30-day notice is automatically waived provided that a complete notice is filed with the appropriate regional director within two business days after the individual's election.

Subpart I – Mutual-to-Stock Conversions

An insured state chartered mutually owned savings bank that proposes to convert from mutual to stock form shall file with the FDIC a notice of intent to convert to stock form.

At a minimum, such notice shall contain:
- The plan of conversion with specific information concerning the record date used for determining eligible depositors and the subscription offering priority;
- Certified board resolutions relating to the conversion;
- A business plan including a discussion of how the capital acquired in the conversion will be used, expected earnings for at least a three year period following the conversion and a justification for any proposed stock repurchase;
- The charter and bylaws of the converted institution
- The bylaws and operating plans of any other entities formed in connection with the conversion transaction such as a holding company or charitable foundation;
- A full appraisal report, prepared by an independent appraiser of the value of the converting institution and the pricing of the stock to be sold in the conversion transaction;
- Detailed descriptions of any proposed management or employee stock benefit plans or employment agreements and a discussion of the rationale for the level of benefits proposed;
- Indemnification agreements;
- A preliminary proxy statement and sample proxy;
- Offering circular(s);
- All contracts or agreements relating to solicitation, underwriting, market-making or listing of conversion stock and any agreements among members of a group regarding the purchase of unsubscribed shares;
- A tax opinion concerning the federal income tax consequences of the proposed conversion;
- Consent from experts to use their opinions as part of the notice; and
- An estimate of conversion-related expenses.

The FDIC shall review the notice and other materials for considerations such as: the proposed use of the proceeds, the adequacy of the disclosure materials, the participation of depositors in approving the transaction, the appropriateness of any proposed increased compensation and other remuneration to be granted to officers and directors, the adequacy and independence of the appraisal of the value of the mutual savings bank for purposes of determining the price of the shares of stock to be sold and the extent to which the proposed conversion transaction conforms with the various provisions of the mutual-to-stock conversion regulations of the Office of Thrift Supervision.

The FDIC will issue either a letter of non-objection if the FDIC determines that the proposed conversion transaction would not pose a risk to the institution's safety or soundness, or a letter of objection. In the latter case, if the FDIC determines either that the proposed conversion transaction poses a risk to the institution's safety or soundness, violates a law or regulation, or presents a breach of fiduciary duty, the objection letter would instruct the institution not to consummate the transaction until such point as the objection letter is rescinded.

Other Filings

Golden Parachute and severance plan payments – Pursuant to section 18(k) of the FDI Act and Part 359 of the FDIC Rules and Regulations, an insured depository institution or depository institution holding company may not make golden parachute payments or excess nondiscriminatory severance plan payments unless permission is obtained.

For additional information and guidance on the various applications, please also refer to:

- The Division of Supervision and Consumer Affairs **Formal and Informal Action Procedures Manual**, and
- The Division of Supervision and Consumer Protection **Case Managers Procedures Manual**.

INFORMAL ACTIONS

INTRODUCTION

Regulatory agencies may use formal or informal procedures to address weak operating practices, deteriorating financial conditions, or apparent violations of laws or regulations. A memorandum of understanding (MOU) is a common informal agreement used by the FDIC to obtain a commitment from a bank's board of directors to implement corrective measures. Other informal actions include board resolutions, letter agreements, and other forms of bilateral agreements or unilateral actions. Informal actions are not public information or legally enforceable. A financial institution's failure to implement the corrective measures detailed in an informal agreement may lead to formal corrective actions.

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MEMORANDUMS OF UNDERSTANDING

An MOU provides a structured way to correct problems at institutions that have moderate weaknesses, but have not deteriorated to a point requiring formal corrective actions. An MOU may be appropriate if examiners (after discussing examination findings with field- and regional-office personnel and the bank), determine that the board of directors and management are committed to, and capable of, implementing effective corrective measures.

An MOU may be used to address specific problems at institutions rated 1 or 2 and should, at a minimum, be considered for all institutions rated 3. An MOU may not be required at an institution rated 3 if the regional director or designee determines that the institution's financial condition improved significantly or that there are other strong mitigating circumstances. For example, a weak management team may have been replaced by a strong management team, or an acceptable action by a state authority might make an MOU unnecessary. However, the mere belief that management recognized its errors and will improve the bank's condition is generally not a sufficient reason to make an exception.

Examiners should consider recommending formal enforcement action pursuant to Section 8 of the Federal Deposit Insurance (FDI) Act for institutions rated 3 if management appears unwilling to take appropriate corrective measures, and for all composite 4- or 5-rated institutions.

Memorandum Considerations

When determining whether to seek an informal (or formal) action, examiners should consider:

- Management's attitude towards complying with laws and regulations and correcting undesirable or objectionable practices;
- Whether violations or objectionable practices were intentional, repetitive, substantive, or numerous;
- The institution's history of violations and unsatisfactory practices;
- Management's history of instituting timely remedial or corrective actions;
- Whether management already initiated corrective actions;
- Whether management established procedures to prevent future deficiencies or violations;
- The extent of harm caused, or likely to be caused, by the violations or unsatisfactory practices; and
- Any other circumstances that warrant use of an informal action.

Issuing Memorandums

Examiners considering the use of an MOU should contact their supervisory examiner, field supervisor, or regional reviewer (in accordance with regional policy) to discuss the possibility of issuing an MOU. When an institution is affiliated with a bank or holding company supervised by another federal regulatory agency, the regional reviewer should notify the agency of the proposed action. In all instances, state authorities should be notified of, and invited to join, proposed actions.

If an MOU is deemed appropriate, the examiner should draft a memorandum to the regional director recommending the MOU and detailing areas that the MOU should address. The examiner's memorandum to the regional director should include:

- A brief description of the examination findings, and
- Detailed recommendations for addressing each significant concern.

With the concurrence of the regional office, the examiner (and when appropriate, regional- or field-office representatives) should discuss the possible use of an MOU with management and the board at the exit and board meetings. Also, with regional- or field-office concurrence, the examiner should explain that the FDIC might consider implementing other actions if the MOU does not result in effective corrective actions.

Monitoring Compliance with Memorandums

Monitoring an institution's progress in achieving the goals of an outstanding MOU may involve offsite monitoring, visitations, and examinations. Examiners should reflect the adequacy of an institution's response to an MOU in the Management rating.

Examiners should include a summary of outstanding MOUs in the Examination Conclusions and Comments section of the Report of Examinations (ROE). Examiners should detail action provisions and the status of compliance with the provisions on the Compliance with Enforcement Actions page. Examiners should describe each provision and the status of compliance at the first examination after the issuance of an administrative action. At subsequent examinations, examiners may summarize provisions and only address requirements of a continuing nature and items that the institution had not complied with at the previous examination.

Examiner comments should sufficiently detail the institution's actions or inactions so readers can draw meaningful conclusions concerning the extent of compliance. Examiners should not use broad statements of opinion such as "compliance is noted," or "not in compliance." Comments should factually describe corrective efforts and indicate whether or not agreed upon time limits have expired. As part of this analysis, examiners should also determine the underlying reasons for an institution's failure to meet provisions of the MOU or improve the bank's condition over a reasonable time frame, and discuss with the Regional Office whether new or revised provisions, or a formal action, would be appropriate.

Terminating Memorandums

Outstanding MOUs should be terminated promptly when:

- The institution has substantially complied with the terms of the MOU,
- The institution's condition has improved sufficiently and the action is no longer necessary,
- A new formal or informal action is issued that addresses all areas of concern, or
- The institution is merged or closed.

Regional office personnel should coordinate the termination of an MOU with any involved state or other federal authority.

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SECTION 39

Section 39 of the FDI Act requires federal banking agencies to prescribe various standards for insured depository institutions. Section 39 allows the FDIC to request corrective plans from financial institutions that do not meet the standards, which are set forth in Part 364 and the interagency guidelines in Appendix A and Appendix B to Part 364. The standards provide financial institutions guidelines for overseeing activities relating to risk management and daily operations. Section 39 also provides banking agencies a tool to address weak risk management practices or operating weaknesses in otherwise financially sound institutions before deficiencies lead to capital deterioration. The standards relate to issues such as:

- Internal controls, information systems, and internal audit systems;
- Loan documentation and credit underwriting;
- Interest rate exposure;
- Asset growth;
- Compensation, fees, and benefits; and
- Other operational and managerial matters.

Section 39 also provides a tool for the banking agencies to address weak risk management practices or operating weaknesses in otherwise financially sound institutions before deficiencies lead to capital deterioration.

If an institution fails to meet these standards, the FDIC may pursue informal action under Section 39 by requesting management to submit a Safety and Soundness Compliance Plan. The plan must describe the steps the institution will take to correct identified deficiencies and the time frames for completing the steps.

If an institution fails to submit a requested plan or fails to adhere to a submitted plan, the FDIC will pursue formal enforcement action. Procedures for requesting submission of a compliance plan and issuing an enforceable order pursuant to Section 39 are detailed in Subpart R to Part 308 of the FDIC Rules and Regulations.

Examiners considering whether to request a Section 39 plan should contact their case manager to discuss the appropriateness of the request. If regional management determines supervisory action pursuant to Section 39 is warranted, examiners should submit a recommendation memorandum to their regional director.

Note: Examiners and regional directors must exercise care to avoid requesting compliance plans if identified problems are correctable through standard examination practices.

References:
- Manual Section 15.1, Formal Administrative Actions
- Manual Section 16.1, ROE Instructions
- Statement of Policy - Interagency Notification and Coordination of Enforcement Actions by the Federal Banking Regulatory Agencies

CIVIL MONEY PENALTIES Section 14.1

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INTRODUCTION

Section 8(i)(2) of the Federal Deposit Insurance Act (FDI Act) authorizes the FDIC to issue civil money penalties (CMPs) against insured depository institutions (IDI) and institution-affiliated parties (IAPs).

CMPs are assessed to punish violators and to deter future violations. Penalties are based on the severity of a violation and the culpability of the involved party and can be assessed for each day actionable misconduct is outstanding. In determining the amount of CMPs to assess, the FDIC considers the gravity of the violation, the history of previous violations, the financial resources and good faith of the IDI or IAP, and other pertinent matters. Maximum penalty amounts are based on a three-tier system that is adjusted annually for inflation.[1]

The FDIC may assess CMPs against any IDI or IAP for actions or inactions, such as:

- Violating a law or regulation,
- Violating a temporary or final order issued,
- Violating a written agreement between an IDI and the FDIC,
- Violating a condition imposed in writing by the FDIC in connection with the approval of an application,
- Recklessly engaging in an unsafe or unsound practice, and
- Breaching fiduciary duty.

For example, CMPs have been assessed for violations involving:

- Changes in bank control,
- Final cease and desist (C&D) orders,
- Section 23A of the Federal Reserve Act (loans to affiliates),
- Section 22(h) of the Federal Reserve Act (loans to directors, officers, and principal stockholders),
- Section 106(b) of the Bank Holding Company Act (tying arrangements – official family loans and linked correspondent accounts).

Violations

Violation is defined as “any action (alone or with another) for or towards causing, bringing about, participating in, counseling, or aiding or abetting a violation." See 12 U.S.C. 1813(v). The definition is purposely broad and covers a range of misconduct.

Institution-Affiliated Party

An IAP[2] is:

- Any director, officer, employee or controlling shareholder (other than a bank holding company or a savings and loan holding company) of an IDI;
- Any person who has filed or is required to file a change-in-control;
- Any shareholder, consultant, joint venture partner, or other person who participates in the IDI’s affairs; or
- Any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in violations of law or regulation, breaches of fiduciary duty, or unsafe or unsound practices, which caused, or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the IDI.

Fiduciary Duty

Fiduciary duty requires one party to act in the best interest of another and generally involves accepting responsibility for managing and protecting the money or assets of another individual or entity. For example, bank officers and directors have a fiduciary duty to protect the bank’s assets, further the best interests of the bank, and not place their personal interests above those of the bank.

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ASSESSMENT OF CIVIL MONEY PENALTIES

Although relevant to the FDIC’s interests, the primary purpose for assessing CMPs is not to effect remedial action. Such action, in the form of restitution or other corrective measures, should be pursued separately.

In 1998, the FDIC adopted the *Interagency Policy Regarding the Assessment of Civil Money Penalties by the Federal Financial Institutions Regulatory Agencies* (Policy Statement). The Policy Statement specifies 13 factors (13 Factors) that regulatory agencies should consider in determining whether, and in what amount, CMPs should be assessed. The 13 Factors identified as relevant are:

1. Evidence that the violation, practice, or breach of fiduciary duty was intentional or committed with a disregard of the law or of the consequences to the IDI;
2. The duration and frequency of the violations, practices, or breaches of fiduciary duty;

[1] Refer to the Federal Civil Penalties Inflation Adjustment Act Improvements Act of 2015 and Part 308 of the FDIC Rules and Regulations.

[2] See Section 3(u) of the Federal Deposit Insurance Act for the complete definition of an IAP.

3. The continuation of the violations, practices, or breach of fiduciary duty after the respondent was notified or, alternatively, its immediate cessation and correction;
4. The failure to cooperate with the agency in effecting early resolution of the problem;
5. Evidence of concealment of the violation, practice, or breach of fiduciary duty or, alternatively, voluntary disclosure of the violation, practice, or breach of fiduciary duty;
6. Any threat of loss, actual loss, or other harm to the IDI, including harm to the public confidence in the IDI, and the degree of such harm;
7. Evidence that a participant or his or her associates received financial gain or other benefit as a result of the violation, practice, or breach of fiduciary duty;
8. Evidence of any restitution paid by a participant of losses resulting from the violation, practice, or breach of fiduciary duty;
9. History of prior violation, practice, or breach of fiduciary duty, particularly where they are similar to the actions under consideration;
10. Previous criticism of the IDI or individual for similar actions;
11. Presence or absence of a compliance program and its effectiveness;
12. Tendency to engage in violations of law, unsafe or unsound banking practices, or breaches of fiduciary duty; and
13. The existence of agreements, commitments orders, or conditions imposed in writing intended to prevent the violation, practice, or breach of fiduciary duty.

A recommendation to assess CMPs should be initiated when one or more of the following criteria are present:

- The violation, practice, or breach causes substantial harm to depositors or to an IDI;
- The violation, practice, or breach is willful, flagrant, or otherwise evidences bad faith on the part of the bank or the IAP (e.g., repeated or multiple violations);
- The violation, practice, or breach directly or indirectly involves an IAP, associate, or related interest who receives material or substantial benefit from the activity;
- Weaknesses exist in the IDI's third-party oversight that causes harm to consumers or the institution;
- The IDI intentionally or repeatedly misreports or fails to report government monitoring information (such as Call Reports or Y-14s) relied upon by government agencies or, where required by law, fails to implement systems to ensure the reporting or accuracy of this data; or
- Previous supervisory means (e.g., Memorandum of Understanding or C&D order) have not been effective in eliminating or deterring a violation, practice, or breach.

Anti-Money Laundering/Countering the Financing of Terrorism Considerations

In addition to the criteria listed above, a recommendation for the assessment of a CMP against an IDI or IAP should be considered in Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) cases when one or more of the following criteria are present:

- A violation or practice potentially exposes the IDI to money laundering or other illicit financial activity or caused substantial harm to public confidence in the IDI;
- A violation or practice is willful, flagrant, or demonstrates bad faith on the part of an IDI or IAP (e.g., repeated or multiple violations);
- Previous AML/CFT formal or informal enforcement actions (e.g., Board Resolution, Memorandum of Understanding, or C&D) have been ineffective in eliminating or deterring a violation, pattern, or practice;
- The IDI has a violation of the AML/CFT Compliance Program and a history of noncompliance with laws and regulations; or
- The IDI fails to maintain a satisfactory AML/CFT Compliance Program, which may include uncorrected component (also referred to as pillar) violations.

Considerations Involving Restitution

When a violation, practice, or breach committed by an IAP results in personal financial or economic gain or financial loss to the bank and the statutory factors are met, restitution in lieu of or in addition to a CMP should be considered. If the bank suffered a loss, the willingness and promptness in making restitution should have a bearing on the amount of penalty recommended. Where an IAP is willing to consent to a restitution order, but lacks financial resources to reasonably pay both restitution and a CMP, the FDIC generally favors payment of restitution to the bank. Where restitution is not applicable and the IAP's profits or gains can be verified and traced to the IAP's misconduct, the FDIC favors assessing the total amount of the benefit. This amount is in addition to the recommended penalty amount derived from the applicable CMP matrix,[3] as long as the total amount does not exceed the statutory maximum.

[3] The FDIC uses various matrices (e.g., Individual, Institution, and AML/CFT) to determine CMP amounts and to ensure consistent application of the 13 Factors outlined in the Policy Statement. See the Formal and Informal Enforcement Actions Manual, Chapter 9 – Restitution and Civil Money Penalties.

Penalty Tiers

The maximum penalty amounts for each CMP tier are detailed in Section 308.132 of the FDIC Rules and Regulations. The Federal Civil Penalties Inflation Adjustment Act Improvements Act of 2015 requires the FDIC to annually adjust the maximum amount of each CMP within its jurisdiction. By January 15 of each calendar year, the FDIC will publish notice in the Federal Register of the maximum penalties that may be assessed after January 15. When recommending or assessing a CMP, staff should review the most recent notice to ensure that the CMP amount recommended or assessed reflects the most recent inflation adjusted CMP amounts.

Tier 1 – An IDI or IAP may be assessed Tier 1 level CMPs for a violation of law or regulation, a final or temporary order, a condition imposed in writing in connection with granting of an application or other request by an IDI, or any written agreement between an IDI and the FDIC.

Tier 2 – An IDI or IAP may be assessed Tier 2 level CMPs for a violation listed under Tier 1, or recklessly engaging in an unsafe or unsound practice or breach of fiduciary duty if the violation, practice, or breach is part of a pattern of misconduct, causes or is likely to cause more than minimal loss to the IDI, or results in a financial gain or otherwise benefits the IAP.

Tier 3 – An IDI or IAP may be assessed Tier 3 level CMPs for knowingly committing violations, practices, or breaches listed under Tier 1 or 2 CMPs and knowingly or recklessly causing substantial loss to an IDI or substantial financial gain or other benefit to an IAP.

Penalty Recommendations

To determine an appropriate penalty amount, each case must be considered on its own merits in light of applicable laws and factors discussed in the Policy Statement. In no case should the penalty amount assessed exceed the maximum amount allowed. In some cases, the amount suggested in applicable guidance may be so large as to be considered unreasonable, and the penalty should be tempered through judgment as to the seriousness of the violation.

In determining the amount of a CMP, the FDIC must consider the financial resources and good faith of the IDI or IAP, the gravity of the violation, the history of previous violations, and other matters as justice may require. An IDI's or IAP's lack of financial resources may result in a recommended CMP amount below that which would otherwise appear appropriate. Consideration should also be given relative to whether the IDI or IAP cooperates throughout the proceedings, provides an explanation that does not show malice or intentional disregard, voluntarily makes restitution, and helps regulatory agencies or law enforcement in the investigation. A determination that the violation, practice, or breach was particularly egregious or that the IDI or IAP was directly involved in causing the violation or benefited from it should generally result in a larger recommended penalty.

Other Corrective Procedures

When the assessment of a CMP is not considered appropriate, corrective action may be sought by means of a supervisory letter sent by the regional office to the bank's board of directors. The letter should request adoption of a resolution indicating the directorate's intent to correct the violation, practice, or breach and advise the bank of the importance of implementing procedures to prevent future infractions. Supervisory letters may also recommend that the bank seek reimbursement for any loss. Supervisory letters may also be issued to IAPs. The IDI or IAP should be advised to notify the regional director when and how the violation, practice, or breach has been remedied. An insufficient response from the bank or IAP to the regional office on the issues covered in the supervisory letter may constitute grounds for recommending more severe enforcement action, including CMPs, related to the original violation, practice, or breach.

With regard to a violation of a final C&D order or an issued capital directive, a recommendation may be made, at the discretion of the regional director, for court enforcement under Section 8(i)(1) of the FDI Act, initiation of assessment of a CMP, as authorized, or both. The determination should be based on which recommendation appears to be most appropriate for the given situation, will most likely result in correction of deficiencies, and will achieve the FDIC's objectives.

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EXAMINATION PROCEDURES

Examiners should consider the following procedures when violations of laws or regulations are encountered and CMPs are contemplated:

- When violations are encountered, promptly consult with the field and regional offices.
- Complete a CMP matrix[4] when violations, unsafe or unsound banking practices, or breaches of fiduciary duty are discovered and CMPs are considered.

[4] The CMP matrices can be accessed through Chapter 9 of the Formal and Informal Enforcement Actions Manual.

- If the FDIC is considering a CMP based on a violation, and the maximum Tier 1 CMP does not adequately reflect the seriousness of the misconduct, then examiners should discuss with regional counsel whether a Tier 2 or Tier 3 CMP may be appropriate and whether the Tier 2 or Tier 3 elements may be satisfied.
- Generally, comments in the Report of Examination (ROE) should not reference potential CMPs, the FDIC's power to impose CMPs, or the maximum dollar amount of CMPs that may be imposed.
- Fully discuss violations of law with management, but do not initiate discussions about CMPs or advise management in any way that CMPs will, or may, be recommended. If management raises any issue regarding CMPs:
    - Inform the board or management that violations of law may be subject to CMPs; and
    - Only discuss the general process and criteria used by the FDIC to determine whether to recommend CMPs.
- When CMPs against IAPs are contemplated, the home mailing address for all directors and, to the extent possible, any other individuals involved in a violation should be included in the Confidential Section of the ROE.
- When a violation involves financial gain to an insider or financial loss to the bank (in most instances, the insider's gain will be the bank's loss), attempt to determine a monetary value. If the amount cannot be quantified, estimate the amount and include it in the violation write-up in the ROE along with the method of calculation. If the monetary value cannot be estimated with any degree of confidence, state this and include the reason why.
- Consult with the regional office to determine the supporting evidence needed in connection with citing an apparent violation where a CMP is contemplated. Consult regional counsel regarding the determination of the apparent violation and sufficiency of evidence.[5]
- Copy evidence in support of a likely action, segregate it from regular workpapers, and retain it in conformance with established procedures for accessing, transporting, storing, and disposing of sensitive electronic and paper information.

Examiners should forward recommendations for assessing CMPs to the regional office. Examiners must not discuss or otherwise communicate CMP recommendation(s) or potential recommendation(s) to the IDI or any IAP.

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OTHER CONSIDERATIONS

State Reports of Examination

If a state ROE cites a violation for which prompt action appears warranted, the regional office should schedule a visitation. The assigned examiner should investigate the violation and, if appropriate, gather sufficient documentation to support a CMP recommendation and, if appropriate, request for restitution. If a flagrant violation does not appear to be involved, regional management may postpone an investigation until the next scheduled FDIC examination or visitation. The FDIC prefers to use FDIC findings of a violation to support a CMP recommendation or request for restitution, but may use a state ROE when appropriate.

Equal Access to Justice Act

Examiners involved in enforcement cases, including for CMPs or restitution, should be mindful that such actions are covered under the Equal Access to Justice Act and Part 308, Subpart P of the FDIC Rules and Regulations. The Act provides that certain parties who prevail in contested administrative or judicial proceedings against an agency of the federal government may be able to recover their litigation expenses from the agency if the position of the agency was not substantially justified. Examiners should use special care not to write-up or cite any practice or violation on inadequate grounds that will be the basis for charges. Examiners should also be mindful that Confidential Section comments in the ROE likely would be a matter of record at any required hearing. Comments and observations in the Confidential Section must be accurate and well-supported, which can help them to withstand cross-examination in a hearing.

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GENERAL GUIDELINES FOR USING THE CMP MATRICES

The CMP matrices contain factors that assist in determining whether it is appropriate to initiate a CMP assessment. Use of the matrices supports the appropriateness and amount of CMPs and the consistent application of the 13 Factors.

The Matrices and factors are provided solely as guides. They do not replace sound supervisory judgment or reduce the CMP process to a mathematical equation.

[5] In certain instances, the FDIC may pursue a CMP for a violation even if a CMP was not originally contemplated by the examiners.

Examiners should complete the CMP Matrices based on the facts and circumstances of each particular case. Completed matrices must fully support and properly document all assigned scores in a recommendation memorandum. Generally, examiners should use the following guidelines in determining how many matrices to complete:

- One matrix should be used per person for all violations, reckless unsafe and unsound practices, or breaches of fiduciary duty. When there are multiple violations, practices, or breaches of duty addressed in one matrix, the highest severity level applicable to any of the violations, practices, or breaches of duty should be recorded for each factor on the matrix.

  For example, if a single director approved a loan in violation of Regulation O and another loan in violation of state lending limitations, and engaged in reckless unsafe practices, only one matrix should be completed for that director, with the highest severity level applicable to either of the violations and any of the unsafe practices recorded for each matrix factor.

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INTRODUCTION

Examiners must initiate corrective measures promptly if they identify excessive risks at financial institutions. Generally, examiners can use examination comments and supervisory recommendations or informal agreements to correct problems. However, various statutes and regulations authorize the FDIC to use formal enforcement actions, when necessary, to reduce risks and address deficiencies. This chapter discusses some of the main statutes and regulations that authorize formal actions, such as:

- Sections 8, 38, and 39 of the Federal Deposit Insurance (FDI) Act; and
- Part 324 of the FDIC Rules and Regulations.

Section 8 of the FDI Act provides the FDIC's Board of Directors (FDIC's Board) with broad enforcement powers. The FDIC's Board has the power to:

- Terminate deposit insurance - Section 8(a),
- Issue cease and desist orders - Section 8(b),
- Invoke temporary (effective upon service) cease and desist orders - Section 8(c),
- Remove institution-affiliated parties (IAPs) or prohibit their participation in institution affairs - Sections 8(e) and (g),
- Assess Civil Money Penalties (CMP) – Section 8(i),
- Issue orders to cease and desist from violating certain anti-money laundering regulations - Section 8(s), and
- Terminate deposit insurance for certain money laundering offenses - Section 8(w).

Section 38 of the FDI Act and various sections of Part 324 of the FDIC Rules and Regulations authorize the FDIC to take prompt corrective actions (PCA) against institutions that fail to maintain certain capital levels.

Section 39 of the FDI Act authorizes the FDIC to take formal actions if an institution fails to submit and implement, upon FDIC request, an acceptable plan to achieve compliance with safety and soundness standards.

Authorizations

The FDIC's Board has authority to implement various formal actions and has delegated to various levels within the Division of Risk Management Supervision (RMS), the authority to implement other actions. Parts 303 and 308 of the FDIC Rules and Regulations detail various rules and procedures relating to various types of formal actions.

Ratings

Formal action is generally initiated against an IDI with a composite rating of "4" or "5" if there is evidence of unsafe or unsound practices and/or conditions or concern over a high volume or severity of violations at the institution. However, initiation of formal action is not limited to these cases and may be justified in other situations as well, such as financially sound institutions with significant violations in their Anti-Money Laundering/Countering the Financing of Terrorism programs. Such formal action normally consists of an order to cease and desist under Section 8(b), and may also include an order of removal or prohibition against an IAP under Section 8(e), as well potential orders for restitution or orders to pay CMPs against an IDI or IAP under Section 8(b)(6) or 8(i). Under rare circumstances, formal actions may consist of a temporary cease and desist order under Section 8(c) or initiation of insurance termination proceedings under Section 8(a). Exceptions to the policy may be considered when the condition of the institution clearly reflects significant improvement resulting from an effective corrective program or where individual circumstances strongly mitigate against formal action.

Section 8(b) of the FDI Act authorizes the FDIC to deem that a state nonmember bank is engaging in unsafe or unsound practice if the institution receives less than satisfactory component ratings for asset quality, management, earnings, or liquidity. Examiners should assess all facts and circumstances to determine whether recommendation of Section 8(b) action is warranted under such circumstances.

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EXAMINATION CONSIDERATIONS

The ROE often serves as the FDIC's primary supporting evidence for formal actions. Comments must be factually correct, free of inconsistencies, and not contain gratuitous, editorial, or inflammatory statements. All comments, conclusions, and recommendations must be well supported. Primary examiner responsibilities include:

- Identifying practices or conditions that may result in excessive risk or loss to the institution or the Deposit Insurance Fund;
- Documenting such practices or conditions in accordance with instructions for the type of enforcement action recommended;
- Determining, in consultation with field- and regional-office management, if an enforcement action is necessary to address an unacceptable practice or condition;
- Ensuring that all credit classifications, component ratings, and composite ratings are accurate; and

- Submitting a memorandum to the regional director recommending an enforcement action.

Evidence Required

The FDIC must be able to prove that grounds for an action are based on facts and evidence and not merely based on suspicion. Consequently, FDIC examiners and staff must appropriately retain evidence such as:

- Copies of institution records needed to support charges;
- Documentation of all relevant meetings with management and the board;
- Documentation of all applicable recommendations made to management and the board; and
- Documentation of pertinent comments, requests, and commitments by management and the board.

Copies of institution records used as evidence should generally be complete copies of the records. And, whenever possible, at least two examiners should attend relevant meetings and sign or initial examiner notes taken during meetings.

Examiners should use special care not to make any charges on unsupported or inadequate grounds. Section 8 proceedings are within the purview of the Equal Access to Justice Act. The act provides that certain parties, who prevail in contested administrative or judicial proceedings against a federal government agency, may be able to recover litigation expenses if the position of the agency was not substantially justified. Examiners should also be mindful that all examiner writings, including but not limited to emails, notes, workpapers, and any memorandums to the regional director recommending formal actions might be a matter of record at any required hearing. Therefore, comments must be supported by substantive evidence and be able to withstand scrutiny in a hearing.

Recommendations for Action

A recommendation to pursue a formal order is not dependent upon completion of an ROE. If sufficient evidence is otherwise available, examiners should not wait for the completion of an examination or submission of the ROE before recommending a formal order.

Examiners are to consult with the regional office prior to discussing possible formal enforcement actions with the institution's board or management. Documentation of notification to the institution's board should be included in the memorandum to the regional director.

When examiners anticipate that Section 8(e) removal action may be appropriate, they should promptly consult with the regional office, including regional counsel, as directed. It is especially important that the ROE or other documentary evidence support all alleged practices or violations, particularly as they pertain to actions of the respondents.

Examiners that identify sufficient grounds for an action should submit, upon concurrence of regional office staff, a memorandum to the regional director recommending pursuit of an action. The memorandum, and ROE if available, should include as many details and documented facts pertaining to objectionable practices, unacceptable conditions, or apparent violations as reasonably possible.

The information required for inclusion in memorandums to regional directors varies based upon the type of proposed action. For proposed Section 8(b) actions, examiners should draft their memorandum to the regional director in accordance with the following guidelines:

- Detail each practice or condition regarded as unsafe or unsound;
- Identify any practice or condition that deviates from the institution's formal policies;
- Detail any apparent violations of law or regulations;
- Describe all relevant facts regarding each conclusion and recommendation;
- Include any institution director or officer statements that indicate disagreements, support charges, or show corrective actions;
- Describe issues or quote comments from previous examination reports or correspondence letters that support or refute promised corrective actions;
- Reference specific ROE schedules for additional details as necessary; and
- List items in order of importance and under appropriately descriptive subheadings.

The examiner's memorandum to the regional director should contain specific comments and recommendations relative to the adequacy of the institution's management. In some cases, existing management may be considered capable of solving the problems facing the institution, although a redirection or a clarification of authority may be necessary. If material management deficiencies are identified, the memorandum should address, as necessary, such matters as:

- The addition of independent outside directors;
- The addition of a chief executive officer, senior lending officer, or other senior officer;
- The establishment or modification of board committees, considering outside director representation;

- The addition or modification of board-approved policies;
- The implementation of board procedures to assure compliance with established directives and policies;
- The assessment of active management or the board by an independent committee or outside consultant;
- The establishment or modification of lines of authority;
- Restrictions on the authority of specific officers; and
- Any other managerial situations particular to the institution's circumstances.

For recommendations to pursue personal 8(b) actions and limitations on activities imposed against IAPs, examiners should identify any:

- Applicable misconduct;
- Necessary corrective measures;
- Deficiencies in an IAP's practices, skills, or competence; and
- Additional training or education requirements.

For all proposed Section 8(b) actions, examiners should include suggested measures and timeframes for correcting each practice or condition detailed in the memorandum to the regional director. The measures should be tailored to each specific issue and allow sufficient time for completion. Examination findings that are unrelated to issues being recommended to address in the proposed order should not be included.

The memorandum to the regional director should include the names and home addresses of any individuals to be named in a formal action to facilitate the service of a Notice of Charges. The memorandum and ROE should include facts that support why each named individual was included.

If the information needed to fully support the examiner's recommendations cannot be obtained through customary examination techniques, the regional office should be notified of the situation as soon as possible. If the matter remains unresolved, the examiner should so indicate in the memorandum and the regional director should consider using more formal investigative procedures authorized under Section 10(c) of the FDI Act.

Reviewing Compliance with an Order

Examiners are required to review management's compliance with any outstanding order during examinations. Orders typically require management to submit certain documents, including progress reports, to the regional office. Therefore, examiners should review all documentation submitted (since the prior examination) to the regional office to avoid requesting previously submitted information. Examiners should also review any regional office responses to institution submissions and follow-up on any deficiencies or recommendations included in the responses.

Examiners should include a summary of outstanding formal enforcement actions in the Examination Conclusions and Comments section of the ROE. In the Compliance with Enforcement Actions section of the ROE, examiners must document, in a factual manner, the steps taken by management to comply with the provisions of the order. As part of this analysis, examiners should also determine the underlying reasons for an institution's failure to meet any provisions of an Order or improve the institution's condition over a reasonable time frame, and discuss with the regional office whether a new or revised Order would be appropriate. At the first examination after the issuance of an order, examiners should detail each provision and management's response. At subsequent examinations, examiners may summarize provisions and only detail items of a continuing nature and those that the institution had not complied with at the previous examination. Examiners should not use conclusory statements of opinion such as, "The institution is in compliance/noncompliance with this provision."

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SECTION 8 – FDI ACT

Section 8 of the FDI Act authorizes the FDIC to take certain formal enforcement actions when: (1) an institution or IAP: violates any law, regulation, or final order, (2) an IAP breaches a fiduciary duty; (3) an institution or IAP engages in an unsafe or unsound practices; or (4) where unsafe or unsound conditions are found to exist at an institution. However, the FDI Act does not define unsafe or unsound practices or conditions. The concept of unsafe or unsound practices or conditions touches upon an institution's entire operations, and a single definition would not capture the broad spectrum of activities or conditions included in the term.

The FDIC's Board has established examples of unsafe or unsound practices or conditions in previous Section 8 proceedings. However, examiners should understand that these examples of activities or conditions are not necessarily unsafe or unsound in every instance or when considered in light of all relevant facts pertaining to that situation.

Practices Deemed Unsafe or Unsound

Generally, an unsafe or unsound practice encompasses any action, or lack of action, by an institution or an IAP which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would result in abnormal risk of loss or damage to an institution, its shareholders, or the Deposit Insurance Fund.

Actions Deemed Unsafe or Unsound

The FDIC's Board has found the following types of actions to be unsafe or unsound practices:

- Operating with inadequate capital for the type and quality of assets held;
- Engaging in hazardous lending and lax collection practices that include but are not limited to, extending credit that is inadequately secured, extending credit without first obtaining complete and current financial information, extending credit in the form of overdrafts without adequate controls, and extending credit with inadequate diversification of risk;
- Operating without adequate liquidity relative to the institution's asset and liability mix;
- Operating without adequate internal controls and an adequate audit program;
- Engaging in speculative or hazardous investment practices; and
- Paying excessive dividends in relation to the institution's capital position, earnings capacity, and asset quality.

Lack of Action Deemed Unsafe or Unsound

The FDIC's Board has found the following lack of actions to be unsafe or unsound practices:

- Failure to provide adequate supervision and direction over the officers of the institution,
- Failure to provide for an adequate allowance for loan and lease losses,
- Failure to keep accurate books and records,
- Failure to enforce programs for repayment of loans, and
- Failure to implement an adequate compliance management system.

Conditions Considered Unsafe or Unsound

An unsafe or unsound condition is a condition that, if continued, would result in abnormal risk of loss or damage to the institution or the Deposit Insurance Fund. An assessment of unsafe and unsound condition should be based on an assessment of virtually every aspect of the institution's operation and position. At a minimum, the institution's capital position, asset condition, management, earnings posture, and liquidity position must be carefully evaluated.

The FDIC's Board has found the following types of conditions to be unsafe or unsound:

- Maintenance of unduly low net interest margins,
- Excessive overhead expenses,
- Excessive volumes of loans subject to adverse classification,
- Excessive net loan losses, and
- Excessive volumes of nonearning assets.

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TERMINATION OF INSURANCE

Section 8(a)

Section 8(a) provides the FDIC's Board with voluntary and involuntary termination of insurance powers. Voluntary termination of insurance actions under Section 8(a) are uncommon. Rather, voluntary termination of insurance actions are regularly done under Sections 8(p) and 8(q). Involuntary termination of insurance actions are also uncommon and generally used by the FDIC's Board only when other administrative actions have been ineffective.

The FDIC's Board may involuntarily terminate an institution's insured status under Section 8(a)(2) on the following grounds:

- An insured institution or its directors or trustees have engaged or are engaging in unsafe or unsound practices;
- An insured institution is in an unsafe or unsound condition; or
- An insured institution or its directors or trustees have violated any applicable law, rule, regulation, order, condition imposed in writing by the FDIC in connection with an application or other request by the institution, or any written agreement entered into with the FDIC.

Note: For the purposes of Section 8(a)(2), the term *written agreement* refers to a legally enforceable document, not an informal agreement such as a Memorandum of Understanding.

Before initiating formal proceedings to terminate an institution's deposit insurance, the FDIC must provide written notice to the institution's primary federal regulator or state authority. If the primary regulator or state authority fails to secure correction of the problems, the FDIC issues a *Notice of Intention to Terminate Insured Status, Findings, and Order Setting Hearing* to the institution. Unless the institution chooses not to litigate the matter, the FDIC has the burden of proving the allegations made in the Findings through the introduction of evidence at the hearing.

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CEASE AND DESIST ORDERS

Section 8(b)

Section 8(b) of the FDI Act authorizes the FDIC to issue a cease and desist order against a state nonmember insured bank or an IAP when facts reasonably support that:

- The institution or IAP is engaging, or has engaged, in unsafe or unsound practices;
- The institution or IAP is violating, or has violated, a law, rule, or regulation; any condition imposed in writing by the FDIC with regard to the approval of a request or application; or a written agreement entered into with the FDIC; or
- There is reasonable cause to believe the institution or IAP is about to do either of the above.

The purpose of a cease and desist order is to remedy unsafe or unsound practices or violations, to correct conditions resulting from such practices or violations, and to prevent future unsafe and unsound practices or violations. Formal actions may be pursued before a violation or unsafe or unsound practice occurs in order to prevent a developing situation from reaching more serious proportions. Cease and desist orders generally contain provisions that require an institution or IAP to take, or prohibit an institution or IAP from taking, specific actions relating to inappropriate practices, violations, or conditions. Under certain circumstances, the enforcement action may require the institution or IAP to make restitution or provide indemnification against losses.

The failure of an institution to comply with any cease and desist order or consent order that has become final can be the basis for subsequent Section 8(a) termination of insurance action or 8(e) removal action against an IAP, as defined by Section 3(u) of the FDI Act. Such failure also can be the basis for the FDIC petitioning the U.S. District Court to enforce the order. Civil money penalties may also be imposed against the institution or any officer, director, employee or other person participating in the affairs of such institution that was responsible for such non-compliance.

Types of Section 8(b) Orders

The type of Section 8(b) order issued by the FDIC varies based on the institution or IAP's response to an enforcement action. If an institution or IAP agrees to comply with an enforcement action (stipulates), the FDIC will issue a consent order. However, if an institution or IAP does not stipulate, the FDIC may pursue a cease and desist order. Both actions generally contain the same corrective provisions and are public documents.

Cease and Desist Order When an institution or IAP does not agree to stipulate to a proposed enforcement action, the FDIC may pursue a cease and desist order by issuing and serving the institution or IAP with a Notice of Charges. The Notice of Charges contains a statement of facts detailing alleged practices or violations and fixes a time and place for an administrative hearing. A hearing is held to determine whether an order to cease and desist should be issued against the depository institution or IAP. If the party or parties served with the Notice of Charges does not appear at the hearing, they may be deemed to have consented to the issuance of the cease and desist order.

The FDIC's Board may issue a cease and desist order after the hearing. The action orders the institution and/or its IAPs to cease and desist from the unsafe and unsound practices or violations outlined in the order and to take affirmative actions to correct the conditions resulting from such a violation or unsafe or unsound practice. In certain cases, the cease and desist order may require the institution or IAP make restitution or provide indemnification against loses where the institution or IAP was unjustly enriched in connection the violations or unsafe and unsound practices or where the violation or practices involved a reckless disregard for the law or applicable regulations. A cease and desist order becomes effective 30 days after it is served upon the institution.

Consent Order Alternatively, if the institution or IAP agrees to a proposed enforcement action, the FDIC will issue a consent order. By stipulating, the institution or IAP waives its right to an administrative hearing. Eliminating the administrative hearing allows the institution or IAP to avoid lengthy and costly legal proceedings and allows the FDIC to address unsafe or unsound practices and violations more quickly. By stipulating to the action, the institution consents to the enforcement action without admitting or denying engagement in unsafe or unsound practices or violations. A consent order becomes effective at the time specified in the order, which is typically the date of issuance.

Personal 8(b) Orders The FDIC can seek 8(b) orders against IAPs under the same statutory authority and on the same statutory conditions as against an institution. The FDIC may pursue a personal 8(b) order when remedial action is warranted regardless of whether the elements could be met for a permanent prohibition of an IAP from the banking industry.

The FDIC may consider prioritizing possible 8(b) action against an IAP when facts reasonably support that an IAP. For example, when an IAP:

- Engaged in dishonest conduct;
- Was a director or officer;

- Had a substantial role in directing the misconduct;
- Engaged in repeated or large-scale misconduct;
- Received an FDIC supervisory letter, but continued the misconduct;
- Was identified in an ROE or other formal or informal enforcement action that detailed their misconduct, but continued the misconduct; or
- Was a director or officer who abdicated their fiduciary duties in an unsafe or unsound manner.

Examiners should assess IAPs' compliance with outstanding enforcement actions during examinations. Information on IAPs subject to personal enforcement actions may be available through regional offices. However, during the examination, examiners should also ask management to identify any IAPs subject to personal enforcement actions to ensure any recently hired IAPs appropriately notified the institution and to ensure management and the board are fulfilling their responsibilities to remain informed on the professional background and qualifications of directors, officers, and employees.

If an IAP appears to be in substantial compliance with all provisions of a personal cease and desist order (PC&D), examiners should detail their findings in the Confidential - Supervisory Section. However, if an IAP appears to be in substantive noncompliance with one or more provisions of an outstanding PC&D, examiners should describe their findings on the Compliance with Enforcement Actions page in a manner similar to evaluations of an institution's compliance with other enforcement actions. Examiners should carry forward a summary of their findings to the Examiners Conclusions and Comments page.

In general, a PC&D should have a time limit of five years and automatically expire at the end of that time. If the actions of the IAP were particularly egregious, compliance with a specific provision deemed critical, or another important supervisory reason can be articulated, the time limit can be greater than five years or eliminated completely. This decision will be made at the initiation of the PC&D. Justification for a time limit longer than five years should be included in the recommendation memo.

Termination prior to the end of five years, or termination of PC&Ds without a time limit should be based on satisfactory or full compliance with the provisions of the Order. When considering the issuance and provisions of a PC&D, the remedies set forth in a PC&D should lend themselves to measureable and verifiable compliance to permit a reasoned basis for termination.

In order to terminate a PC&D, regional directors should submit a memorandum to the appropriate Associate Director - Risk Management Supervision based upon an IAP's satisfactory or full compliance with the provisions of the Order.

Section 8(c) - Temporary Cease and Desist Orders

If the FDIC cannot obtain an institution's stipulation and consent for a cease and desist order, the time required to complete the administrative proceedings and obtain a cease and desist order may result in additional damages to the institution. Section 8(c), therefore, authorizes the FDIC to issue a temporary cease and desist order to stop particularly dangerous practices, or take affirmative actions to remedy conditions, pending completion of the administrative proceedings. Temporary cease and desist orders are not meant to replace permanent orders and must be issued in conjunction with or subsequent to a Notice of Charges supporting an order.

The FDIC may issue a temporary order if a violation, threatened violation, or unsafe or unsound practice specified in the Notice of Charges is likely to cause insolvency or substantial dissipation of assets or earnings, weaken the condition of the institution, or prejudice the interests of depositors prior to the completion of the Section 8(b) action. The FDIC may also issue a temporary order if an institution's accounts and records are so inadequate that the FDIC cannot determine the institution's financial condition or cannot determine the details of a transaction that may have a material effect on the institution.

A temporary order, accompanied by a *Notice of Charges*, can be issued against the institution or IAP. The order becomes effective upon service and, unless set aside or limited by court proceedings, remains effective and enforceable pending completion of the administrative proceedings pursuant to a Section 8(b) action.

Within 10 days after service of a temporary cease and desist order, the institution or IAP may apply for an injunction setting aside, limiting, or suspending the enforcement, operation, or effectiveness of such order.

Due to the nature of temporary actions, recommendations for such actions are frequently developed without the benefit of a completed ROE. In those cases, a visitation report, memorandum, or letter will discuss the practices and violations and the effect, or anticipated effect, on the institution. Examiners should immediately contact the regional office to discuss the possible need for Section 8(c) action when a situation is discovered in which an apparent violation of law or unsafe or unsound banking practice is likely to cause insolvency or substantial dissipation of assets prior to the completion of proceedings under Section 8(b).

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REMOVAL AND PROHIBITION PROCEDURES

Section 8(e) - Removal and Prohibition

Section 8(e) of the FDI Act authorizes the FDIC to order the removal of an IAP (director, officer, employee, controlling stockholder, etc.) from a state nonmember depository institution. It also allows the FDIC to prohibit the IAP from future participation in the conduct of the affairs of any insured depository institution. Removal and/or prohibition orders may be based upon conduct at the institution from which the individual is removed or upon conduct at another institution or affiliate.

The FDIC must establish three distinct and separate grounds to institute a removal and/or prohibition action:

1. **Misconduct** The IAP has directly or indirectly violated any law or regulation, any final cease and desist order, any condition imposed in writing in connection with the granting of an application or other request, or any written agreement; participated in any unsafe or unsound practice in connection with the depository or business institution; or engaged in an act, omission, or practice which constitutes a breach of fiduciary duty; and
2. **Effect of the Misconduct** Due to the misconduct, the insured depository institution or business institution has suffered or will probably suffer financial loss or other damage; the interests of the depositors have been or could be prejudiced; or the IAP has received financial gain or other benefit; and
3. **Culpability** The IAP's acts or omissions involved personal dishonesty or demonstrated willful or continuing disregard for the safety and soundness of the insured depository or business institution.

If an IAP does not consent to the action, the FDIC may serve the IAP with a Notice of Intention to Remove from Office or to Prohibit from Further Participation. The Notice of Intention contains a statement of the facts and conclusions constituting grounds for an action and a place and time for a hearing.

Pending the hearing, the FDIC may order the temporary and immediate suspension or prohibition of an IAP if the IAP's continued participation poses an immediate threat to the institution or to the interests of the institution's depositors. Unless a court issues a stay, a temporary suspension or prohibition order remains effective until the FDIC dismisses the charges or until the effective date of the permanent removal or prohibition order.

Examiners should be alert for situations where Section 8(e) may be applicable and should promptly communicate concerns to the regional office. The examiner, regional director or designee, and regional counsel should consult as needed to determine whether to proceed with an investigation authorized under Section 10(c) of the FDI Act. The examiner, regional director or designee, and regional counsel should also determine what evidence should be collected during the course of the investigation. Upon completion of an investigation, examiners are required to submit a recommendation memorandum to the regional director outlining the alleged misconduct and evidence supporting the allegations. If the memorandum is submitted in conjunction with an ROE, the ROE should also support the allegations.

When an IAP's acts support a removal/prohibition action and the alleged misconduct meets the criteria for filing a Suspicious Activity Report (SAR), the examiner should encourage the institution to file. If the institution refuses to file the SAR, the FDIC should file the SAR.

Section 8(g) - Suspension, Removal, and Prohibition

Section 8(g) of the FDI Act authorizes the FDIC to suspend an IAP charged with a felony and to remove an IAP convicted of a felony.

IAP Charged with a Felony Under Section 8(g)(1)(A), the FDIC may suspend an IAP from office or prohibit that IAP from participating in the conduct of any institution's affairs if:

- An IAP is charged with a crime involving dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under state or federal law (a felony) or is charged with a violation of section 1956, 1957, or 1960 of title 18 or section 5322 or 5324 of title 31; and
- Continued service or participation by the IAP may pose a threat to the interests of the institution's depositors or may threaten to impair public confidence in the institution.

When determining the threat posed by the IAP's continued service or participation, the FDIC must consider all relevant factors, including the nature of the charges in the indictment. If the indictment relates to alleged crimes against an institution or other financial institution, it may be that, the IAP's continued service would pose a threat to the institution. The FDIC should also consider any potential impact to the institution from publicity that associates the institution with the criminal activity due to the IAP's continued service or participation.

If the FDIC determines that the Section 8(g) criteria for suspension have been met, the regional office may notify the IAP of the contemplated recommendation for Section 8(g) action and offer the IAP the option of a voluntary suspension. Voluntary suspension is an IAP's resignation from office and/or pledge not to participate in any manner in the affairs of the institution. A voluntary suspension is not a consent or stipulation to a formal action and it is not enforceable. When factors warrant a formal enforceable action, the FDIC will not offer a voluntary suspension.

If an IAP does not agree to voluntary suspension, the FDIC will serve a written notice of suspension upon the IAP and a copy of the notice upon the institution. The notice will suspend the IAP from office and/or prohibit his or her from further participation in the affairs of any institution. Such suspension or prohibition will remain in effect until the indictment or charge is finally disposed or until the notice is terminated. A finding of not guilty to a specific charge does not preclude the FDIC from instituting removal proceedings under Section 8(e).

IAP Convicted of a Felony Under Section 8(g)(1)(C), the FDIC may remove an IAP from office and/or prohibit an IAP from further participation in the conduct of the affairs of any depository institution without the prior written consent of the FDIC if:

- The IAP is convicted of a crime involving dishonesty or breach of trust which is punishable by imprisonment for a term exceeding one year under State or Federal law, or is convicted of a crime under section 1956, 1957, or 1960 of title 18 or section 5322 or 5324 of title 31,
- The judgment is not subject to further appellate review, and
- The FDIC determines that the IAP's continued service or participation may pose a threat to the interest of the institution's depositors or may threaten to impair public confidence in the institution.

Although the FDIC typically has the discretion to determine whether it is appropriate to issue a removal and/or prohibition order, Section 8(g) removes such discretion and requires the FDIC to issue a removal and/or prohibition order when an IAP is convicted of violating:

- 18 U.S.C. § 1956 (Laundering of Monetary Instruments),
- 18 U.S.C. § 1957 (Engaging in Monetary Transactions in Property Derived from Specified Unlawful Activities),
- 18 U.S.C. § 1960 (Prohibition of Unlicensed Money Transmitting Businesses),
- 31 U.S.C. § 5322 (Criminal Penalties), or
- 31 U.S.C. § 5324 (Structuring Transactions to Evade Reporting Requirement Prohibited).

Within 30 days of service of any notice of suspension or order of removal pursuant to Section 8(g), the IAP may request an opportunity to appear before the FDIC to show that continued service to the institution, or participation in its affairs, is not likely to pose a threat to the interests of an institution's depositors or impair public confidence in the institution. Upon receipt, the FDIC shall schedule a hearing before agency personnel (not more than 30 days after receipt of the request). Within 60 days after such hearing, the party will be notified of the FDIC's decision as to whether the prohibition or suspension will be continued, terminated, or modified, or whether an order of removal will be rescinded or modified.

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ENFORCEMENT ACTIONS

Section 8(t) - Authority to Take Enforcement Action

Section 8(t) of the FDI Act authorizes the FDIC to take enforcement action under Section 8 of the FDI Act (among other Sections) against any insured depository institution, holding company, or IAP in certain circumstances.

When the FDIC is not the primary federal regulator, the FDIC may recommend to the appropriate federal banking agency that the agency take any enforcement action authorized under Section 8. If, within 60 days, the federal banking agency does not take the enforcement action recommended or provide a plan acceptable to the FDIC, the FDIC may take the recommended enforcement action if the FDIC's Board determines:

- The insured depository institution is in an unsafe or unsound condition,
- The institution or IAP is engaging in unsafe or unsound practices and the recommended enforcement action will prevent the institution or IAP from continuing such practices,
- The conduct or threatened conduct (including any acts or omissions) poses a risk to the Deposit Insurance Fund or may prejudice the interest of the institution's depositors, or
- The conduct or threatened conduct (including any acts or omissions) of the depository institution holding company poses a risk to the Deposit Insurance Fund. (Such authority may not be used with respect to a depository institution holding company in a generally sound condition and whose conduct does not pose a foreseeable and material risk of loss to the Deposit Insurance Fund.)

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ANTI-MONEY LAUNDERING

Section 8(s) - Recordkeeping and Reporting

Section 8(s) of the FDI Act states the FDIC shall issue a cease and desist order if an institution:

- Has failed to establish and maintain the procedures to ensure compliance with the Bank Secrecy Act, or
- Has failed to correct any problems that were previously reported to the institution by the FDIC.

The FDIC shall issue the order in the same manner prescribed under Section 8(b) or 8(c) and shall require the institution to cease and desist from its violation of Section 8(s) or its prescribed regulations.

Section 8(w) - Terminating Insurance

Section 8(w) of the FDI Act states the FDIC Board shall issue a notice of intent to terminate deposit insurance when the Attorney General notifies the FDIC that an institution has been convicted of violating:

- 18 U.S.C. § 1956 (Laundering of Monetary Instruments), or
- 18 U.S.C. § 1957 (Engaging in Monetary Transactions in Property Derived from Specified Unlawful Activities).

Section 8(w) also authorizes the FDIC Board to issue a notice of intent to terminate deposit insurance when the Attorney General notifies the FDIC that a state institution has been convicted of violating 31 U.S.C. §§ 5322 (Violating Certain Provisions of 31 U.S.C. subch. II) or 5324 (Structuring Transactions to Evade Reporting Requirement Prohibited).

In determining whether to terminate insurance under Section 8(w), the FDIC's Board shall take into account several factors, such as the extent of:

- Director or executive officer knowledge or involvement in the offense,
- Director or executive officer cooperation in the investigation,
- Existing institutional policies and procedures designed to prevent the offenses,
- Implementation of additional controls subsequent to the offense to prevent future money laundering offenses, and
- Adequate deposit and credit services in the local community if deposit insurance is terminated.

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INADEQUATELY CAPITALIZED INSTITUTIONS

To promote capital adequacy, the FDIC is authorized, and in some instances obligated, to take action against institutions that are less than adequately capitalized. For example:

- Section 38 of the FDI Act grants the FDIC's Board powers to take prompt corrective action against institutions that are less than adequately capitalized;
- Part 324 of the FDIC Rules and Regulations authorizes the FDIC, under certain conditions, to utilize Section 8(a), 8(b), or 8(c) powers against institutions that fail to meet certain capital levels; and
- Part 324 of the FDIC Rules and Regulation authorizes the FDIC to issue a capital directive to an institution that fails to maintain capital at or above the minimum leverage capital requirements under the generally applicable capital rules and the community bank leverage ratio (CBLR) framework.
- The CBLR framework does not affect the FDIC's supervisory authority or ability to pursue formal enforcement actions when appropriate. Further, FDIC can recommend formal actions with a capital maintenance provision that requires a leverage ratio above the applicable CBLR requirement.

Section 38 - Prompt Corrective Actions

Section 38 of the FDI Act establishes a framework of supervisory actions to address issues at less than adequately capitalized financial institutions. The implementation of a PCA is intended to ensure early intervention at institutions experiencing problems and the timely closure of failing institutions.

Prompt corrective actions are based on an institution's capital levels and become increasingly severe if an institution falls into a lower capital category. Some supervisory actions associated with PCAs are mandatory; that is, the actions immediately apply to the institution as it is classified in a particular category. Other actions are discretionary.

Reclassifying a Capital Category

Pursuant to Section 38(g) of the FDI Act (as implemented by Sections 324.403(d) and 308.202 of the FDIC Rules and Regulations), the FDIC may reclassify a well-capitalized, adequately capitalized, or under capitalized institution to the next lower capital category if:

- The FDIC determines, after notice and opportunity for hearing, that the institution is in an unsafe or unsound condition; or
- The FDIC determines, after notice and opportunity for hearing, that the institution has less than satisfactory asset quality, management, earnings, or liquidity.

With respect to the CBLR, electing institutions are considered to have met the well-capitalized ratio requirements mandated by section 38 of the FDI Act. However, if an electing institution is subject to a consent order with a condition to meet and maintain a specific capital level for any capital measure, it would be re-categorized as "adequately capitalized" for PCA purposes pursuant to section 324.403(b)(1)(i)(E) of the capital rule. The electing institution could remain in the CBLR framework as long as it meets the qualification standards.

Issuing Supervisory PCA Directive

Section 38 outlines supervisory actions applicable to an institution based on its capital category. Section 38 requires the FDIC to impose (by issuing a supervisory PCA directive) one or more of the following provisions on a significantly undercapitalized institution or an undercapitalized institution that failed to submit and implement a capital restoration plan:

- Require recapitalization,
- Restrict transactions with affiliates,
- Restrict interest rates paid,
- Restrict asset growth,
- Restrict activities involving excessive risk,
- Improve management,
- Prohibit deposits from correspondent institutions,
- Require prior approval for capital distributions by a bank holding company,
- Require the institution or holding company to divest of subsidiaries,
- Require a holding company to divest of the institution, or
- Require any other action the FDIC determines will resolve the problems of the institution.

Section 38 also authorizes the FDIC to take the following actions if the FDIC determines the action will resolve the problems of the institution at the least possible cost to the Deposit Insurance Fund:

- Impose upon an undercapitalized institution any of the discretionary provisions applicable to a significantly undercapitalized institution or an undercapitalized institution that failed to submit and implement a capital restoration plan; or
- Impose upon a significantly undercapitalized institution or undercapitalized institution that failed to submit and implement a capital restoration plan one or more of the restrictions placed upon critically undercapitalized institutions by Section 38 (i).

The FDIC must (except as described below) provide the institution with written notice prior to issuing a supervisory PCA directive that imposes any of the discretionary actions listed above. The notice provides the institution with an opportunity to respond to the proposed directive. Although a supervisory PCA directive does not entitle an institution to a hearing, the FDIC will consider the institution's response prior to determining whether to issue a directive. The FDIC may issue a directive without prior notice if the FDIC deems it necessary to carry out the purposes of Section 38.

Dismissing a Director or Senior Executive Officer

Section 38 authorizes the FDIC to issue a supervisory PCA directive to require institutions to improve management in the case of significantly undercapitalized institutions and undercapitalized institutions supervised by the FDIC that fail to submit or implement acceptable capital restoration plans. The supervisory PCA directive may require the institution to dismiss from office any director or senior executive officer who held office for more than 180 days immediately before an institution became undercapitalized. Dismissal by a supervisory PCA directive is not construed as a removal under Section 8 of the FDI Act.

When the FDIC issues a directive to an institution requiring the dismissal of a director or senior executive officer, the FDIC also serves a copy of the relevant sections of the directive upon the person to be dismissed. If removed, the director or senior executive officer may file a request for reinstatement with the FDIC not later than 10 days after receiving notice of the dismissal. A post-dismissal hearing may be requested by the director or senior executive officer at which time the director or officer must demonstrate that continued employment would materially strengthen the institution's ability to become adequately capitalized and to correct the unsafe or unsound conditions or practices.

Part 324 - Section 8 Powers

Section 324.4 of the FDIC Rules and Regulations defines certain capital levels as unsafe or unsound practices or conditions pursuant to Section 8 of the FDI Act.

Unsafe or Unsound Practice Any state nonmember bank that has less than its minimum leverage capital requirement is deemed to be engaged in an unsafe or unsound practice pursuant to Section 8(b)(1) and/or 8(c) of the FDI Act.

Exception: An institution is not deemed to be engaged in an unsafe or unsound practice if the institution has entered into and is in compliance with a written agreement with the FDIC, or the institution has submitted and is in compliance with a plan approved by the FDIC to:

- Increase its Tier 1 leverage capital ratio to such level as the FDIC deems appropriate, and
- Take such other action as may be necessary to be operated so as not to be engaged in such an unsafe or unsound practice.

Unsafe or Unsound Condition Any insured depository institution with a ratio of Tier 1 capital to total assets that is less than 2 percent is deemed to be operating in an unsafe and unsound condition pursuant to Section 8(a) of the FDI Act.

Exception: An insured depository institution is not deemed to be operating in an unsafe or unsound condition if, in the case of a state nonmember bank, it has entered into and is in compliance with a written agreement with the FDIC (or in the case of any other insured depository institution, has entered into and is in compliance with a written agreement with its primary federal regulator and to which agreement the FDIC is a party), to:

- Increase its Tier 1 capital ratio to such levels as the FDIC deems appropriate, and
- Take such other action as may be necessary to be operated in a safe and sound manner.

In most cases, capital levels may be a reflection of other supervisory concerns that have already resulted in Section 8(a), Section 8(b), or Section 8(c) enforcement actions. Institutions subject to enforcement actions that include a capital provision may meet the criteria for the exception from being deemed to be in or engaged in an unsafe or unsound condition or practice due to capital levels. However, when enforcement action has not been taken or is not warranted due to a lack of other supervisory concerns, the FDIC may choose to enter into a written agreement with the institution thereby providing the institution with an exception from the definition of unsafe or unsound practice or condition and precluding Section 8(a), Section 8(b), or Section 8(c) action solely based on capital levels.

It is important to note that the FDIC is not precluded from taking Section 8(a), Section 8(b), or any other enforcement action against an institution with capital levels that exceed those defined as unsafe or unsound in Section 324.4.

Part 324 - Capital Directives

Section 324.5 of the FDIC Rules and Regulations authorizes the FDIC's Board to issue a directive against any insured state nonmember bank that fails to maintain capital at or above the minimum leverage capital requirement. A capital directive requires the institution to restore its capital to the minimum leverage capital requirement within a specified period. The directive may require the institution to submit a plan describing the means and timing by which it shall achieve the applicable minimum leverage capital requirement.

Prior to issuing a capital directive, the FDIC must provide the institution with written notice. The institution may submit a written response to the proposed directive. The FDIC will issue a written determination supporting any decision to issue or not to issue a directive after considering the response.

The key difference between a capital directive and PCA directive is the requirement that the FDIC may impose under each directive. Under a PCA directive, the FDIC can impose requirements ranging from recapitalization to restricting activities. However, under a capital directive, the FDIC is largely limited to requiring the institution to recapitalize and submit a capital restoration plan.

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SAFETY AND SOUNDNESS ORDERS

Section 39 of the FDI Act requires the federal banking authorities to establish various safety and soundness standards. The Act allows the FDIC to request corrective plans from financial institutions that do not meet the standards, which are set forth in Part 364 and the interagency guidelines in Appendix A and Appendix B to Part 364.

Once a Section 39 action is initiated, the FDIC lacks discretion to avoid issuing an order if the institution fails to submit, or to materially implement, an acceptable plan.

In addition, the FDIC may require by order, other corrective measures, such as restricted asset growth, higher capital levels, limits on deposit interest rates, or any other measure deemed necessary to effect corrective action.

Corrective programs for safety and soundness standards can also be incorporated into other types of formal and informal actions pursued against problem institutions. Section 39 actions may be considered for non-problem institutions having clearly inadequate safety and soundness practices and policies; however, this response will normally be limited to situations that could result in material loss to the institution, or where management has not responded effectively to similar criticisms in prior examinations.

Examiners should consult with the regional office prior to discussing possible actions with the institution's board or management. If regional management determines Section 39 action is warranted, examiners should submit a recommendation memorandum to their regional director. The memorandum should detail any discussions with the institution's board or management regarding possible actions.

Note: Examiners and regional directors must exercise care to avoid requesting compliance plans if identified problems are correctable through standard examination practices.

References:
- Manual Section 13.1, Informal Actions
- Manual Section 14.1, Civil Money Penalties
- Manual Section 16.1, ROE Instructions

GENERAL INSTRUCTIONS

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These instructions apply to all safety and soundness Reports of Examination (ROE).

References

Examiners should also consider the following:

- Federal Deposit Insurance Act, FDIC Rules and Regulations, and related statutes and regulations,
- FDIC and other applicable Statements of Policy,
- Instructions for the Preparation of Reports of Condition and Income (Call Reports),
- The User's Guide for the Uniform Bank Performance Report (UBPR),
- RMS Manual of Examination Policies (Manual),
- State Statutes and Regulations,
- FFIEC Information Technology Examination Handbooks,
- Outstanding Memoranda,
- Financial Institution Letters,
- Uniform Financial Institutions Rating System,
- Uniform Rating System for Information Technology,
- Uniform Interagency Trust Rating System, and
- Statements of FDIC Board of Directors

Unless otherwise specified, complete Report financial schedules according to Call Report Instructions.

Reminder: Reports may be affected by changes to definitions, laws, regulations, Call Report Instructions, and regulatory policies within the aforementioned references. When significant Report changes occurred since the previous examination, use footnotes on the applicable report pages to explain the difference(s). Do not footnote minor changes.

Report Comments, Supervisory Recommendations, and Matters Requiring Board Attention

As used in these instructions, the term “report comments” refers generally to text set forth in the ROE. The term “supervisory recommendation” refers to FDIC communications with a bank that are intended to inform the bank of the FDIC’s views about changes needed in its practices, operations or financial condition. As described in the Statement of FDIC Board of Directors on the Development and Communication of Supervisory Recommendations (Statement), a principal purpose of supervisory recommendations is to communicate supervisory concerns to a bank so that it can make appropriate changes in its practices, operations or financial condition and thereby avoid more formal remedies in the future, such as enforcement actions.[1] All supervisory recommendations must address meaningful concerns, communicate concerns clearly and in writing, and discuss corrective action. Supervisory recommendations are not formal or informal enforcement actions, but they are communications of FDIC expectations of banks. The Statement acknowledges that bankers take seriously supervisory recommendations made by FDIC personnel; accordingly, care should be taken in their development and communication.

In the context of the ROE, supervisory recommendations include recommendations communicated on the Examiner’s Comments and Conclusions (ECC) page, and recommendations communicated on other report pages, such as the Risk Management Assessment page. Most supervisory recommendations are generally correctable in the normal course of business. However, when there are material issues and recommendations that require the attention of the institution’s board of directors and senior management, examiners must communicate concerns using Matters Requiring Board Attention (MRBA). MRBA are a subset of supervisory recommendations. It is FDIC policy to make supervisory recommendations in writing in the ROE, in a transmittal letter, or in other correspondence under official FDIC letterhead. Supervisory recommendations may not be solely verbal, but should be discussed with, and explained to bank management.

[1] See https://www.fdic.gov/about/governance/recommendations.html

Writing Report Comments and Supervisory Recommendations

ROE comments should be fact-based, professional, and objective. Proper presentation of factual information can be very persuasive and will ordinarily be more effective than criticism alone in achieving the desired response from bank management. Use clear, concise, well-organized, language appropriate to the subject or field and the intended audience. Simple language and short sentences are generally the most effective.

Use an Effective Writing Style. While each examiner will develop an individual style of writing comments and supervisory recommendations, the following suggestions may be helpful in increasing effective communication:

- Accurate and descriptive topical headings, in order of importance, promote reader interest.
- Comments should be as brief as is consistent with clarity.
- Comments should be factually objective and not phrased as criticisms of particular individuals.
- Comments on matters not subject to criticism or recommendation, on minor matters, or on unsatisfactory practices corrected during the examination should be limited.
- Ratios, or percentages, are meaningful to examiners, but their significance is not always apparent to bankers and particularly bank directors. Therefore, examiners should not rely upon ratios alone to convey the ideas they wish to express. When ratios are cited, they should be in support of a conclusion or supervisory recommendation, and their import should be made understandable to the reader.

Explain the Basis for any Supervisory Recommendations or Concerns. The ROE should describe the potential consequences of inaction or the benefit of corrective action to the institution related to implementing a supervisory recommendation or correcting a deficiency before the issue leads to deterioration in operations or financial performance. The ROE should factually document bank management and Board commitments for correcting the noted weaknesses.

Reminder on Major Matters. Supervisory recommendations that could establish or change existing FDIC policy, attract unusual attention or publicity, or would involve an issue of first impression must be discussed with regional office management. Regional office management should raise any such matters with senior RMS management for consideration as a Major Matter under the FDIC Board's Major Matter Resolution.

Peer Group Information - Examiners may use UBPR or user-derived ratios and peer group comparisons to support comments. However, examiners are reminded that comparisons to peer are not a part of the UFIRS ratings definitions, and should avoid over reliance on peer group comparisons.

Apparent Criminal Violations - Examiners must not discuss criminal referrals or apparent criminal violations in the open section of the ROE. All comments regarding these matters in confidential report pages or workpapers should be limited to clear-cut statements of fact. Examiners must not include opinions about the probability of indictment, conviction, or related matters. Comments should be as specific as possible and identify who reported an issue and how it occurred. Do not use language such as, "It is reported...," or, "Management indicated...." Instead, use language such as, "President Scott reported...."

Consolidated and Institution-Only Schedules

Examiners should complete ROE schedules on a consolidated basis in accordance with Call Report instructions and generally accepted accounting practices. Institution-only schedules, or a list of an institution's investments in subsidiaries, may be included in ROEs when they add meaningful information. Institution-only schedules may be meaningful when:

- A material volume of a subsidiary's assets is adversely classified and inclusion of institution-only schedules highlight a concentration of risk in a subsidiary,
- A material amount of an institution's assets or capital is invested in a subsidiary, and inclusion of institution-only schedules helps explain an examination concern (such as weak core earnings), or
- An institution is at risk of failing, and inclusion of institution-only schedules might help the bank's board or regulatory authorities develop recovery or resolution strategies.
- Examiners should create institution-only pages on continuation pages. Often, simple lists of investments in each subsidiary are adequate.

Report Dates

The Report uses four different dates:

- ***Examination as of Date -*** This is the date of the financial information analyzed throughout the Report, generally the most recent quarter-end Call Report data available. For example, if an examination commences on August 31, and June 30 financial data is available, the Examination as of Date would likely be June 30.
- ***Examination Start Date -*** This is the date the examination commenced, typically, the date when the examination team begins formal on-site examination of the institution. It is used to monitor ROE completion times and the length of time between examinations.
- ***Date Examination Completed -*** This is the date the examiner formally completes the examination and submits the ROE for review. The date is used to monitor ROE completion and processing times.
- ***Asset Review Date -*** This is the date of the asset data analyzed in the loan review, and often the investment portfolio and other real estate reviews. Although the date could be the same as the Examination as of Date, often examiners are able to obtain more current information. For example, if an examination commences on August 31, and July 31 loan data is available, the Asset Review Date might be July 31. Note the Asset Review Date on the Confidential-Supervisory Section page and within the Asset Quality comment on the Examination Conclusions and Comments (ECC) page.

Selection of the Examination as of Date and the Asset Review Date - When selecting these dates, examiners should consider the availability of the information (quarter-end Call Report data is generally not available until 45 days after the quarter end), the amount of time institutions need to compile requested information, and any material changes that occurred between the dates.

When significant changes in the composition of the balance sheet occur between the Examination as of Date and the Asset Review Date, make appropriate comments in the ROE. There may be circumstances when a more recent month-end date would better serve as the Examination as of Date (rather than the most recent quarter-end).

Page Order and Numbering

Page order is addressed in the Inventory of Report Pages section.

All pages in the open section are sequentially numbered. Sequential numbering continues through the Confidential-Supervisory Section page, but those pages are not listed in the Table of Contents. The Table of Contents lists the titles and page numbers of all open section pages. The sequence of pages should generally follow the pages listed in the Inventory of Report Pages. When user-defined pages are included, they should be included where most appropriate, but not before the Risk Management Assessment (RMA) page.

Generally, do not number the Officer's Questionnaire. However, if the Officer's Questionnaire is included in the Report, numbering may be appropriate when the Officer's Questionnaire is lengthy. In such instances, the letters OQ should precede the number (for example, OQ.1, OQ.2, and OQ.3).

Supplemental Pages

Supplemental (non-mandatory) pages should be used to support the conclusions, supervisory recommendations, and ratings on the ECC page. The Bank of Anytown ROE includes many supplemental pages that provide examples of how to format the pages. Therefore, the supplemental pages shown in The Bank of Anytown do not necessarily provide examples of comments that support ECC page conclusions and should be used as illustrations only.

Rounding

Numbers/Dollar Amounts - Examiners may round dollar amounts to the nearest thousand and omit "000." In narrative comments, "M" is the acceptable abbreviation for thousands. Examiners should round amounts consistently throughout the Report and not use abbreviations like $2.5MM, $2,500M, and $2,500,000 interchangeably.

In the Items Subject to Adverse Classification and the Items Listed for Special Mention pages, round to the nearest thousand and omit "000" in both the heading and the extended criticized amount (refer to the Bank of Anytown). In narrative comments, the numbers and dollar amounts may be rounded and abbreviated; however, it is acceptable to use precise dollar or numerical amounts to avoid confusion. *Example:* The $25,000 loan is secured by a mortgage on an 1,800 square-foot condominium valued at $31,500, or $17.50 per square foot.

When rounding, minor adjustments may be necessary to balance related totals in the Report.

Ratios

Generally, round percentages to the nearest hundredth of a percent, especially critical ratios such as Prompt Corrective Action capital ratios in problem institutions. Round noncritical or imprecise ratios to the nearest whole number.

Abbreviations

MRBA, ECC, and Compliance with Enforcement Actions (CEA) pages - An abbreviated term must be spelled out the first time it is used, with the abbreviation enclosed in parentheses following the term.

Other Report Pages - A list of standardized abbreviations for use on the other Report pages is provided on the back cover of the Report (shown in Appendix A).

Note: The effectiveness of Report comments is significantly diminished if the overuse of abbreviations makes a document harder for readers to understand by forcing them to refer to the list of approved abbreviations too often.

Writing Style and Grammar

Examiners should follow Federal Plain Language Guidelines when completing ROE comments, including loan write-ups. Following the guidelines helps improve the effectiveness of Reports by making comments and recommendations easier for directors and managers to understand. Therefore, examiners should consider the needs of their readers and avoid the use of jargon, and overuse of technical terms, acronyms, adjectives, and adverbs. When considering whether to use an abbreviation, or how many to use in a comment, examiners should keep in mind that abbreviations should make comments easier for readers to understand. The effectiveness of comments and loan write-ups is significantly diminished if the overuse of abbreviations make a document harder for readers to understand by forcing them to refer to the list of approved abbreviations too often.

Listed below are a few style and grammar conventions that should be used in the Report. Refer to the Federal Plain Writing Guidelines; Appendix B (Grammar and Punctuation Guide), of this document; and references such as dictionaries and writer’s handbooks for additional guidance.

Footnotes - For ROE pages that have a section titled Footnotes, use the section for footnotes and not for comments.

Dollar signs - Use dollar signs in narrative comments, but not tables.

Commas - Use commas in amounts of 1,000 or more.

Spaces - Use two spaces between sentences.

Negative figures - Consistently enclose negative figures in parentheses or refer to them as negative values. Reminder: Do not write double negative numbers.

Examples:

Correct: The borrower reports a negative NW of $25M.
Or
The borrower reports a NW of ($25M).

Incorrect: The borrower reports a negative NW of ($25M).

Names - On the first reference to a person in the Report, generally use the complete title, first name, middle initial, and last name (for example, Senior Vice President (SVP) John A. Doe). After the initial reference, an abbreviated name may be used (SVP Doe), if confusion with other officers is unlikely. Use references consistently throughout the Report.

Financial Ratios - Typically, UBPR financial ratios are uploaded into the ROE through automated examination tools. The most current information should be in the left column on all pages. Manually calculated ratios should conform with UBPR Users Guide definitions and be footnoted as having been manually calculated

INVENTORY OF REPORT PAGES

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Report of Examination Page Order

Items in bold font indicates a mandatory schedule or a schedule that is mandatory when applicable.

Page	Section	Mandatory
Cover	**Open**	**Yes**
Table of Contents	**Open**	**Yes**
Matters Requiring Board Attention (MRBA)	**Open**	**Yes, when applicable**
Examination Conclusions and Comments (ECC)	**Open**	**Yes**
Compliance with Enforcement Actions	**Open**	**Yes, when applicable**
Risk Management Assessment (RMA)	Open	No
Violations of Laws and Regulations	**Open**	**Yes, when applicable**
Information Technology and Operations Risk Assessment (ITA)	**Open**	**Yes**
Fiduciary Activities Assessment (FAA)	Open	No
Examination Data and Ratios (EDR)	**Open**	**Yes**
Comparative Statements of Financial Condition	Open	No
Loans and Lease Financing Receivables	Open	No
Recapitulation of Securities	Open	No
Items Subject to Adverse Classification	Open	No
Items Listed for Special Mention	Open	No
Analysis of Loans Subject to Adverse Classification	Open	No
Analysis of ORE Owned Subject to Adverse Classification	Open	No
Assets with Credit Data or Collateral Documentation Exceptions	Open	No
Concentrations	**Open**	**Yes, when applicable**
Capital Calculations	Open	No
Analysis of Earnings	Open	No
Comparative Statements of Income and Changes in Equity Capital Accounts	Open	No
Relationships with Affiliates and Holding Companies	Open	No
Extensions of Credit to Directors/Trustees, Officers, Principal Shareholders, and Their Related Interests	Open	No
Composite Rating Definitions	**Open**	**Yes**
Signatures of Directors/Trustees	**Open**	**Yes**
Officer's Questionnaire	**Open**	**Yes***
Abbreviations	**Open**	**Yes**
Confidential – Supervisory Section	**Confidential**	**Yes**
Directors/Trustees and Officers	**Confidential**	**Yes***

**Page must be completed at each examination (to collect data), but inclusion in ROEs is optional.*

International Report Page Order

Page	Section	Mandatory
Examination Data and Ratios (International)	Open	Yes, when applicable
Transfer Risks Subject to Classification or Comment	Open	Yes, when applicable
Analysis of the Country Exposure Management System	Open	Yes, when applicable
Selected Concentrations of Country Exposure	Open	Yes, when applicable

For International ROE: Use the EDR (International) page, in lieu of the standard EDR page, in the core section of the Report. Place International Report Pages immediately after the Items Subject to Adverse Classification and Items Listed for Special Mention pages.

MATTERS REQUIRING BOARD ATTENTION (MRBA)

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Purpose

MRBA are a subset of Supervisory Recommendations,[2] which are an FDIC communication intended to inform the institution of the FDIC's views about changes needed in its practices, operations, or financial condition to help directors prioritize their efforts to address examiner concerns, identify emerging problems, and correct deficiencies before the bank's condition deteriorates (or to keep the bank viable if conditions already deteriorated). A principal purpose of supervisory recommendations is to communicate supervisory concerns to a bank so that it can make appropriate changes in its practices, operations or financial condition and thereby avoid more formal remedies in the future, such as enforcement actions.

A MRBA is defined as an issue or risk of significant importance that requires board attention. Examples of matters requiring board attention that could warrant highlighting include:

- Emerging issues in which the board needs to be more proactive in establishing policy and risk management parameters;
- Policy weaknesses that, if left unaddressed, could increase the institution's risk profile or, adversely affect the condition of the institution;
- Ineffective management;
- Repeat examination recommendations or regulatory, audit, or risk management criticisms that have escalated in importance;
- Enforcement action provisions requiring continued attention (these should be included in one summary bullet point); or
- Significant noncompliance with laws, regulations, or the bank's own policies.

When To Include This Schedule

Examiners must use this schedule whenever MRBA are included in the ROE to briefly highlight material issues and recommendations that require prompt attention by the directorate and senior management and follow-up by regulators between examinations. When the MRBA page is included in a Report, place it before the ECC page.

Deficiencies and supervisory recommendations that management can address in the normal course of business should be included in the ECC, RMA, or other supporting pages.

Comment Structure

MRBA should be brief, addressed to the board of directors, and include:

- An introductory statement to explain the purpose of the MRBA comments.
- For each MRBA, a description of the practice or condition that is of concern, a description of the corrective action needed, and a description of the potential consequence of the inaction or non-timely action to the bank's financial condition or operations. Comments should be informative and persuasive by describing the risk(s) associated with an issue and the benefits of corrective action, or consequences of inaction, to the institution and board of directors. The comment should not highlight the threat of potential, escalated supervisory action. In cases where conditions have already deteriorated, comments should prompt the board and senior management to take immediate action to correct deficiencies.
- A statement reminding the directorate and senior management of the importance of addressing the noted issues and its responsibility to respond appropriately to the matters highlighted in the schedule and informing them that there will be follow-up by regulators between examinations.

The MRBA should be listed in order of importance. As with all supervisory recommendations, MRBA are expected to be meaningful, actionable, fully supported and clearly communicated. For example, "develop a plan to reduce overhead expenses by…" rather than "improve earnings." Clear expectations will enable the institution's board, senior management, and examiners to determine when the MRBA has been adequately addressed.

[2] Statement of FDIC Board of Directors on the Development and Communication of Supervisory Recommendations, see footnote 1.

EXAMINATION CONCLUSIONS AND COMMENTS (ECC)

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Purpose

The ECC page is the primary schedule examiners use to summarize examination findings, inform directors and senior management of undue risks, and guide corrective actions through presentation of supervisory recommendations, when appropriate.

Content

Examiners should convey all significant examination findings on this page, including those relating to risk management, specialty areas, and, when material and relevant, Compliance/ Community Reinvestment Act (CRA) examinations.

The ECC page should include significant issues to be addressed by senior management ─with board awareness─ that do not meet the significant and immediate criteria of MRBA. However, when applicable, ECC comments should support issues raised on the MRBA schedule. Generally, the remediation of supervisory recommendations set forth on the ECC page can occur during the normal course of business. Supervisory recommendations on the ECC page should be associated with material practices that deviate from sound governance, internal controls, or risk management or consumer protection principles and noncompliance with laws and regulations, enforcement actions, or conditions imposed in writing. Supervisory recommendations should be relevant to the institution and not based on examiner preference or industry "best practices."

Examiners must document management's response to each supervisory recommendation and include an assessment of each CAMELS component on this page.

In general, comments on the ECC page should not be duplicated on other ROE pages. However, some duplication is acceptable as certain types of examination issues can affect multiple UFIRS components.

Comment Structure

Comments should focus the reader's attention on the condition or practices that caused or otherwise led to the examiner's criticisms and supervisory recommendations. Comments should be sufficiently detailed to support all examination findings, ratings, and recommendations. Examiners are encouraged to use tables, charts, or graphs to illustrate a complex concept or to help readers understand examination findings. Generally, commentary for a stable 1-rated component should be concise, while commentary for 2- through 5-rated components should be progressively more detailed.

Page Structure

Numerical Ratings

Uniform Financial Institutions Rating System – The top of the ECC page includes a grid to display the component and composite ratings for the current and two prior examinations. Previous examination dates should correspond to those noted elsewhere in the Report. Identify state examinations with "S" following the date, and designate other agency examinations with appropriate abbreviations. Composite ratings for the current and two prior specialty examinations, and the most recent Compliance and CRA examinations should be included at the bottom of the rating grid. Footnote any examination dates that do not correspond with the current or previous risk management examination dates. Composite rating definitions for risk management and specialty examinations should be included on the Composite Rating Definitions page. Definitions of component ratings are publicly available in the FDIC Statement of Policy on the Uniform Financial Institutions Rating System.[3]

[3] See https://www.fdic.gov/regulations/laws/rules/5000-900.html

Overall Condition, and Risk Profile Summary

The first narrative comments on this page should be a concise, high level, executive summary of the overall condition, business model, risk profile, and complexity of the bank. This comment should be concise; however, more extensive comments may be necessary for institutions with elevated risks or a complex business model. The focus should be on providing the reader with a concise description of the bank's nature and scope of major activities and business lines (business model); the overall risk associated with the business model (risk profile) and the complexity of the bank's operations (complexity). The comments should include a description of applicable external factors such as the operating environment in the beginning of the report. Often, bulleted comments can provide brief, yet effective, summaries. Examiners should include brief assessments of specialty areas in this section, but avoid significant duplication of comments included in other sections of the ECC page. In all cases, the narrative should:

- State the approximate asset size of the institution ($80 million, not $80,604M)
- Provide an overview of the institution's business model (e.g. the primary products and/or services offered by the institution).
- Provide a concise analysis of the institution's key risks as it relates to the condition of the institution and an assessment of how management is managing the risks to the institution.
- Summarize the complexity of the institution's operations (e.g. volume, sophistication, and interconnectedness among various activities and business lines)
- Describe external factors, operating environment, major planned changes in management or mergers.
- Avoid using adjectives to describe component areas and instead, focus on how a component area is affected by the institution's risk management practices. For example, avoid statements such as "Liquidity is marginal" in favor of "Management's recent decision to use wholesale funding to support strong loan growth without adopting a contingency funding plan exposes the bank to elevated risk of not being able to secure cost-effective funding going forward."

Compliance with Enforcement Actions

Examiners should include a summary of outstanding formal or informal enforcement actions on the ECC page. Detailed analysis of outstanding actions should be presented on the Compliance with Enforcement Actions page. Generally, the summary should be included after the Overall Condition and Risk Profile summary; however, placement of the comment depends on its significance in relation to other examination issues. Regardless of the type of action (formal or informal), the summary should discuss any unsafe or unsound practices or apparent violation of law that precipitated the enforcement action. Examiners should conclude comments by indicating if each practice, condition, or apparent violation was discontinued or still exists.

Only the FDIC's Board of Directors is authorized to make a finding of unsafe or unsound banking practices. Therefore, do not use the statutorily significant phrase "unsafe or unsound" in ROE comments. However, examiners should describe the facts that relate to unsafe and unsound conditions, and can use terms such as undesirable, unacceptable, or objectionable when commenting on unsafe and unsound practices and describe consequences to the institution of not addressing such practices.

***Prompt Corrective Action* -** When applicable, present a summary of the Prompt Corrective Action (PCA) provisions included on the Compliance with Enforcement Actions page**.**

CAMELS Components

Each CAMELS component must be addressed on the ECC page. Components should be addressed in order of risk, although some latitude is allowed to facilitate effective communication. Include the assigned rating after each component heading (for example, Capital - 1). The narrative for each component must include an assessment of pertinent factors and support the assigned rating. If applicable, recommendations and management responses should also be detailed. When recommendations are included, the rationale for the recommendation should be provided. Refer to the Addendum to Section 1.1 (Basic Examination Concepts and Guidelines), of the RMS Risk Management Manual of Examination Policies for rating definitions and specific items to consider when evaluating each component. Note that "peer" is not included among the specific items to consider when evaluating each component. When relevant, peer data may be considered in conjunction with other pertinent evaluation factors. However, peer data

should not be used in isolation in assigning ratings.
The length of comments and level of detail should be consistent with assigned ratings. Generally, comments should be brief for 1- and 2-rated components and progressively more detailed for 3-, 4-, and 5-rated components. When comments are critical, ensure the narrative describes the underlying conditions or practices that led to the criticism. As commentary expands, it is important to use effective organization and presentation techniques. Subheadings and bullet points are encouraged to improve readability, as are charts and graphs when appropriate. Generally, lengthy comments should begin with a concise summary of the major issues being covered.

Violations of Law

If apparent violations of law, regulations, or nonconformance with interagency guidelines included as appendices to FDIC Rules and Regulations, are cited in the ROE, the ECC page must include, at a minimum, a brief summary comment and reference to the Violations of Laws and Regulations page. References to other report pages may also be necessary if related issues, such as internal control or policy weaknesses, are detailed elsewhere in the ROE. Based on the significance of the violations, examiners may place the comments under a subheading in the appropriate CAMELS or specialty examination sections, or in a separate section on the ECC page. The amount of detail provided on the ECC page should be based on the materiality of a violation, management's response, and supervisory intentions regarding civil money penalties and enforcement actions.

Disposition of Assets Classified Loss

When applicable, management's response to examination Loss classifications should be discussed within the Asset Quality segment of the ECC page. For example, "President Smith indicated he will charge off all assets classified Loss prior to filing the June 30, xxxx Call Report."

Examiners should not suggest management charge off a portion of loans classified Doubtful except when required by state law or in formal enforcement actions. When securities are adversely classified Doubtful or Loss, examiners should follow guidance contained in Section 3.3 (Securities and Derivatives), of the Manual. Other asset categories against which valuation allowances are not normally maintained require a judgment regarding a recommendation for charge-off.

Specialty Examinations

Concurrent specialty examinations <u>embedded in the Risk Management ROE</u> - Specialty examination findings must be summarized in the ECC pages of the ROE. The placement and length of the comments should be commensurate with identified risks. When structuring comments, examiners should consider a department's risk profile, control environment, and risk management practices. Generally, comments should:

- Summarize the examination scope and key findings,
- Detail material recommendations and violations,
- Include management's response (including the timing of promised corrective actions) to material recommendations and violations, and
- Identify bank officials with whom examination findings were discussed.

With the exception of the ITA page, there are no other mandatory specialty examination pages. However, examiners may include specialty examination pages in the ROE to communicate findings, or to facilitate forwarding of information to other regulators or serviced institutions.

Comments on the ECC page relating to RTA/MSD/GSD examinations should specifically state whether any apparent violations of laws or regulations were discovered. If apparent violations were discovered, but management disagrees, the apparent violation(s) should be cited and discussed in the ROE. If apparent violations were discovered and management agrees the violation occurred, examiners can list the violations associated with the applicable specialty examination in the ROE or include a statement indicating a list of violations was left with management. In either case, an ECC comment must be included detailing management's commitment, or lack of commitment, to correct the violations cited at the examination.

Comments on the ECC page relating to IT examinations must summarize key ITA findings and assessments of the institution's cybersecurity preparedness and conformance with Appendix B to Part 364, Interagency Guidelines Establishing Information Security Standards (Security Guidelines). The length of the comment should vary based on the size and complexity of the institution and the significance of any weaknesses noted and should support the composite Uniform Rating System for Information Technology (USIRT) rating assigned. The comment should reference the ITA page when IT risk examinations are embedded in the Safety and Soundness examination. Significant findings from separate cover IT reports completed during the risk management examination cycle must also be summarized on the ECC page.

Bank Secrecy Act (BSA)

Examiners must describe the adequacy of BSA and Office of Foreign Assets Control (OFAC) programs on the ECC page and factor their assessment into the Management component. The placement and length of comments should relate to the adequacy of the program and any outstanding regional guidance.

- Programs deemed satisfactory should be briefly discussed within a subsection of the Management component.
- Programs with moderate deficiencies should be discussed within a subsection under Management, with details of noted deficiencies and related recommendations included, as deemed appropriate, on the RMA or ECC page.
- Programs with significant deficiencies or violations of BSA related regulations should be presented, as deemed appropriate, in subsections under Management or as a separate section on the ECC page or MRBA page. Details of noted deficiencies and related recommendations should be included on the RMA or ECC pages.

Concurrent specialty examinations <u>submitted under separate cover</u> (Information Technology (IT), Trust, Municipal/Government Securities Dealers (MSD/GSD), or Registered Transfer Agent (RTA)) - In some situations, it may be necessary for specialty examination reports to be completed separately from Risk Management examinations. In these rare cases, separate cover specialty examinations should be prepared consistent with specialty examination instructions. Separate cover specialty ROEs require the approval of the regional director or designee.

Specialty examination findings for separate cover reports should be summarized in the ECC section of the risk management ROE. The placement and length of specialty examination comments should be commensurate with the risk profile of the specialty area.

Meetings with Management and the Board of Directors

If a meeting with the board of directors is held, the ECC page should include a concise description of the topics discussed and any related board responses and commitments. Specific management actions, commitments, or responses that are included in preceding comments need not be repeated. However, examiners should include enough detail to make the comment informative and to document commitments for corrective actions. The date of the meeting and a listing of attendees should be included. If a board meeting was not held, examiners should summarize the exit meeting held with senior management. This comment should precede the Board of Directors Reminder described below.

Board of Directors Reminder

This comment should be under a separate heading and the last narrative item on the ECC page. The comment should remind the directorate of their responsibility to review the entire ROE and sign the Signatures of Directors/Trustees page.

Examiner's Signature and Reviewing Official's Signature and Title

The examiner's signature (signatures if joint), and the reviewing official's signature and title should be the last items on the ECC page.

COMPLIANCE WITH ENFORCEMENT ACTIONS

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Purpose

This schedule presents facts relating to an institution's adherence to formal and informal administrative actions and to Prompt Corrective Actions. As noted below, examiners should address continuing conditions related to applications, notices, or other written requests on a separate schedule.

Formal enforcement actions are notices or orders issued by the FDIC against insured financial institutions and/or individuals. The purpose of formal actions is to correct noted safety and soundness deficiencies, ensure compliance with Federal and State banking laws, assess civil money penalties, and/or pursue removal or prohibition proceedings. Formal actions are legally enforceable and final orders are available to the public after issuance.

Informal enforcement actions are voluntary commitments made by an institution's board of directors. They are designed to correct noted safety and soundness deficiencies or ensure compliance with Federal and State laws. Informal actions are not legally enforceable and are not available to the public.

When To Include This Schedule

Include this schedule when an institution has one of the following outstanding actions:

Formal Action

- Final Order pursuant to Section 8
- Capital Directive
- Section 39 Safety and Soundness Order
- Other formal administrative action of a state authority or other regulatory agency
- Continuing Condition

Informal Action

- Board Resolution
- Memorandum of Understanding
- Section 39 Safety and Soundness Compliance Plan
- Other informal administrative action of a state authority or other regulatory agency

Prompt Corrective Actions

When an institution is subject to Prompt Corrective Action (PCA), summarize the applicable provisions of the PCA and follow each provision with an examiner assessment.

Continuing Conditions

Create a separate schedule titled "Compliance with Ongoing Conditions" to discuss an institution's adherence to conditions imposed by the FDIC or other relevant banking agency in connection with an application, notice, or other request made in writing. Address continuing conditions, including any conditions or requirements imposed through orders approving deposit insurance, mergers, or other applications, as well as continuing conditions or requirements imposed through a non-objection to a change in bank control notice or other filing. Continuing conditions or requirements to be addressed may also be included in various agreements relating to an application, notice, or filing such as operating agreements, parent company agreements, capital and liquidity maintenance agreements, and passivity agreements. The schedule should follow the Compliance with Enforcement Actions page (if formal or informal actions are in place) or the ECC page.

Page Structure

Examiners should begin comments with a brief overview of the facts leading to the issuance of an action. (For example, "Based on deficiencies noted at the xx/xx/xx examination, ...") Comments should detail the type of action, effective date, and affected parties. At the first examination after the issuance of a formal or informal administrative action, the action should generally appear verbatim on this page. If the action is lengthy and management is agreeable, it may be paraphrased.

Use bold print, indentation, quotations or similar techniques to differentiate between action provisions and examiner assessments.

Each provision should be followed with an assessment of the adequacy of the steps taken by the institution to comply with each provision of the action. For example, an assessment of a new policy might say, "The updated Liquidity Policy appears to address the requirements of provision X." Examiners should not use conclusory statements of opinion such as, "The institution is in compliance/partial compliance/substantial compliance/noncompliance with this provision." Comments should also indicate whether time limits set forth in actions have been met.

At subsequent examinations, provisions may be paraphrased or summarized. Address only those points of the action that the institution has not complied with since the previous examination and requirements of a continuing nature. When all provisions have been satisfied, and the only remaining provisions are those of a continuing nature having no expiration date, remarks may be limited to a short paragraph concerning the continuing requirements of the action.

In all cases, carry forward a summary of the institution's adherence to any outstanding formal or informal actions to the ECC page.

RISK MANAGEMENT ASSESSMENT

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Purpose

The purpose of this schedule is to highlight deficiencies in risk management policies, procedures, and practices and to provide recommendations for corrective action, ideally before risk management practices impact the institution's condition.

When To Include This Schedule

Examiners should use the Risk Management Assessment (RMA) page to concisely detail supervisory recommendations about risk management deficiencies and corresponding management responses that are material enough to be included in the ROE, but not on the ECC page. When determining where to place comments (ECC vs. RMA), consider the materiality of an issue, the impact an issue has on CAMELS ratings, and how placement of a comment most effectively supports recommendations and ratings.

General

Examiners should answer each RMA question by responding: "Yes," "No," or "Generally, yes." Responses at most 1 and 2 rated institutions will likely be answered: "Yes," or "Generally, yes."

"Yes" answers do not require ROE comments.

"Generally, yes" answers, which may be appropriate for moderate weaknesses, require comment on the RMA page, but may not require ECC page comments. Related comments should be concise and address management's response.

Answers of "No" normally require ECC page comments and may even require MRBA, depending on the significance of the deficiency and urgency and seriousness of required corrective action. To the extent possible, examiners should not duplicate comments on the ECC and RMA pages; however, RMA page comments may be used to address less significant issues or to provide additional details about weaknesses that are addressed on the ECC page.

In some cases, coverage of related issues may be split between the ECC and RMA pages. For example, assume a bank's loan policy is inadequate for several significant reasons. In addition, a number of less significant policy related weaknesses are identified that alone would not justify considering the policy inadequate. In this scenario, an appropriate RMA Question No. 2 response may be:

No. As indicated on the Examination Conclusions and Comments page, underwriting and credit administration practices relating to acquisition and development lending are deficient. Additionally, management should strengthen the Loan Administration Policy by:

- Addressing minimum documentation requirements relating to home lending,
- Developing minimum liquidity and net worth requirements for unsecured borrowers, and
- Modifying accounts receivable lending guidance to be consistent with actual practices.

President Smith agreed to modify the Loan Policy by the end of the year.

Risk Management Questions

The list of items under each question is for illustrative purposes and is not all-inclusive. In responding to these questions, examiners should consider the institution's existing and projected business model, risk profile, and complexity.

1) Are risk management processes adequate in relation to economic conditions and asset concentrations?

Consider issues such as:

- Local economic conditions and trends (including real estate markets),
- Trade area demographics,
- Loan demand and diversification strategies,
- Industry or economic-sector concentrations, and
- Diversity and availability of funding sources.

The level of formality in risk management processes should be consistent with the existing and projected size and complexity of an institution's activities. For example, written policies relating to monitoring economic conditions may not be needed in a stable 1 or 2 rated community bank.

2) Are risk management policies and practices for the credit function adequate?

Consider the adequacy of policies and practices relating to issues such as:

- Credit administration,
- Underwriting standards,
- Credit grading system,
- ALLL or ACL methodology,
- Real estate appraisals and evaluations,
- Concentration limits and oversight,
- Internal and external loan review programs,
- Documentation standards,
- Lending authorities,
- Loan approval processes,
- Loan committee structures,
- Nonaccruals and chargeoffs,
- Environmental risk controls,
- Out-of-area lending,
- Loan purchases and participations,
- Subprime lending programs,
- Credit card lending programs, and
- Renewals and extensions.

Additional guidance regarding this area is included in Section 3.2 (Loans), of the Manual.

3) Are risk management policies and practices for asset/liability management and the investment function adequate?

Consider the adequacy of policies and practices relating to issues such as:

- Asset/Liability management,
- Liquidity strategies,
- Investment strategies,
- Hedging strategies,
- How growth is funded,
- Investment authorities,
- Committee structures, and
- Outside advisory services.

Additional guidance regarding this area is included in Sections 3.3 (Securities and Derivatives), 6.1 (Liquidity and Funds Management), and 7.1 (Sensitivity to Market Risk), of the Manual.

4) Are risk management processes adequate in relation to, and consistent with, the institution's business plan, competitive conditions, and proposed new activities or products?

Consider the adequacy of policies and processes relating to issues such as:

- Strategic and capital planning,
- Management depth and succession,
- New or expanded activities or products,
- Competitive environment,
- Feasibility and budgeting analysis,
- Fidelity insurance coverage, and
- Consistency of present business plan and proposed new activities with that provided with the Application for Federal Deposit Insurance (de novo institutions).

5) Are internal controls, audit procedures, and compliance with laws and regulations adequate (includes compliance with the Bank Secrecy Act [BSA] and related regulations)?

Consider the adequacy of practices, as well as policy coverage and implementation, relating to issues such as:

- Independence, scope, and frequency of internal/external audit programs;
- Internal control standards;
- Management information systems;
- Audit committee composition;
- Management's responses to previous regulatory and audit recommendations;
- Accounting issues/Call Report errors;
- Fidelity insurance coverage;
- Compliance with the Bank Secrecy Act and Financial Recordkeeping regulations; and
- Compliance with laws and regulations, including continuing conditions other than orders granting approval for deposit insurance (which should be covered on the Compliance with Enforcement Actions Page).

RMA page comments should only briefly address cited violations. Primary commentary regarding apparent violations should be included on the ECC and Violations of Laws and Regulations pages.

BSA and OFAC comments are not required on the RMA page if there are no concerns. However, moderate deficiencies or recommendations for program enhancements that do not require MRBA or ECC comments may be detailed on this page.

6) Is board supervision adequate; and are controls over insider transactions, conflicts of interest, and parent/affiliate relationships acceptable?

Consider issues such as:

- Ownership/Control of the institution;
- Quality and completeness of Board reporting;
- Committee structure adequacy to the extent not addressed in prior questions;
- Directorate attendance;
- Transactions with insiders, affiliates, holding companies, and parallel-owned banking organizations;
- Unusual or nontraditional activities conducted through affiliates;
- Policies and procedures regarding conflicts of interest and ethical conduct;
- Affiliate/subsidiary relationships;
- Compensation policies, procedures and practices including excessive compensation and appropriateness of director's fees; and
- Key man life insurance/deferred compensation arrangements.

VIOLATIONS OF LAWS AND REGULATIONS

←

Purpose

Examiners use this page to communicate details regarding apparent violations of laws and regulations, or nonconformance with guidelines or standards that are incorporated into regulations as appendices to FDIC rules, such as the appendices to Parts 364 and 365 of the FDIC Rules and Regulations.

General

The ECC page must include a reference to this page whenever violations of laws or regulations, or nonconformance with guidelines incorporated into an appendix to a regulation, are cited. The MRBA page may also require a reference to this page depending upon the significance and prevalence of the infractions and whether they are repeat infractions. References to this page on other report pages may also be necessary if related issues, such as internal control or policy weaknesses, are detailed elsewhere in the ROE.

Because of possible administrative or judicial reviews, all violations must be described as "apparent violations."

Examiners should list violations in order of importance, with consideration given to the materiality of violations, adequacy of management's response, and supervisory intentions regarding civil money penalties and enforcement actions.

Formatting Write-ups

Headings - A descriptive heading should precede each scheduled violation or group of violations.

Citation of Violation - When scheduling apparent violations of laws or regulations:

- Refer to general regulations by part number (for example, Part 329);
- Refer to specific parts of regulations by section number (for example, Section 328.2 or Section 329.1(e));
- Quote or paraphrase the requirements of violated statutes; and
- Ensure all summarized statutes or regulations accurately reflect the key aspects of the statutes or regulations. For example, "Section 337.3(b) of the FDIC Rules and Regulations prohibits banks from making loans exceeding defined amounts to directors without prior board approval."

Description of Violation - Describe the specific actions or circumstances that caused an apparent violation. For example, "The $3 million loan to Director Smith funded on 12/2/16 is in apparent violation of Section 337.3 (b) of the FDIC Rules and Regulations because it was extended without prior board approval." Lengthy descriptions of violations may be unnecessary, especially if details are included in other schedules. In such cases, include references to the other schedules.

Management Response - Comments should include:

- Management's explanation for violations and their commitments for corrective action, or lack thereof,
- The name and title of any officers or directors who provided explanations and commitments, and
- Details of any promises of restitution (when applicable).

Director Approval - To reflect director responsibility, include the names of directors who approved assets held in nonconformance with applicable State or Federal laws, regulations, or similar guidelines. While this is not necessary in all violation write-ups, it is essential when violations may result in civil money penalties. In such cases, show the date approval was granted and include the names of any dissenting directors. Follow this procedure even when an approval consisted merely of ratifying a group of loans identified only by numbers. Generally, also include director approval information when the apparent violation(s) involves insider transactions, whether or not civil money penalties are being recommended.

Summary of Technical Violations – Generally, when citing technical violations involving numerous accounts or credits, examiners may include lists of sample violations in the ROE. If sample lists are included, examiners should give complete lists to management and retain a copy in the workpapers. Refer to specialty examination instructions when citing apparent violations relating to specialty examinations.

Legal Lending Limit Violations

Generally, courts have held that only the loan(s) that cause a borrower's debt to exceed the legal limit is illegal. Therefore, consider only the advance(s) that cause the excess over the legal limit a violation. However, the state law or practices regarding this matter should prevail.

Uncorrectable Vs. Repeat Violations

After violations are first cited at an examination, refrain from citing the violations at subsequent examinations if they cannot be corrected. For example, violations of Regulation O prior approval requirements are not correctable and should not be cited at subsequent examinations. However, examiners should cite repeat violations (new infractions of previously cited violations), and violations that could have been corrected but were not.

Civil Money Penalties

Examiners must not refer to the FDIC's ability to impose Civil Money Penalties (CMPs) except in the most serious circumstances. If institutions repeat or fail to correct serious violations, comments can indicate that violations may be subject to CMPs.

Examiners must determine if an insured depository institution should be considered for a CMP referral when significant violations of the BSA/AML Compliance Program have been cited.

When CMPs are being recommended, the home mailing addresses of all directors and any other individuals involved in the violation should be included in the Confidential-Supervisory Section.

Nonconformance with Guidelines Incorporated into Regulations

After cited apparent violations, list nonconformance with guidelines or standards that are incorporated into an appendix of a regulation under the heading *Nonconformance with Guidelines Incorporated into Regulations*. An example of nonconformance with guidelines incorporated into a regulation would be when the institution did not meet one or more of the standards established in Appendix A or B of Part 364, or Appendix A of Part 365. Write-ups for nonconformance should follow the general format as violation write-ups.

INFORMATION TECHNOLOGY AND OPERATIONS RISK ASSESSMENT (ITA)

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Purpose

The purpose of the ITA page is to convey the URSIT ratings for embedded information and operations risk (IT) examinations and provide detailed comments that support each component rating.

Examiners must include comments on the Examination Conclusions and Comments (ECC) page that summarize key ITA findings, and assessments of the institution's cybersecurity preparedness and conformance with Appendix B to Part 364, Interagency Guidelines Establishing Information Security Standards (Security Guidelines). Significant findings from separate cover IT examination reports completed during the risk management examination cycle must also be summarized on the ECC page.

Page Structure and Order

The ITA is a mandatory page when IT examinations are embedded in the Safety and Soundness examination. The page should immediately follow the Violations of Laws and Regulations page, if it is included. Detailed comments supporting assigned URSIT ratings and assessments of the institution's cybersecurity preparedness and conformance with Security Guidelines are required on the ITA page.

Numerical Ratings

The ITA page includes a grid at the top of the page to display the composite and component ratings for the current and two prior IT examinations.

Supporting Comments

Comments should be presented in order of importance and provide support for the conclusions and supervisory recommendations summarized on the ECC page. Use descriptive subheadings, bulleted lists, and other such devices to promote readability.

Comments should include:

- Assessment or condition statements for each component;
- Findings and, as needed, recommendations;
- Descriptions of the consequences of inaction, or benefit of corrective action, relating to each recommendation; and
- Management's response, name and title of respondent, and timeframe specified for corrective action.

If the institution incorporates a cybersecurity tool or framework (e.g., FFIEC Cybersecurity Assessment Tool or NIST Cybersecurity Framework) into its risk management process, examiners should detail the results of management's assessment. The details should be presented in conjunction with the examiner's review of the institution's overall information security risk assessment and can be included under the supporting comments for cybersecurity preparedness.

FIDUCIARY ACTIVITIES ASSESSMENT (FAA)

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Purpose

The purpose of the FAA page is to convey supporting comments for embedded trust examination findings that are summarized on the ECC page.

When to Include

Examiners have the option to include an FAA page when additional information regarding embedded trust examination findings, recommendations, or management responses is necessary to support ECC page comments.

Supporting comments on an FAA page may relate to apparent violations, contingent liabilities, potential losses, estimated losses, or other issues subject to comment or criticism.

Page Structure and Order

Numerical Ratings

The FAA page includes a grid at the top of the page to display the component and composite ratings for the current and two prior trust examinations. At a minimum, examiners must include composite trust ratings and a summary comment on the ECC page. However, if deemed appropriate, examiners may also include composite and component trust ratings on the FAA page. The definition of the assigned composite rating must be included on the Composite Rating Definitions page.

Supporting Comments

Examiners should prepare comments on an exception-only basis as much as possible. Comments should be presented in order of importance and provide support for the conclusions and supervisory recommendations summarized on the ECC page. Descriptive subheadings, bulleted lists, and other such devices should be used to promote readability.

EXAMINATION DATA AND RATIOS (EDR)

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Purpose

The EDR page includes various data that details trends in key financial components and supplements examination assessments of capital, asset quality, earnings, and liquidity. Examiners must include the EDR page in all examination reports.

Summary of Items Subject To Adverse Classification

Generally, classification information automatically pulls from other report schedules. The Adversely Classified Items Coverage Ratio[4] included on this page represents all adversely classified items (ACI), including loans and leases, securities, other real estate owned, other assets, other transfer risk, and contingent liabilities.

Contingent Liabilities

Only Category I contingent liabilities (liabilities that will result in an equivalent increase in bank assets if the contingencies convert to actual liabilities) are subject to adverse classification.

Financial Performance and Condition Ratios

The standard ratios included on this page are derived from examination results, Call Reports, and the UBPR. When Call Report data is used, ratio calculations are consistent with UBPR User's Guide definitions. Call Report instructions require banks to report capital ratios, which are used for determining the PCA capital category, as a percentage, rounded to four decimal places. Capital ratios reflected in the EDR page are truncated at two decimals.

Note: Institutions can elect the Current Expected Credit Loss (CECL) transition provision in order to transition the day-one impact of adopting CECL in regulatory capital through transition adjustments to retained earnings, average total consolidated assets, temporary difference deferred tax assets (DTAs), and the adjusted allowance for credit losses (AACL). Additionally, those institutions that were required to adopt CECL during the 2020 calendar year can elect the CECL revised transition to delay for two years an estimate of CECL's effect on regulatory capital followed by the three-year transition provision.

Selection of Ratios

Data in the Asset Quality section and the top portion of the Capital section[5] is based on results from current and prior examinations (if applicable). The left column of the bottom three Capital ratios[6] and the Earnings and Liquidity ratios should tie to the Examination as of Date of the current examination. The information in the adjacent columns is user-defined. When selecting the period and type of information displayed in the adjacent columns (whether institution or peer), examiners should select the data that best supports examination conclusions.

For institutions reporting capital under the community bank leverage ratio (CBLR) framework, the risk based capital ratios will not be calculated; the related ratios can be shown as NC and footnoted as "Not calculated under CBLR".

Examiners can add one user-defined ratio to each section to further support examination findings. User-defined ratios for prior periods that are not readily available can be shown as NA and footnoted as Not Available, or manually calculated based on UBPR definitions.

Note: The Capital Category will need to be changed from "W-Well-Capitalized" if the bank is operating under a formal corrective action that contains a capital provision even if the capital ratios meet the requirements of the Well-Capitalized PCA category. (Change the category designation by overwriting the Capital Category cell in the automated examination tool.)

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[4] For institutions that have adopted the CECL methodology, total ACI is divided by Tier 1 Capital plus the ACL for loans and leases (including the off-balance sheet liability) plus the ACL for HTM debt securities plus assets other than loans and debt securities classified loss plus the ineligible amount of the ACL transferred from Tier 1 capital to Tier 2 capital, if applicable. For institutions that have not adopted the CECL methodology, total ACI is divided by Tier 1 Capital plus the ALLL plus assets other than loans classified loss plus the ineligible amount of the ALLL transferred from Tier 1 Capital to Tier 2 Capital, if applicable.

[5] Tier 1 Capital/Average Total Assets, Common Equity Tier 1 Capital/Risk Weighted Assets, Tier 1 Capital/Risk-Weighted Assets, and Total Capital/Risk-Weighted Assets.

[6] Retained Earnings/Average Total Equity, Asset Growth Rate, and Cash Dividends/Net Income

COMPARATIVE STATEMENTS OF FINANCIAL CONDITION

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Purpose

This schedule presents a general snapshot of the balance sheet. It is not intended for detailed financial analysis. Examiners should use the institution's Report of Condition, UBPR, and other sources for balance sheet analysis.

General

This schedule should conform to Call Report Instructions. If Call Report Instructions change, examiners may need to add new line items.

Show all asset categories net of specific and general valuation allowances, except Total Loans and Leases, which has a separate line item for general valuation allowances (the Allowance for Loan and Lease Losses or the Allowance for Credit Losses, as applicable). Additionally, examiners should consider the following:

- *Securities Purchased Under Agreements to Resell*, and *Held-to-Maturity* (HTM) securities - These items are reported net of applicable Allowances for Credit Losses.
- *Securities: Available-for-Sale (AFS) (at Fair Value)* - This line item includes AFS debt securities. *Note:* Equity securities with readily determinable fair values, which includes mutual funds, may no longer be designated as AFS.
- *Equity securities with readily determinable fair values not held for trading* - This line item includes investments in all equity securities with readily determinable fair values, unless the institution has designated the investments as trading.

Dates

Left Column - In the left column, place the financial information for the current Examination as of Date. Generally, this will be the most recent quarter-end available; however, month-end or another date may be more appropriate when circumstances dictate.

Right Column - The right column should usually detail information for the year-end prior to the Examination as of Date shown in the left column. However, when desired, substitute a different date, such as the Examination as of Date from the prior examination. If using a date other than the previous Examination as of Date, ensure the information follows Call Report Instructions.

At the first examination of a new institution, examiners may use the right column to display a projected balance sheet. If this information is not useful, leave the right column blank. In the case of a new institution, footnote the date the institution opened.

Assets, Liabilities, and Equity Capital

Ensure line items tie to Call Reports line items and footnote any unusual items. If an examination as-of date does not correspond to a quarter-end, line items must still conform to Call Report definitions.

Derivatives and Off-Balance Sheet Items

Derivatives and off-balance sheet Items should correspond to amounts listed on Call Report Schedule RC-L, (for banks that file Form 031 or 041), or Schedule RC-L and Schedule-SU, item 1 (for banks that file Form 051). If additional categories are needed, space is available below Other Off-Balance Sheet Items.

Include only Category I contingent liabilities (contingencies that give rise to accompanying increases in assets if the contingencies convert into actual liabilities). Do not include Category II contingent liabilities (those that are not expected to result in an increase in assets if converted to actual liabilities, such as pending litigation). Significant Category II contingent liabilities should be discussed on the ECC page under the financial aspect most significantly affected (for example, capital, management, earnings, or liquidity). If more than one financial aspect is impacted, comments relating to the other areas should briefly reference the contingencies and be cross-referenced as needed.

Footnotes

Use this section strictly for footnotes, not comments.

LOAN AND LEASE FINANCING RECEIVABLES

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Purpose

The purpose of this schedule is to provide an overview of the types of loans in an institution's loan portfolio and the volume of past-due and nonaccrual loans. This schedule is not intended for in-depth loan analysis. Examiners should review an institution's internal records, Call Reports, and UBPR to gain a thorough understanding of the composition and quality of a loan portfolio.

General

Complete this schedule according to Call Report Instructions.

Percentages - Round percentages to the nearest whole percent in the loan portfolio section and to the nearest hundredth percent in the past-due and nonaccrual section.

Dates - Examiners have the flexibility to use the same or different dates for the loan category and past-due/nonaccrual sections. The loan category date will usually be the Examination as of Date. The past-due/nonaccrual date should normally correspond with the Asset Review Date.

Past due and nonaccrual ratios may not tie to Call Report ratios if the Asset Review Date and the Examination as of Date are not the same. When the dates differ, ensure the dates used are clearly footnoted. Examiners may prepare the loan portfolio section as of the Asset Review Date if significant loan portfolio changes occurred after the Examination as of Date.

Loan Portfolio Breakdown

All Other Loans and Leases - This item includes overdrafts.

Gross loans and leases per the Call Report may actually be total loans and leases (gross loans and leases less unearned income). Call Report Instructions encourage but do not require institutions to report loan categories net of unearned income. Using total loans is acceptable when total and gross figures are not substantially different or unearned income is difficult to separate from loan categories.

Past-due And Nonaccrual Loans And Leases

Past-due and nonaccrual information should correspond to information in Call Report Schedule RC-N. Refer to the instructions for Schedule RC-N and the Call Report Glossary under "Nonaccrual Status."

The past-due columns are only for past due loans that are still accruing interest. The nonaccrual column may contain current and past-due loans.

Total Past Due and Accruing - This column is the sum of the previous two columns within each category.

Percent of Category Columns - The Percent of Category column calculates the ratio of past-due and accruing loans to the respective loan category. The Nonaccrual Percent of Category column calculates the ratio of nonaccrual loans to the respective loan category. (The totals in these two columns are not the sum of the ratios above the totals. The column totals are the Total Past Due and Accruing and the Nonaccrual dollar amounts expressed as a percent of gross loans and leases. The total Percent of Category ratio plus the total Nonaccrual Percent of Category ratio equals the Past Due and Nonaccrual Loans and Leases/Gross Loans and Leases ratio shown on the Examination Data and Ratios Page.) The percent of categories columns should not add to 100 percent unless the entire loan portfolio is past-due or on nonaccrual.

Restructured Loans and Leases

Memorandum: Restructured Loans and Leases - Include restructured loans here only if they are past due and accruing or on nonaccrual. These restructured loans are included in the above past-due and nonaccrual totals. Footnote restructured loans that are not past due and accruing or on nonaccrual.

Restructured loans, also known as troubled debt restructurings, are described in ASC Subtopic 310-40, Receivables - Troubled Debt Restructurings by Creditors (formerly FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," as amended by FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan"). Such loan restructurings may include, but are not limited to, reductions in principal or accrued interest, reductions in interest rates, and extensions of the maturity date because of deterioration in the borrower's financial position.

The following loans are not considered troubled debt restructurings:

- A loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk,
- A loan that was a troubled debt restructuring, which had, subsequent to its restructuring, been assumed by a financially sound, unrelated third party, and
- A loan to purchasers of ORE which, to facilitate disposal, is granted at contract rates lower than market rates for loans of similar risk.

References:

- ASC Subtopic 310-40, Receivables - Troubled Debt Restructurings by Creditors
- Call Report Instruction Glossary under Troubled Debt Restructurings
- Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings (FIL-50-2013)

Footnote

Use this area to clarify items in the above sections. Do not use it to detail loan categories. A continuation page may be used if it is necessary to break down loan categories (such as, construction, commercial real estate, 1- to 4-family residential).

RECAPITULATION OF SECURITIES

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Purpose

The purpose of this schedule is to analyze the general composition of a bank's investment portfolio, as well as any appreciation or depreciation in securities. Review the institution's internal records, Call Reports, and UBPR to gain a thorough understanding of the composition and quality of the investment portfolio.

General

Examiners should complete this schedule in accordance with Call Report Instructions-Schedule RC-B and the Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities.

Rounding - Round percentages to the nearest hundredth of a percent.

Trading Account Assets - Do not include trading account assets, other than as a footnote.

Equity Securities With Readily Determinable Fair Values Not Held For Trading – The fair value of these securities include investments in mutual funds, if not designated as trading.

Sub-investment Quality/Investment Quality

This schedule allows examiners to detail investment and sub-investment quality securities for States and Political Subdivisions, Mortgage-backed Securities, Other Debt Securities, and Equity Securities. When applicable, schedule sub-investment quality securities immediately below the appropriate line item. For instance, if an institution has a sub-investment quality other debt security (other domestic debt), add a line item titled Sub-Investment Quality Other Domestic Debt Securities directly below Other Domestic Debt Securities. The manually created Sub-investment line items will not appear unless a sub-investment quality security exists.

Fair Value And Estimated Fair Value

Fair Value is defined as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants in the principal, or most advantageous, market of the asset or liability at the measurement date. The value is often referred to as an "exit" price.

An orderly transaction is a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities. It is not a forced liquidation or distressed sale.

If using other than quarter-end statements and it is impractical to obtain the fair value for some securities, include the amortized cost of those securities in the Fair Value column. For each line item, footnote the dollar amount of amortized costs included in the Fair Value column.

Asset-backed Securities

For the purpose of this schedule, asset-backed securities are backed by assets other than 1- to 4-family residential properties. For example, securities backed by credit card receivables, home equity lines, automobile loans, other consumer loans or commercial and industrial loans. Footnote, if appropriate, the type of assets securitized if other than those previously listed.

References:

- Call Report Instructions for Schedule RC-B
- Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities
- Manual Section 3.3, Securities and Derivatives
- Capital Markets Handbook
- Call Report Glossary (particularly, Coupon Stripping, Treasury Receipts, and STRIPS; Marketable Equity Securities; Participation in Pools of Securities; and Trading Accounts)

ITEMS SUBJECT TO ADVERSE CLASSIFICATION

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Purpose

The purpose of this schedule is to detail adversely classified items, and when necessary, communicate the rationale for adverse classifications via write-ups.

General

The page heading includes the interagency definitions of Substandard, Doubtful, and Loss.

All types of assets are subject to adverse classification.

Asset Classification Write-Ups

Asset classification write-ups are prepared to support the examiner's conclusions and recommendations to the Board of Directors, senior management, and regulatory authorities (including support for enforcement actions). Write-ups may not be necessary when the Asset Quality (AQ) component is rated 1 or 2. However, when AQ is rated 3 or worse, examiners are to prepare a sufficient number of write-ups to explain individual asset classifications, highlight underwriting deficiencies, and support examination supervisory recommendations and ratings.

Examiners should structure their write-ups to present information most effectively. For example, fulsome write-ups, addressing the elements discussed under the Loan Write-Ups heading below, may be completed for loans over a certain size or to support specific conclusions or supervisory recommendations detailed on the ECC or RMA pages. Less comprehensive write-ups, or write-ups that only include a bulleted list of facts, may be completed for less complex credits. Examiners may also include lists of individual loans, or group homogeneous loans together, if appropriate. The examiner-in-charge has discretion as to the level of detail necessary to support conclusions and satisfactorily convey examination findings.

Regardless of the Asset Quality rating, examiners should consider including loan write-ups when any of the following circumstances are present:

- Significant weaknesses or adverse trends in credit underwriting or administration policies or practices,
- Material Loss classifications,
- Management disagrees with one or more classifications,
- Directors or management are not adequately aware of the impact of significant weaknesses in credit policies, practices, or conditions,
- Adversely classified assets involve institution insiders, or
- Internal credit grading systems are deficient.

Report Presentation

General

- In all cases, the dollar amount of adverse classifications must be included in the table at the top of the Examination Data and Ratios (EDR) page.
- If adverse classification write-ups are not prepared, examiners may list individual assets and groups of homogeneous assets on the Items Subject to Adverse Classification page.
- Regardless of ROE presentation, a detailed list of classifications should be left with management before the end of the examination. If this list differs from management's internal classifications, then examiners should obtain written acknowledgement from an executive officer regarding receipt of the list. This detailed list may be generated by examiners, or examiners may leverage a list of adversely classified assets provided by the institution, so long as the final list reconciles to the adversely classified items totals within the Report of Examination. Examiners should retain a copy of the list and the executive officer's acknowledgement in the

workpapers.
- If classified assets are grouped together, include a comment as to the number of assets and basis for classification. For example, "32 Consumer Installment Loans adversely classified based on the Uniform Retail Credit Classification and Account Management Policy."
- The order of adversely classified asset categories should follow the table at the top of the EDR page. Use appropriate subheadings, alphabetize assets within categories, and subtotal each category containing adversely classified items.

Loan Write-ups

When full-scope loan write-ups are prepared, comments should address pertinent factors affecting a classified asset. To the extent necessary, write-ups should address the following elements:

Identification - Indicate the name and occupation or type of business of the borrower. In the case of business loans, identify the business structure (corporation, partnership, sole proprietorship, etc.). Identify signers, cosigners, endorsers, and guarantors.

Description - Concisely describe the make-up of the debt as to the loan type, original and current amounts, and terms. Briefly describe the loan's general history, purpose, and source of repayment.

Collateral - Describe and evaluate any collateral, including its condition and/or marketability. When relevant, identify the appraiser. Also, state if the appraisal or estimate of value is independent or in-house.

Financial Data - Present key balance sheet and income information of the borrower and guarantors. The amount of financial information included in the write up should coincide with its relevance to the classification.

Summarization of the Problem - Explicitly point out the reasons for the adverse classification. Where portions of the line are accorded different classifications or are not subject to adverse classification, state the reasons for the split classifications.

Management's Intentions - Describe management's intention with the debt/borrower. Include any corrective actions contemplated by management, and identify the bank manager who committed to the actions.

Responsibility - Immediately following each loan write-up, identify the originating officer, servicing officer, and the examiner who reviewed the loan.

Consider the following when preparing write-ups:
- The format of write-ups within each asset category should be consistent in presentation, style, and appearance.
- Be concise, but do not omit pertinent information. Assess only relevant factors.
- Write informatively and factually. Do not include extraneous information that may overshadow important weaknesses.
- Round to the nearest thousand (with 000 omitted) in both the heading and adverse classification. In narrative comments, round dollar amounts to the nearest dollar (for example, $24,985) or to the nearest thousand (for example, $25M). Note: Round all dollar amounts in narrative ROE comments the same.
- When participation loans are adversely classified, list each participant and the participant's corresponding ownership percentage (whether or not originated by the institution). This requirement does not apply to Shared National Credits.
- When applicable, discuss contingent liabilities with the related credit relationship. However, do not extend adversely classified contingent liabilities with classified credits. Adversely classified contingent liabilities should be listed under the subheading Contingent Liabilities.
- When applicable, include overdraft amounts in outstanding debt recaps and discuss details on material or chronic overdrafts of borrowers with adversely classified loans in the same general comment.

- If an adversely classified asset has been partially charged off prior to the asset review date, note the date and amount of the charge-off.
- If an asset was adversely classified at prior examinations, indicate the number of times the asset was previously classified.
- If a previously classified and written up asset is again listed for classification, an abbreviated narrative, or a simple listing of name and amount, may be sufficient, if all of the following conditions are met:
    - The fundamental deficiencies have not materially changed,
    - Management agrees with the adverse classification,
    - Management and the board are sufficiently familiar with the deficiencies, and
    - Management and the board are taking feasible steps to improve or collect the asset.
- Indicate whether the loan is identified on the institution's internal watch list. If internally identified, indicate the internal rating.
- Indicate the past-due (30 days or more) or nonaccrual status of an asset. Occasionally, it may be pertinent to disclose delinquencies of less than 30 days.
- Indicate whether a loan had numerous extensions or rewrites.

It may not be necessary to address credit factors that do not have a significant bearing on a classification. For example, it may be unnecessary to identify the interest rate on a loan that is delinquent because a borrower went out of business and is no longer making payments. However, examiners may need to identify the interest rate on a variable rate loan that is chronically delinquent if the rate is about to increase and further strain the borrower's repayment ability. Additionally, it may be unnecessary to include numerous details on several small loans if a majority of a borrower's debt is centered in one or more large loans. For example, if a borrower has six loans totaling $1 million and the current balance of one of the loans is $950,000, the remaining five loans might be grouped together and described as, "Five related loans totaling $50,000 originated in 2005-2010. Debts classified Substandard due to the troubled financial condition of the borrower and weak overall collateral protection." (Do not group small loans together if detailed descriptions of the credits would provide better support for other examination comments or recommendations.)

Miscellaneous

- When adversely classified loans or other assets involve alleged fraud, embezzlement, or other dishonest conduct, state the facts that support the adverse classification. Do not discuss any possible criminal intent or conduct.
- Clearly distinguish the adversely classified assets of consolidated subsidiaries from institution-only classified assets.

ITEMS LISTED FOR SPECIAL MENTION

Purpose

The purpose of this schedule is to detail assets listed for Special Mention, and when necessary, communicate the rationale for the designation via write-ups.

General

The page heading includes the definition for Special Mention items.

All types of assets are subject to Special Mention designation.

Assets internally identified by management as Special Mention with definitions that do not align with the Interagency Statement on the Supervisory Definition of Special Mention Assets[7] or are not consistent with the related instructions included within the Manual of Examination Policies' Section 3.2 – Loans should not be included within this schedule.

Special Mention Designation Write-Ups

Special Mention designation write-ups may be prepared to support the examiner's conclusions and recommendations to the Board of Directors, senior management, and regulatory authorities. Write-ups should be included if necessary to explain potential weaknesses deserving management's close attention and how these deficiencies can reasonably be expected to lead to increased credit risk. Potential weaknesses identified that merit Special Mention designation may also be discussed, where appropriate, within other schedules of the Report of Examination including the Examination Conclusions and Comments and/or Risk Management Assessment pages to help support conclusions and examination findings.

Examiners should structure their write-ups to present information most effectively. When appropriate, comprehensive write-ups similar to those constructed on the Items Subject to Adverse Classification Report of Examination Instructions may be necessary depending on the complexity of the asset. Less comprehensive write-ups, or write-ups that only include a bulleted list of facts, may also be completed for less complex credits. Examiners may also include lists of individual loans, or group homogeneous loans together, if appropriate. The examiner-in-charge has discretion as to the level of detail necessary to support conclusions and satisfactorily convey examination findings.

Regardless of the Asset Quality rating, examiners should consider including loan write-ups when any of the following circumstances are present:

- Weak underwriting, administration, and/or imprudent lending practices,
- Assets involve institution insiders,
- Internal credit grading systems are insufficient, or
- Management disagrees with one or more designations.

Report Presentation

- In all cases, the dollar amount of Special Mention designations must be included in the table at the top of the Examination Data and Ratios (EDR) page.
- If Special Mention designation write-ups are not prepared, examiners may list individual assets and groups of homogeneous assets on the Items Listed for Special Mention page.
- Regardless of ROE presentation, a detailed list of Special Mention designated assets should be left with management before the end of the examination. If this list differs from management's internal classifications,

[7] Interagency Statement on the Supervisory Definition of Special Mention Assets, June 10, 1993.

then examiners should obtain written acknowledgement from an executive officer regarding receipt of the list. This detailed list may be generated by examiners, or examiners may leverage a list of Special Mention loans provided by the institution, so long as the final list reconciles to the Special Mention totals within the Report of Examination. Examiners should retain a copy of the list and the executive officer's acknowledgement in the workpapers.

- If Special Mention assets are grouped together, include a comment as to the number of assets and basis for designation. For example, if the bank's risk rating framework and practices are deemed reliable, examiners can accept the list of assets the bank designates as Special Mention and put the total volume of Special Mention on the Items Listed for Special Mention page, with an explanatory comment, such as: "This total represents [number] loans and commitments that meet the bank's internal definition of Special Mention. Complete list provided to management during the examination."
- If the Items Listed for Special Mention page is not included in the report, and examiners have reflected the bank's designations of Special Mention on the Examination Data and Ratios (EDR) page, examiners should include an explanatory statement on the Examination Conclusions and Comments or Risk Management Assessment pages, or in a footnote on the EDR page, as appropriate.

Miscellaneous

- When Special Mention assets involve alleged fraud, embezzlement, or other dishonest conduct, state the facts that support the designation. Do not discuss any possible criminal intent or conduct.
- Clearly distinguish the Special Mention assets of consolidated subsidiaries from institution-only Special Mention assets.

ANALYSIS OF LOANS SUBJECT TO ADVERSE CLASSIFICATION

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Purpose

The purpose of this schedule is to provide insight regarding the migration of classified loans from one examination to the next. From the analysis, the examiner will be better able to cite specific areas of change and the causes of these changes. In particular, the schedule may illustrate deterioration in the loan portfolio through the migration of loans previously classified Substandard to more severe classification categories.

When To Complete

- When institutions have marginal or unsatisfactory loan quality.
- When the volume or composition of adversely classified loans changed significantly from the previous examination.

General

Classification totals from the previous FDIC examination should normally be the starting point for the schedule. The FDIC may not always have access to state or other regulatory examination classification workpapers, which makes it difficult to use non-FDIC examinations as the starting point. However, when possible, analyze changes from a previous non-FDIC examination.

Generally, do not include adversely classified consumer loans and overdrafts. If overdrafts or consumer loans are included, they should be footnoted. Examiners also have discretion to exclude other small dollar loan balances from the schedule. Examiners should footnote amounts that are excluded.

Reductions pertain only to loans adversely classified at the previous examination.

Additional Line Items

Examiners may add line items when necessary. For example, other line items under Additions may include Previously Classified ORE where disposition did not originally meet the criteria for consummation of a sale (under ASC Subtopic 360-20, Property, Plant, and Equipment – Real Estate Sales (formerly FASB Statement No. 66, Accounting for Sales of Real Estate)), but now, subsequent to the transfer of the ORE, meets those requirements.

Payments vs. Recoveries

Nominal recoveries on loans charged off since the previous examination may be handled by: (a) including recoveries in Payments and deducting them from the line item Charged-Off, or (b) making no adjustment. However, when recoveries are significant, examiners should add a line item called Recoveries rather than include recoveries in the line item Payments. The amount included in the line item Recoveries would also be deducted from the line item Charged-Off.

Further Advances - Loans Not Adversely Classified Previously

Circumstances when this line item may be used include:

- Advances (since the previous examination) on a loan existing at the previous examination, and
- A new loan is granted to borrowers who were indebted to the institution at the previous examination and whose loans were not adversely classified at that time.

For practical purposes, do not research the payment and advance history on a loan that was on the bank's books at the last examination and not adversely classified previously. The amount listed in Further Advances - Loans Not Adversely Classified Previously should be the difference between the current balance and the previous examination balance (assuming the current balance is greater than the previous examination balance).

Further Advances - Loans Adversely Classified Previously

Circumstances when this line item may be used include:

- Advances (since the previous examination) on an adversely classified loan existing at the previous examination, and
- A new loan granted to borrowers who were adversely classified at the previous examination.

Credits Newly Extended

Include loans to borrowers who were not indebted to the institution at the previous examination.

Note: The aforementioned examples are not all-inclusive.

ANALYSIS OF OTHER REAL ESTATE SUBJECT TO ADVERSE CLASSIFICATION

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Purpose

The purpose of this schedule is to provide analysis of adverse ORE classifications from one examination to the next. From the analysis, examiners will be better able to cite specific areas of change and the causes of the changes. In particular, the schedule may illustrate deterioration in the ORE portfolio through the migration of ORE classified Substandard to more severe classification categories.

When To Complete

Examiners should consider completing this schedule if the volume of ORE is material or the composition of adversely classified ORE changed significantly since the previous examination.

General

Generally, the previous FDIC examination should be the starting point for preparing the schedule. The FDIC does not always have access to state or other regulatory examination workpapers, which makes it difficult to use non-FDIC examinations as the starting point. However, if it is possible to analyze changes from the previous non-FDIC examination, examiners may do so.

This schedule is designed to illustrate changes in adverse ORE classifications since the previous FDIC examination. Therefore, only include activity for ORE that was on the books at the last examination and ORE assets on the books at the current examination. (Do not schedule assets that both transferred into and transferred out of ORE between examinations.) If significant activity in the ORE account occurred between examinations, examiners should evaluate the reasons why assets transferred in and how they transferred out (with or without internal financing). Narrative comments may suffice to address this activity. For example, assume the following:

> Book value at previous examination: $ 5MM
> Book value at current examination: $ 3MM
> Book value of ORE acquired and sold between examinations: $12MM

In situations such as this, a separate schedule may be completed for the acquisition and sale of the $12MM. (This schedule may aid in analyzing management practices, asset quality, and loss histories.)

Examiners have the flexibility to exclude some ORE parcels. (That is, when numerous smaller parcels represent only a small portion of the total volume of ORE.) Footnote the schedule to indicate what is excluded.

Additional Line Items

Add line items when necessary.

Examples of other possible line items under Reductions:

- To Premises
- Sales for Cash
- Sales to Insiders
- Now Adversely Classified Loan (This line item may be used when internally financed sales of ORE, which did not originally meet ASC Subtopic 360-20 requirements, now meets those requirements.)
- Examples of other possible line items under Additions:
- Capitalized Improvements (This line item may be used when capitalized improvements are substantial as a whole or to a particular parcel. Otherwise, one of the Further Advances line items may be used.)
- Formerly Premises

- Loans to Facilitate the Sale of ORE (sales of ORE that do not meet the criteria for the consummation of a sale under ASC Subtopic 360-20). Use this line item when a significant volume of sales has occurred. Otherwise, sales can go under ORE from Credits Newly Extended.

Note: Reductions pertain only to ORE adversely classified at the previous examination.

Charged-off

This line item may include losses on the sale of ORE, or write-downs on existing ORE, that resulted from re-evaluations or new appraisals.

Not Adversely Classified Previously

This line item may include amounts representing both loans and ORE at the previous examination

ORE From Credits Newly Extended

This line item may include loans to facilitate ORE sales that do not meet down-payment requirements (that is, loans reported as ORE for Call Report purposes). Additionally, this item may include loans extended since the previous examination that are now adversely classified ORE.

Note: The aforementioned examples are not all-inclusive.

ASSETS WITH CREDIT DATA OR COLLATERAL DOCUMENTATION EXCEPTIONS

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Purpose

The purpose of this schedule is to support criticisms of excessive documentation exceptions and highlight specific risk management weaknesses, such as numerous exceptions involving outdated financial information.

When To Include

This schedule may be included for support when documentation exceptions are excessive, and comments regarding poor risk management practices on the MRBA page, ECC page or RMA page are appropriate. Do not include this schedule in the Report when the number of exceptions is not deemed excessive. Instead, leave a detailed list with management.

In certain circumstances, MRBA, ECC or RMA page comments about risk management practices may be appropriate if excessive deficiencies were outstanding when the examination commenced, but were substantially corrected during the examination and this schedule is not included in the Report.

General

During the examination, examiners should provide management with a list of documentation deficiencies on specific assets. This procedure is intended to expedite early correction of the deficiencies. Generally, deficiencies corrected during the examination are not included in this ROE schedule. However, examiners may include corrected deficiencies (clearly noted as having been corrected during the examination), to demonstrate reactive, rather than proactive, risk management practices.

Examiners have the flexibility to add line items in the heading to more accurately describe documentation exceptions encountered at the institution. Descriptive headings may include but are not limited to:

- 1 - Appraisal,
- 2 - Title Search or Legal Opinion,
- 3 - Borrowing Authorization,
- 4 - Recordation,
- 5 - Insurance,
- 6 - Collateral Assignment,
- 7 - Financial Statement,
- 8 - Inadequate Income/Cash Flow Statement,
- 9 - Livestock Inspection, and
- 10-Crop Inspection.

Include the date of a borrower's financial statement in the Date of Most Recent Financial Statement column only when financial statements are stale or otherwise deficient. Enter "None" when credit files contain no financial statements.

When documentation deficiencies are listed on adversely classified assets, cross-reference the appropriate ROE page.

Use this schedule to detail loan documentation deficiencies, as well as deficiencies in other assets/items (for example, ORE, securities, and letters of credit). Use subheadings to segregate categories and list exceptions in alphabetical order by the borrower's name within each subheading.

CONCENTRATIONS

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Purpose

The Concentrations page is an analytical page intended to identify *specific* concentrations of assets and liabilities that have similar risk characteristics and to communicate the examiner's evaluation of the institution's risk management practices for concentrations meeting the thresholds for write-ups described below. As an analytical page, the Concentrations page should not contain supervisory recommendations or management comments or commitments.

Overall concentration management practices and supervisory recommendations relating to concentrations should be detailed elsewhere in the ROE, such as on the ECC page, or, if included, the Risk Management Assessment (RMA) page. Material supervisory recommendations and management responses regarding concentrations should always be summarized on the ECC page. Also, depending on the extent of issues identified, commentary may be warranted on the Matters Requiring Board Attention (MRBA) page.

When to Include

Examiners must include this page to highlight asset or funding concentrations that exceed the *listing* thresholds below, and examiners must include their analysis of the potential risks and risk management practices for concentrations that exceed the *concentration written analysis* thresholds below.

Asset concentrations are pools of assets that share common risk characteristics or have heightened sensitivity to similar economic, financial, or other risk factors. An institution's asset quality, earnings, or capital can be disproportionally affected by a single or localized economic event or market conditions if the institution holds significant asset concentrations. Therefore, having risk management systems that ensure early identification of problems in these portfolios is a prudent risk management practice.

Funding concentrations are funding types that share common risk characteristics or have heightened sensitivity to similar economic, financial, or other risk factors. The primary risk of a funding concentration is that an institution may have to replace the related funds quickly or at unfavorable terms or both. This risk may become more pronounced if the bank's condition, or the condition of the party or parties providing the funds, deteriorates, which can significantly reduce the availability of funding.

The thresholds are only aimed at directing the examiner in the context of when to list a concentration for informational purposes and when to include a written analysis of a particular concentration in the Report of Examination (ROE). The thresholds are **not** limits for institutions.

Sound examiner judgment must be used to determine the most appropriate ROE treatment of concentrations in relation to the overall risk to the institution. Concentrations not meeting thresholds set forth in these instructions may also be included and analyzed on this page at the discretion of the Examiner-in-Charge (EIC) if elevated risk is evident or inclusion supports material examination findings.

Concentration Categories Requiring Listing

Asset and funding concentrations that meet or exceed the thresholds below should be listed on the Concentrations page. As a general rule, asset concentrations for credit-related assets should be measured as a percentage of Tier 1 Capital (T1C)[8] plus the entire allowance for loan and leases losses (ALLL), or the portion of the allowance for credit losses (ACL) attributable to loans and leases,[9] as applicable. The Allowance for Credit Losses (ACL) related to loans and leases, is applicable for institutions that have adopted the Current Expected Credit Losses (CECL) methodology. Examiners should identify only the funded exposures in the "Detail" and "Amount Extended" columns; unfunded amounts should be commented on in the narrative analysis but not be included in the calculation determining listing applicability.

[8] "Tier 1 Capital" as reported in the Consolidated Reports of Condition and Income, Schedule RC-R-Regulatory Capital.

[9] "Allowance for Credit Losses (ACL) on loans and leases" as reported in the Consolidated Reports of Condition and Income, Schedule RC- Balance Sheet.

For institutions that have adopted the CECL methodology and elected to use the three-year CECL transition or the revised CECL transition to delay the impacts of CECL to regulatory capital, transitioned amounts could result in a portion of the ACL to also be included as a component of T1C for the years the institution reports its regulatory capital ratios using the allowable capital relief provided by those rules. To prevent potential double-counting of the transitioned amounts of the ACL in the denominator for purposes of measuring lending-related concentrations, examiners should eliminate from T1C the transitioned amounts during the period the institution reports its regulatory capital ratios using the three-year CECL transition or the revised CECL transition provisions.

The amount to be eliminated from T1C can be calculated as the difference between the item reported on Schedule RC, Balance Sheet, item 26.a., Retained Earnings and the item reported on Schedule RC-R, Part I, Regulatory Capital Components and Ratios, item 2, Retained Earnings in the Consolidated Reports of Condition and Income. As a result of this adjustment, the amount of retained earnings used to calculate T1C for purposes of measuring lending-related concentrations will equal retained earnings as reported on the balance sheet of the institution. Examiners should ensure that, for the purposes of measuring and assessing lending-related concentrations, the denominator within the calculation represents T1C, excluding CECL transitioned amounts, if elected, plus the ACL related to loans and leases.

Asset concentrations for all other assets should be measured as a percentage of T1C, which excludes the allowance for credit losses. When capital is so low that it is no longer useful in identifying an asset concentration, examiners should use an appropriate percentage of assets as a guideline for the calculation (generally two percent of total assets (TA)).

List concentrations in order of importance (concentrations with higher perceived risks should be listed first). In determining whether, and how, to list a concentration, consider whether elevated risk is evident or whether groups of assets or funding types share common characteristics or have heightened sensitivity to similar economic, financial, or other risk factors.

1) Asset concentrations representing 25 percent or more of T1C plus the ALLL or the ACL related to loans and leases (for loans) or T1C (for securities and all other) by:

- Individual borrower,
- Small, interrelated group of individuals,
- Single repayment source, or
- Individual project.

2) Asset concentrations representing 100 percent or more of T1C plus the ALLL or the ACL related to loans and leases (for loans) or T1C (for securities and all other) by:

- Industry,
- Product line,[10]
- Type of collateral, or
- Short-term obligations of one financial institution or affiliated group.[11]

For example, a listing would be required for a concentration in non-owner occupied commercial real estate (CRE)[12] loans; owner-occupied CRE loans only if they have similar risk characteristics; agricultural real estate loans; agricultural production loans (crop loans and other loans to farmers); livestock loans; or asset-based loans, among others.

3) Funding concentrations representing 10 percent or more of TA by a single funding type.[13] Additionally, include

[10] Product lines are common programs used by an institution that target specialty lending within a broad loan category, such as leveraged financing, accounts receivable, home equity, row crops, farm equipment, and subprime.

[11] For the purposes of concentration identification, short-term obligations represent Federal funds sold with a maturity of one day or less or Federal funds sold under a continuing contract, and resale agreements that have an original maturity of one business day (or is under a continuing contract) and are in immediately available funds in domestic offices.

[12] For the purposes of this schedule, non-owner occupied CRE loans is the sum of construction and land development loans, multifamily property loans, non-owner occupied non-farm non-residential property loans, and loans to finance CRE not secured by real estate.

13 Funding "types" could include funding categories or programs that may be sensitive to interest rates or have other common risk factors. See FDIC RMS Manual of Examination Policies, Section 6.1 "Liquidity and Funds Management" for descriptions of types of funding.

any uninsured deposit[14] concentration if it represents 50 percent or more of total deposits.

Concentration Categories Requiring Written Analysis of Risk Management

In addition to listing, examiners are to provide a written analysis on the Concentrations page summarizing the examiner's evaluation of the institution's related risk management practices for each of the following asset or funding concentrations:

- Individual borrower concentrations (including small interrelated groups of individuals, a single repayment source, or an individual project) of 25 percent or more of T1C plus the ALLL or the ACL related to loans and leases (for loans) or T1C (for securities).
- Industry, product line, or collateral type loan concentrations of 300 percent or more of T1C plus the ALLL or the ACL related to loans and leases. For example, written analysis would be required for a concentration of non-owner occupied CRE loans; owner-occupied CRE loans only if they have similar risk characteristics; agricultural real estate loans; agricultural production loans (crop loans and other loans to farmers); livestock loans; or asset-based loans, among others.
- Acquisition, Development, and Construction (ADC) loan concentrations of 100 percent or more of T1C plus the ALLL or the ACL related to loans and leases.
- Correspondent credit concentrations of 100 percent or more of T1C plus the ALLL or the ACL related to loans and leases.
- Obligations of one, or a closely related group of, municipalities of 100 percent or more of T1C.[15]
- Non-agency securities (including private label mortgage backed securities, asset backed securities, and structured products) concentrations of 100 percent or more of T1C.
- Bank-owned Life Insurance (BOLI) concentrations of 25 percent or more of T1C.
- Single funding types representing 10 percent or more of TA.
- Uninsured deposit concentrations representing 50 percent or more of total deposits.

Written Analysis Instructions

Written analysis for concentrations should be risk-focused and provide a forward-looking assessment of risk that is centered on consideration of the institution's risk management practices. As a risk-focused analysis:

- When concentration risk is appropriately evaluated and controlled by institution management, the examiner's written analysis will usually be more concise than when concentration risk management is weak or deficient.
- Examiners have the option to combine concentrations with similar risk characteristics into one written analysis. For example, if the institution has ADC loans exceeding 100 percent of T1C plus the ALLL or the ACL related to loans and leases, that include an exposure to a single developer of more than 25 percent of the same denominator, then both concentrations may be combined into one analysis. Similarly, agricultural real estate loans and agricultural production loans are generally viewed as separate product lines. However, examiners have the discretion to aggregate the types, if the related risk is supported in the analysis.

The written analysis must address material factors within each of the following areas, although the examiner has discretion on formatting and does not need to expressly list or bullet each of the areas. In situations in which examiners address the areas on other ROE pages, such as the RMA page or ECC page, discussion on the Concentration page should be limited to minimize repetition.

Identification – Describe the concentration and the percentage of capital or assets it represents; deposit concentrations should be described as both a percentage of assets and deposits. Examiners should consider, and

[14] Per 12 U.S.C. 1813(m)(3), the term "uninsured deposit" means the amount of any deposit of any depositor at any insured depository institution in excess of the amount of the insured deposits of such depositor (if any) at such depository institution.

[15] Examiner judgment is needed to assess when municipalities are related. For example, if a bank invests over 100 percent of T1C in municipals located in one county, an examiner could find that there is an economic co-dependence on local employers and other microeconomic factors that could collectively impact the local municipalities' repayment capacity in some counties but not in others. Secondly, an examiner could find that a class of municipal securities, like non-rated bonds, "dirt" bonds, or revenue obligations, might be appropriate for inclusion as a concentration above 100 percent of T1C.

address in written analysis if warranted, the impact of unfunded loan commitments in the assessment of concentration management. Also, describe the methodology used by the institution to identify and monitor exposure to this specific concentration.

Economic, Market, and Competitive Factors - Discuss management's consideration of relevant economic, market, and competitive conditions that affect the concentration's risk profile.

Risk Stratification and Vulnerability Assessment - Discuss the current risk profile and trends, including (when appropriate) product type, collateral type, geographic location, internal risk ratings, source of funding, and other factors deemed relevant.

Also, include management's assessment of the concentration's vulnerability to an economic downturn, sharp interest rate movements, or other scenarios as applicable. For asset concentrations, detail management's estimate of potential deterioration in credit quality. For funding concentrations, include management's assessment of the funding type's stability.
Comments must also specifically address any interrelationship between concentrated asset and funding exposures, including whether concentrations in funding types are being used to support significant growth in concentrated assets or whether an economic downturn or other scenario is negatively affecting, or could negatively affect, both asset and funding concentrations concurrently.

Risk Management and Control Processes - Discuss the risk management practices and control processes regarding the concentration including current levels, proposed levels, and adverse scenario sensitivity analyses (if applicable). Risk-focused analysis and comments should also address the following considerations, although examiners have flexibility in presentation and do not need to list all risk management and control processes:

- The reasonableness of the board's and management's risk tolerance in relation to the inherent risk of the concentration, capital protection, and risk management practices.
- Management's consideration of current and projected economic and competitive factors when establishing concentration policies, practices and monitoring processes covering items such as concentration limits, underwriting standards, and pricing terms. When applicable, this should also include scenario analyses and contingency funding plans.
- The presence of risk-mitigating enhancements, such as government guarantees or crop insurance backed by government agencies for loans or asset pledging, private insurance arrangements, or callable features for liabilities.
- Strategic actions to address changing risk profiles of the concentration, including capital adequacy determinations, staffing and managerial needs, and pricing actions.
- Adequacy of the incorporation of analytical information (such as scenario analysis results, if conducted) into policy limits, staffing and managerial resources, capital support, funding requirements, etc.
- Sufficiency of reports used by management and the board regarding concentration exposure levels and risk estimates.

Assessment Summary – Summarize the overall risk posed by the concentration; assess the overall governance, risk management, and controls over the concentration; and address any risk management issues. Also address the volume of adversely classified assets within a concentration, if the volume is material. If management plans to change the administration or size of the concentration, briefly address the change. If a concentration is well-managed and monitored, examiners should comment to that effect.

Treatment of Select Concentration Types

Specialty Business Models - If an institution has a specialty business model concentrated in one general class of credit (such as credit cards or equipment leases), it may be appropriate to simply identify the entire loan class as a concentration and focus assessments on the adequacy of related underwriting, credit administration, monitoring, and other risk management practices.

U.S. Government Securities - Securities issued by the U.S. Treasury, U.S. Government agencies and corporations, and other obligations either backed by the full faith and credit of or fully guaranteed by the U.S. Government (hereafter referred to as "U.S. Government securities") are considered risk-free from a credit risk standpoint. Therefore, these securities and other assets collateralized by them should generally not be scheduled as concentrations, provided the existence of the collateral has been verified.

However, examiners may exercise judgment in scheduling concentrations of U.S. Government securities if the instruments could potentially impact an institution's financial condition, particularly through market risk exposure. For example, an examiner may list a concentration in U.S. Government securities (such as zero coupon bonds) that present outsized market risk and potential depreciation in a changing interest rate environment. Finally, concentrations for other U.S. Government-related securities that are not in the zero percent risk-weighted category for regulatory capital purposes may be scheduled at examiner discretion.

Real Estate Lending Concentrations - Analysis of concentrations in CRE lending is warranted, as evidenced by the significant credit losses experienced in the past when such concentrations were coupled with weak loan underwriting and depressed CRE markets.[16] Accordingly, examiners should schedule non-owner occupied CRE concentrations on the page. The risk profile of owner occupied CRE loans may be somewhat less influenced by the condition of the general CRE market because repayment is dependent on the operations of the business housed by the property. Examiners retain the discretion to schedule owner-occupied portfolios where the portfolio contains common risk elements. The analysis expected is similar to that for other concentration types, and the extent of the written analysis, when necessary, will depend on risk identified in the concentration and in how the institution manages the risk.

Prudently underwritten residential loan portfolios generally would not be required to be scheduled as they do not usually have a common risk characteristic. However, when the residential loan portfolio, or one or more segments thereof, share common risk characteristics and meet or exceed the thresholds, then listing and preparing a written analysis (as appropriate) of the portfolio, or the applicable segment(s) thereof, would be appropriate. Examples could include, but are not limited to, subprime loans, high loan-to-value loans, or nontraditional mortgage loans.

At the discretion of the EIC, Other Real Estate (ORE) may be listed as a concentration if such assets are concentrated in a certain industry, product line or collateral type (e.g., ORE concentrated in ADC properties).

Out-of-Territory Lending Concentrations - When properly managed and monitored, out-of-territory lending can diversify an institution's loan portfolio, but in other instances, if out-of-territory credits are concentrated in a particular loan type or geographic area, these exposures could pose increased risk. When examiners identify out-of-territory concentrations, they should determine concentration levels (for example, by loan type or geographic location) and evaluate common risk factors, such as exposure to depressed local economies or elevated credit administration requirements.

Purchased Loans and Participation Loans - Similar to, and often associated with, out-of-territory loans, a significant volume of purchased or participated loans may result in concentration risks. If the loans are centered in a particular loan type or geographic location, purchased through the same loan broker, or originated from the same financial institution, examiners should list and evaluate the loans as concentrations.

Correspondent Bank Concentrations - A financial institution's relationship with a correspondent may result in credit or funding concentrations. A credit concentration exists when an institution advances or commits a significant volume of funds to a correspondent. A funding concentration exists when an institution depends on one or a few correspondents for a disproportionate share of its total funding. List credit concentrations that exceed 25 percent of T1C plus the ALLL or the ACL related to loans and leases. Also provide a written analysis if the credit concentration exceeds 100 percent of T1C plus the ALLL or the ACL related to loans and leases. Funding concentrations that exceed 10 percent of TA should be listed with a written analysis included. While correspondent concentrations often meet legitimate business needs, the concentrations represent diversification risks that management should consider when formulating strategic plans and internal risk limits. Refer to Federal Reserve Board Regulation F, Part 206-Limitations on Interbank Liabilities and the Correspondent Concentration Risks

[16] See FDIC, History of the 80's, Lessons for the Future, https://www.fdic.gov/bank/historical/history/ and FDIC, Crisis and Response, an FDIC History, 2008-2013.

Interagency Guidance for additional details.

Mutual Funds - Despite their inherent diversification, list an investment in a single mutual fund, the book value of which represents 25 percent or more of T1C (including those investing exclusively in U.S. Government securities).

Non-Agency Securitization Exposures in Structured Credit Products - Non-agency structured credit products, such as private label mortgage backed securities, asset backed securities, collateralized debt obligations, and collateralized loan obligations, can contain complex structures and characteristics that make their performance more volatile and susceptible to losses in adverse market or economic environments. Examiners should include these investments as concentrations when the aggregate book or fair value (whichever is greater) of an investment type represents 25 percent or more of T1C or when the aggregate book or fair value (whichever is greater) of all such investment types exceeds 100 percent of T1C.

Extensions of Credit to a Foreign Government – Examiners are expected to aggregate extensions of credit to a foreign government, its agencies, and majority-owned or controlled entities as a class of borrower. If the extensions of credit equal or exceed the 25 percent of T1C guideline, schedule them as a concentration. Loans to private sector enterprises may also be included with public sector borrowings if an interrelationship exists in the form of government guarantees, moral commitments, significant subsidies, or other pertinent factors pointing toward reliance on public sector support. Include amounts where sizable extensions of credit to related private entities equal or exceed the 25 percent of T1C guidelines.

The aforementioned procedures are intended to facilitate reporting of concentrations involving borrowers evidencing commonality of commercial credit risk. Follow outstanding instructions when handling transfer risk or country risk, where all public and private sector credits within a country are aggregated and related to the institution's capital structure. The International Banking section of the Manual and the instructions for the International section of the Bank of Anytown contain additional instructions regarding concentrations in the area of credit to foreign governments and their entities.

Funding Concentrations – Examiners are to include individual funding type concentrations that equal or exceed 10 percent of total assets when they have common risk characteristics. Additionally, uninsured deposit concentrations of 50 percent or more of total deposits should always be included.

Examiners should consider management’s internal analyses, if comprehensive and reasonable in relation to materiality, when identifying funding concentrations. An institution’s liquidity MIS and reporting typically provide information regarding deposit categories, wholesale funding, non-relationship or higher-cost funding strategies and programs, and the stability of deposit customers, among other items. Examiners are also to take into account the purpose for raising the funds and how they are deployed when assessing funding concentrations.

Wholesale funding concentrations are relatively straightforward to identify from Call Reports or institution-provided reports. These may include, but are not limited to, Federal Home Loan Bank borrowings, other borrowings, public funds, deposits raised through listing services, or brokered deposits.

Funding concentrations arising from a targeted deposit gathering strategy or program may be more difficult to identify and are dependent on whether the deposits share common risk characteristics. For example, deposits drawn to the institution solely because it pays significantly higher than market rates may be less stable than deposits with other relationships with the bank.

Similarly, for institutions with a sizeable volume of uninsured deposits, examiners need to consider whether such deposits, or a portion thereof share similar run-risk attributes. Management information and analysis may show these deposits have characteristics that contribute to stability, such as those from local customers with a long-term relationship, those with compensating accounts, or those that are not gathered through a targeted program. However, these characteristics may not prevent uninsured depositors from suddenly withdrawing funds to shield themselves from significant losses in the event an institution exhibits financial difficulties or receives negative publicity. When assessing uninsured deposit stability, examiners should consider the bank’s business model, risk profile, and complexity; the potential impact to the balance sheet; and, management’s ability to identify, measure, monitor, and control the risks of the concentration, including during times of stress. In addition, circumstances may warrant separately identifying the insured deposits of certain depositors with significant uninsured deposits if entire deposit relationships are subject to instability. Uninsured deposit concentrations that do not meet or exceed the 50 percent total deposit threshold may warrant listing and written analysis if the deposits share common risk characteristics or have heightened sensitivity to similar economic, financial, or other risk factors.

Examiners should always include large depositors (depositors who own or control 2 percent or more of total deposits) to the extent that these deposits total 10 percent or more of total assets. Inclusion of these large depositors is premised on run risk as a common characteristic, given the size of the deposits. However, to the extent that management has demonstrated stability or other mitigating factors regarding a concentration of large depositors, this should be noted in the write-up. It is also important to note that, more generally, during times of stress, stability characteristics could be tested when depositors stand to lose their uninsured funds. Therefore, if a bank's financial condition is deteriorating or stress is probable, examiners should assess stability closely and reflect the uninsured levels of these large depositors on the page as warranted.

CAPITAL CALCULATIONS

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Purpose

The purpose of this schedule is to detail regulatory capital calculations, including adjustments resulting from examination findings.

General

Examiners should prepare this schedule according to Part 324 of the FDIC Rules and Regulations. The date of the financial information should be the same as the Examination as of Date.

CBLR – Beginning with the March 31, 2020 Call Report, certain qualifying institutions may elect to use the CBLR framework. Such institutions will not calculate Tier 2 Capital, Total Capital, or risk weighted assets, and therefore those sections of this schedule will not be completed. For further information, refer to FIL-66-2019 *Community Bank Leverage Ratio Framework* and Part 324.

Current Expected Credit Losses (CECL) Methodology – Institutions may begin adopting CECL with the March 31, 2020 Call Report. In general, for those institutions that have adopted CECL, references to the allowance for loan and lease losses (ALLL) below should be considered references to the allowance for credit losses (ACL).

Computation of Common Equity Tier 1 Capital

The definition of Tier 1 Capital is the same for both Leverage and Risk-Based Capital standards.

Individual line items are provided for Common Equity Tier 1 Capital elements, followed by Adjustments and Deductions to Common Equity Tier 1 Capital. Refer to Schedule RC-R of the Call Report Instructions for line item explanations.

In addition to those items, make adjustments for any of the following items identified during the examination process:

Assets Other Than Held-for-Investment Loans & Leases Classified Loss - This item includes assets classified Loss other than held-for-investment loans and leases, such as loans held for sale (or trading), securities, other real estate, and other assets classified Loss.

Automated examination tools may not distinguish between loans held for investment and loans held for sale and may automatically deduct all loans classified Loss from the Allowance for Loan and Lease Losses calculation in Tier 2 Capital. In such instances, examiners should make adjustments to remove the amount of loans held for sale (or trading) classified Loss from the *Less: Held-for-Investment Loans and Leases Classified Loss* line item and make adjustments to include such amount in the *Less: Assets Other than Held-for-Investment Loans and Leases Classified Loss* line item.

Additional Provision to be Transferred to Tier 2 Capital- Refer below for explanation.

Other Adjustments to and Deductions from Common Equity Tier 1 Capital - This item may include:

- Contingent Liabilities Losses - Category I contingent liabilities classified Loss and Category II contingent liabilities Estimated Loss. Refer to the RMS Manual of Examination Policies (Manual) Sections 2.1 - Capital and 3.8 - Off-Balance Sheet Activities for an explanation of Category I and II contingency liabilities, Loss classification, and Estimated Loss. Do not include in this line item Potential Loss, which should be included in the Memorandum section as discussed below. *Note:* To the extent allowances for credit losses on off-balance sheet credit exposures are included in the Allowance for Loan and Lease Losses line item for Tier 2 calculation purposes and are available to cover the Category I contingent liabilities classified Loss, do not include the Category I Loss classifications in the Contingent Liabilities Losses to be deducted from Common Equity Tier 1 Capital; instead include the Loss in the item for Less: Held-for-Investment Loans and Leases Classified Loss.

- Differences in Accounts Which Represent Shortages - Shortages in assets (to the extent not already included in *Assets Other Than Held-for-Investment Loans and Leases Classified Loss* above), overages in liability accounts, or liabilities not shown on the institution's books. Refer to Section 2.1 - Capital for an explanation of Liabilities Not Shown on Books.
- Losses From Apparent Criminal Violations - Material losses attributed to a criminal violation that cannot be addressed by a specific asset classification should be deducted from Common Equity Tier 1 Capital. When the exact amount of the loss has not been determined, the examiner may recommend that the institution engage an outside accountant or legal counsel to conduct an appropriate audit or investigation.

Include the above items only when significant, and add appropriate footnotes. Refer to Deductions for Loss Classifications and Insufficient ALLL (or ACL, as applicable) section below for discussion on what is significant.

Computation of Additional Tier 1 Capital

Individual line items are provided for the Additional Tier 1 Capital elements. Refer to Schedule RC-R of the Call Report Instructions for line item explanations.

Computation of Tier 2 Capital

Individual line items are provided for Tier 2 Capital elements. Refer to Schedule RC-R of the Call Report Instructions for line item explanations.

Allowance for Loan and Lease Losses (ALLL)

The line item, *Allowance for Loan & Lease Losses,* is the ALLL (excluding any Allocated Transfer Risk Allowances) reflected on the Comparative Statements of Financial Condition page. If applicable, add any allowances for off-balance sheet credit exposures reflected in Schedule RC-G, Other Liabilities. As necessary, deduct the amount of held-for-investment loans and leases classified Loss on the line item *Less: Held-for-Investment Loans and Leases Classified Loss* and include any adjustments necessary to replenish the ALLL to an appropriate level in the line item *Add: Additional Provision Transferred from Common Equity Tier 1 Capital.* The resulting figure is the *Adjusted Allowance for Loan and Lease Losses.*

Loans held for sale (or trading) classified Loss should not be included in the amount *Less: Held-for-Investment Loans and Leases Classified Loss*, such losses should instead be included in *Less: Assets Other than Held-for-Investment Loans and Leases Classified Loss* in the Common Equity Tier 1 Capital calculation. Manual adjustments to automated examination tools may be necessary, as discussed above. Also refer to the discussion on Contingent Liabilities Losses in the Common Equity Tier 1 Capital section above.

Eligible ALLL - The eligible amount of the ALLL to be included in Tier 2 Capital is limited to 1.25 percent of Risk-Weighted Assets base for purposes of calculating the ALLL (RWA base), as defined in Call Report Instructions. The RWA base should be adjusted to reflect examination findings as outlined in the RWA section below. When the eligible amount is less than the amount shown on the line item *Adjusted Allowance for Loan and Lease Losses,* the ineligible ALLL is shown on the line item *Less: Excess Allowance for Loan and Lease Losses (If Applicable).*

Capital Calculations for Institutions that have adopted CECL

For institutions that have adopted CECL, the ALLL is replaced with the adjusted allowance for credit losses (AACL) for purposes of regulatory capital calculations. AACL equals allowance for credit losses (ACL) under U.S. GAAP adjusted to exclude credit allowances for purchased credit deteriorated assets and AFS debt securities.

Institutions can elect the CECL transition provision to transition the day-one impact of adopting CECL in regulatory capital, which permits transition adjustments to retained earnings, average total consolidated assets, temporary differences in deferred tax assets, and the ACL. Additionally, institutions that were required to adopt CECL during the 2020 calendar year can elect the CECL revised transition to delay for two years an estimate of CECL's effect on regulatory capital followed by the three-year transition provision.

The eligible amount of the AACL to be included in Tier 2 Capital is limited to 1.25 percent of the Risk-Weighted Assets base. The RWA base should be adjusted to reflect examination findings as outlined in the RWA section below. When the eligible amount is less than the amount shown on the line item *Examination Adjusted AACL,* the ineligible AACL is shown on the line item *Less: Excess Adjusted Allowance for Credit Losses (If Applicable).*

Deductions for Loss Classifications and Insufficient ALLL (or ACL, as applicable)

Part 324 states that on a case-by-case basis and in conjunction with supervisory examinations of an FDIC-supervised institution, other deductions from capital may also be required. These should include any adjustments deemed appropriate for identified losses, including assets other than held-for-investment loans and leases classified Loss and provisions for an insufficient ALLL.

Use the following method to adjust capital for items classified Loss and to adjust for an insufficient ALLL. This method avoids adjustments that may result in a double deduction when Common Equity Tier 1 Capital already has been effectively reduced through the provision expense in establishing an appropriate ALLL level. Additionally, this method addresses those situations where certain institutions have overstated the amount of their Common Equity Tier 1 Capital by failing to take provision expenses necessary to establish and maintain an appropriate ALLL level.

Method

- The amount of Loss for items other than held-for-investment loans and leases is deducted from the calculation of Common Equity Tier 1 Capital.
- Loss for held-for-investment loans and leases are deducted from the ALLL in the calculation of Tier 2 Capital and, if significant, examiners should deduct from Common Equity Tier 1 Capital the provision expenses necessary to replenish the ALLL to an appropriate level (as discussed in the ALLL paragraph above).

Evaluation of the appropriateness of the ALLL includes consideration of the amount of adversely classified loans and leases. If the ALLL is considered insufficient, make an estimate of the amount of provision expense needed for an appropriate ALLL. Make the estimate after the identified losses in the ROE have been deducted from the ALLL. Do not deduct loans and leases classified Doubtful from capital. These items will be included in the evaluation of the ALLL and, if appropriate, will be accounted for by the adjustment for an insufficient ALLL.

Make an adjustment from Common Equity Tier 1 Capital to Tier 2 Capital for an insufficient ALLL only when the amount is considered significant. The decision as to what is significant is a matter of judgment. As such, consider how much the adjustment would change the capital ratios, how much the reader's perception of the institution's capital level will be influenced, and whether the institution's capital category for Prompt Corrective Action will be changed. Where adjustments for an insufficient ALLL may reduce an institution's capital level to a point where Prompt Corrective Action or other restrictions may apply, particular care and attention, including consultation with the appropriate field supervisor and regional office, should be considered prior to incorporating such adjustments in the ROE.

Other-than-Temporary Impairment (OTTI): If an institution made the Accumulated Other Comprehensive Income (AOCI) opt-out election for regulatory capital purposes and it has debt securities (not held for trading) classified Loss because of OTTI, the portion of the amount classified Loss related to all factors other than credit losses that will be included in AOCI (if any) should be reversed using line item *Other Adjustments to and Deductions from Common Equity Tier 1 Capital.* For examination as of dates prior to January 1, 2018, if an institution did not make the AOCI opt-out election and has debt securities (not held for trading) classified Loss because of OTTI, a percentage of the portion of the amount classified Loss related to all factors other than credit losses that will be included in AOCI (if any) should be reversed using the same line item so that the deduction from Common Equity Tier 1 Capital reflects the AOCI adjustment transition schedule outlined in Part 324.

AFS Securities Classified Loss for institutions that have adopted CECL: For institutions that have adopted CECL and made the AOCI opt-out election for regulatory capital purposes and have AFS securities (not held for trading) classified Loss because of impairment, the portion of impairment that has not been charged to earnings, if any, should be reversed using line item Other Adjustments to and Deductions from Common Equity Tier 1 Capital. Examiners should contact the Regional Office accounting and capital markets specialists for more information.

Capital Treatment of Other Real Estate (ORE) Allowances

ORE valuation allowances are not recognized as a component of capital for either Risk-Based Capital or Leverage Capital standards. A valuation allowance is established for each parcel of ORE during the holding period when the real estate's fair value minus the estimated costs to sell the real estate is less than the real estate's *cost*. Call Report Instructions clarify that valuation allowances must be determined on an asset-by-asset basis. As a result, the individual valuation allowance should be subtracted from the related asset's *cost* to determine the property's carrying value.

Risk-Weighted Assets

Risk-Weighted Assets are as of the latest Call Report date. Refer to Schedule RC-R of the Call Report Instructions for information regarding the Risk-Weighted Assets calculation. Adjustments for any Risk-Weighted Assets classified Loss should be reflected in line item *Less: Risk-Weighted Asset Amounts Deducted from Capital*. This line item should also include adjustments for items identified during the examination process in the *Other Adjustments to and Deductions from Common Equity Tier 1 Capital* line item, but only to the extent the items were risk weighted. For example, a Category I contingent liability classified Loss should be deducted if the contingent liability is included in the calculation of risk-weighted assets; however, other losses that are not associated with an asset or off-balance sheet item that is included in the calculation of risk-weighted assets should not be deducted from Risk-Weighted Assets.

The amount deducted from Risk-Weighted Assets should represent the risk-weighted portion of the asset. Automated examination tools may deduct the classified Loss amount instead of the risk-weighted portion; examiners should adjust the automated examination tool deduction from risk-weighted assets if the difference is significant (refer to the inadequate ALLL section above for discussion on significance).

Average Total Assets

Average Total Assets are as of the latest Call Report date. Refer to Schedules RC-K and RC-R of the Call Report Instructions for detailed information on this figure. Use the amounts deducted from Common Equity Tier 1 Capital above to adjust *Average Total Assets* to calculate *Average Total Assets for the Leverage Ratio. Note:* Do not deduct *Other Adjustments to and Deductions from Common Equity Tier 1 Capital* that are not associated with an asset. For example, do not deduct contingent liabilities losses from *Average Total Assets*.

Use Average Total Assets from the latest Call Report date, even if using a month-end financial date throughout the ROE.

Memoranda Items

Capital Conservation Buffer (beginning first quarter of 2016) - The capital buffer necessary to avoid limitations on distributions and discretionary bonus payments.

Securities appreciation (depreciation) - The dollar amount of securities appreciation (depreciation), net of Loss classifications, reflected in the HTM and AFS portfolios.

Contingent Liabilities - The first item, Contingent Liabilities, refers to Category I contingent liabilities. The second item, Potential Loss, refers only to Category II contingent liabilities. Refer to the *Contingent Liabilities* entry in Manual Section 2.1 – Capital for a discussion of potential and estimated losses.

Advanced Approaches Institutions

For an advanced approaches institution that exited parallel run, consult with the Regional Capital Markets Specialist to make any necessary adjustments to Tier 2 Capital, Total Capital, and Risk-Weighted Assets. It may be necessary to overwrite existing Allowance for Loan and Lease Losses line items in Tier 2 on the Capital Calculations page to reflect eligible credit reserves.

Reminder: Examiners adjusting the Call Report schedule within automated examination tools (such as the Examination Tool Suite) to reflect correction of Call Report filing errors identified during the examination, should also determine whether other capital components are impacted and require adjustments. Adjustments to Tier 2 Capital may impact Additional Tier 1 Capital deductions. Likewise, adjustments to certain Common Equity Tier 1 Capital, Additional Tier 1 Capital, or Tier 2 Capital elements may impact Common Equity Tier 1 Capital deductions. Examiners should ensure that any adjustments are in accordance with Call Report Instructions for schedule RC-R.

References:

- Part 324 of the FDIC Rules and Regulations
- Manual Section 2.1 - Capital
- Call Report Instructions

ANALYSIS OF EARNINGS

←

Purpose

This page details changes in income, expense, and equity accounts; activity in the ALLL;[13] and trends in key ratios.

For institutions that have adopted CECL, examiners should ensure that this page reflects the ACL instead of the ALLL.

Selection of Financial Periods

Examiners should use dates consistently in the Comparative Statement of Income, Reconcilement of Allowance for Loan and Lease Losses, and Other Component Ratios and Trends sections. Three data columns are available, allowing for two calendar years and one interim period (or three calendar years for examinations commencing shortly after the end of a calendar year). The interim period should correspond with the Examination as of Date.

Comparative Statement of Income

This schedule reflects data that conforms to Call Report Instructions and generally ties to the supplemental ROE page titled *Comparative Statements of Income and Changes in Equity Capital Accounts*, the Call Report schedule *RI - Income Statement*, and the UBPR *Income Statement* (except that UBPR data is completed on a tax-equivalent basis). Data fields populate automatically; however, examiners should modify the information if necessary (for example, if Call Report changes are required or if information other than quarter end is used). Footnote all changes.

- ***Provision for Loan and Lease Losses*** - Only applicable to institutions that have not adopted CECL.
- ***Provision for Credit Losses*** - Only applicable to institutions that have adopted CECL. This item reflects provisions for credit losses on all financial assets that fall within the scope of CECL.
- ***Securities Gains (Losses)*** - This item includes gains (losses) from the sale of HTM and AFS debt securities and unrealized holding gains (losses) on equities securities with readily determinable fair values not held for trading.
- ***Applicable Income Taxes*** - Worksheets for calculating Applicable Income Taxes are included in quarterly Call Report updates. The worksheets can be beneficial in verifying the accuracy of income tax accruals.
- ***Discontinued Operations, Net of Applicable Income Taxes*** – Corresponds to line item 11, Schedule RI. If the amount reported in this item is a net loss, report it with a minus (-) sign.
- ***Net Income (Loss) Attributable to Noncontrolling (Minority) Interests*** **–** Corresponds to line item 13, Schedule RI. A noncontrolling interest, also called a minority interest, is the portion of equity in a bank's subsidiary not attributable, directly or indirectly, to the parent bank. If the amount reported in this item is a net loss, report it with a minus (-) sign.
- ***Other Increases/Decreases*** - This title does not match a specific Call Report line item but includes all categories in the Changes in Equity Capital section (Schedule RI-A) that are not included in other line items.

Reconcilement of Allowance for Loan and Lease Losses (ALLL), or the Allowance for Credit Losses (ACL), as applicable.

Negative Provisions to the ALLL (or ACL on loans and leases, as applicable) - Negative provisions may be appropriate if clearly supported and applicable accounting guidelines are followed.

- ***Other Increases (Decreases)*** - Refer to Call Report Instructions for details.
- For banks that have adopted CECL, reconcilement reflects Call Report Schedule RI-B, Part II, Column A.

[13] Allowance for Credit Losses on loans and leases held for investment for institutions that have adopted CECL.

Other Component Ratios and Trends

- ***Noncurrent Loans and Leases to ALLL Ratio*** - Noncurrent loans and leases and past-due loans and leases are defined differently. Refer to the UBPR User's Guide and Call Report Instructions for these definitions.
- Examiners should include additional ratios when they are informative and support ECC page comments.
- For institutions that have adopted CECL, references to ALLL should be changed to ACL, reflecting the ACL on loans and leases held for investment.

COMPARATIVE STATEMENTS OF INCOME AND CHANGES IN EQUITY CAPITAL ACCOUNTS

←

Purpose

This page provides details of income and expense items and a summary of changes in equity capital accounts. Include this schedule when needed to support ECC page comments.

General

- Complete this schedule according to Call Report Instructions.
- Dates used should be consistent with the Analysis of Earnings page.
- Securities gains (losses) includes Gains (losses) from the sale of HTM and AFS debt securities, and Unrealized holding gains (losses) on equity securities with readily determinable fair values not held for trading.

Footnotes

Only footnotes, not comments, should appear here.

RELATIONSHIPS WITH AFFILIATES AND HOLDING COMPANIES

←

Purpose

Examiners use this page for detailing information on bank affiliates, their relationships to the bank, and credits extended to affiliated entities. It can also be used to provide a financial overview of the bank's holding company.

General

Include this schedule, when needed, to support MRBA, ECC, or RMA page comments.

Financial Statements - While examiners may obtain financial statements of the holding company (consolidated and parent-only), affiliates, and consolidated and unconsolidated subsidiaries for financial analysis purposes, include the statements in the Report only when necessary to support comments.

Service Corporations and Premises Subsidiaries - Affiliated service corporations and affiliates holding title to premises or ORE for the institution's benefit should be included here.

Holding Company Ratios and Trends

Ratios are included to facilitate holding company financial analysis. All ratios, except This Institution's Assets to Consolidated Holding Company Assets, are available in the Federal Reserve Bank Holding Company Performance Reports (BHCPR). Calculate the referenced ratio from information in Call Reports and the BHCPR. The inclusion of additional BHCPR ratios is encouraged when the ratios contribute to financial analysis or comments.

The type and availability of BHCPRs depend upon the size of a holding company's consolidated assets. A BHCPR is produced quarterly for three groups of top-tier bank holding companies (collectively, "holding companies"): holding companies with consolidated assets of $1 billion or more, holding companies that are required to file the FR Y-9C and FR Y-9LP to meet supervisory needs, and holding companies that are not subject to the FRB's risk-based capital guideline but elect to voluntarily comply with the guidelines and file the FR Y-9C and FR Y-9LP report forms.

Extensions of Credit to Affiliated Organizations Schedule

Extensions of credit to, and securities issued by, affiliated organizations (when the organizations are related interests of insiders), should be included both here and on the Extensions of Credit to Directors/Trustees, Officers, Principal Shareholders, and Their Related Interests page.

Include extensions of credit to insiders that are collateralized by securities issued by affiliated organizations (as well as on the Extensions of Credit to Directors, Officers, Principal Shareholders and Their Related Interests page). Include these items because they are subject to the provisions of Section 18(j) of the Federal Deposit Insurance Act and Section 23A of the Federal Reserve Act with regard to determining possible violations of extensions of credit to affiliated organizations.

Indirect extensions of credit include borrowings guaranteed by an affiliate.

Comments

Holding Company - Describe holding company relationships here. Generally, include the following information:

- Name,
- Location,
- Period of existence,
- Number of shares of the institution's stock owned or controlled by the company, by each subsidiary of the company, and by trustees for the benefit of stockholders or members of the company, and
- A description of holding company trends and their potential impact on the institution. Consider the amount and terms of outstanding debt, lender- or Federal Reserve System-imposed restrictions or covenants, and the dividend payout record. Discuss any adverse trends, conditions, and recommendations on the MRBA, ECC or RMA page, depending upon their significance.

Include comments on the MRBA or ECC page when payments from an institution to its holding company are large and do not appear justified based on the services received by the institution. Also, consider compliance with Section 23B of the Federal Reserve Act.

Affiliates/Subsidiaries - Fully describe affiliate relationships in the comments section. The following information should be included:

- Name,
- Location,
- Asset size,
- Net income,
- Nature of affiliation,
- Period of existence,
- Circumstances under which the affiliation arose, and
- Primary business activities of the affiliate.

Include officers or directors when relevant. Additionally, include details regarding the amount and terms of any transactions, including extensions of credit, to and from affiliates. This information is important because the provisions of Section 18(j) of the Federal Deposit Insurance Act and Section 23A of the Federal Reserve Act apply insofar as determining possible violations of extensions of credit to affiliated organizations. Generally, comments should be brief pertaining to each extension of credit.

Nonbank Banks - Note when the institution under examination is a grandfathered nonbank bank. List violations of the Competitive Equality Banking Act of 1987 on the Violations of Laws and Regulations page and summarize the violations in a memorandum to the Regional Office. In such cases, include appropriate information on the parent company.

References:

- Related Organizations section of the Manual
- User's Guide for the Bank Holding Company Performance Report
- Section 18(j) of the FDI Act
- Section 23A of the Federal Reserve Act
- Section 23B of the Federal Reserve Act
- Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure
- Federal Reserve Board Regulation W
- Part 362 of the FDIC's Rules and Regulations

EXTENSIONS OF CREDIT TO DIRECTORS, OFFICERS, PRINCIPAL SHAREHOLDERS, AND THEIR RELATED INTERESTS

←

Purpose

The purpose of this page is to provide details regarding loans extended to bank insiders and their related interests.

When to Include

Use this schedule to highlight loans to directors, executive officers, principal shareholders, and their related interests that are subject to criticism due to overall volume, credit quality, or preferential treatment.

General

Cross-reference here and on the appropriate Report pages extensions of credit subject to adverse classification, violation, or comment. List the current balances of indebtedness in the total column. Footnote charged-off items.

If a director or principal shareholder is also an executive officer, include that person as an executive officer. (Executive officers are subject to the more stringent restrictions of Regulation O.)

Definition of Terms

Prepare the schedule in conformance with Regulation O definitions of extension of credit, unimpaired capital and surplus, director, executive officer, principal shareholder, and related interest.

List of Insider Credits

List insiders alphabetically by description: Group A (Executive Officers and their related interests), and Group B (Directors/Trustees and Principal Shareholders and their related interests). Generally, comments regarding extensions of credit to insiders should be brief and not include detailed descriptions of the credits or related collateral. However, include details on material overdrafts or other unusual items.

Per Regulation O, directors, executive officers, and principal shareholders of the holding company are considered to be directors, executive officers, and principal shareholders, respectively, of the institution. As such, the prior approval, terms, creditworthiness, and lending limit provisions of Regulation O are applicable. List these individuals when appropriate.

In unusual circumstances, examiners may wish to obtain information regarding extensions of credit to non-executive officers and other employees. If such information is listed, do not include the indebtedness in the table at the top of the schedule.

Duplications With Extensions of Credit to Affiliates

Extensions of credit to, and securities issued by, affiliated organizations that are related interests of insiders should be reported here and on the Extensions of Credit to Affiliated Organizations schedule of the Relationships with Affiliates and Holding Companies page.

References:

- Federal Reserve Board Regulation O
- Section 337.3 of the FDIC Rules and Regulations
- Manual Section 4.3, Related Organizations

COMPOSITE RATING DEFINITIONS

←

Purpose

This page provides definitions of the composite CAMELS (UFIRS) and specialty examination ratings detailed in the ROE. Disclosure of composite and component ratings encourages a more complete discussion of examination findings and assists bank directors and managers in making effective risk management decisions.

General

Examiners should ensure that each composite rating listed on the ECC page is defined on this page. List definitions in the same order as the ratings listed on the ECC page.

References:

- Uniform Interagency Consumer Compliance Rating System - Statement of Policy 11/28/80
- Appendix A to Part 345 of the FDIC's Rules and Regulations
- Uniform Rating System for Information Technology (FIL 12-99 02/05/99)
- Uniform Financial Institutions Rating System (FIL 105-96 12/26/96)
- Uniform Interagency Trust Examination Rating System (FIL 115-98 10/21/98)

All rating definitions are available at www.fdic.gov/regulations/examinations/ratings/.

If the automated examination tool is used to generate the ROE, the rating definitions should appear upon entering the composite ratings on the ECC page.

SIGNATURES OF DIRECTORS/TRUSTEES

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Purpose

This page, when signed and dated by all of the institution's directors, serves as the directors' certification that they each reviewed the Report in its entirety.

This form is the last page in all ROEs forwarded to institutions.

General

Enter the full name of each director in alphabetical order. This will facilitate the proper signatures of directors after they reviewed the ROE.

The page will be included in the institution's copy of the ROE. The signed form is to remain attached to the Report and retained in the institution's files for examiner review at subsequent examinations.

OFFICER'S QUESTIONNAIRE

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Purpose

The purpose of the Officer's Questionnaire (Questionnaire) is to obtain information that might not otherwise come to the examiner's attention during the examination.

General

- The Questionnaire is an official document prepared by the institution. Examiners must not alter the specific questions or answers in any way.
- Generally, the chief executive officer (CEO) should sign the Questionnaire. However, an executive officer, as defined by Regulation O, may sign if designated to do so by the CEO and material concerns are not anticipated.
- The EIC has flexibility in determining the as-of date of the Questionnaire. The Questionnaire may be completed as of the Examination as of Date or the Examination Start Date. However, the Questionnaire should never be completed as of a date subsequent to the date the institution received the questionnaire.
- The Questionnaire should be completed on a consolidated-bank basis.
- In general, bank management should be instructed to base their responses on transactions or events that have occurred since the date of the previous FDIC examination. Where a specific timeframe is not specified in the question, examiners have the discretion to request only information since the previous state examination if the state ROE is acceptable. Exception: responses to questions 10, 11, and 12 are not to be limited to any time period.
- Examiners may review these instructions with management to help them understand and complete the Questionnaire.
- Answers can be listed on continuation pages if adequate space is not provided following a question. Copies of the institution's records are acceptable if the documents furnish all the requested information and contain original signatures. If responses are voluminous, they may be provided separately from the Officer's Questionnaire. The Questionnaire should state when separate information was given to the EIC, and the information should identify the questions to which it pertains.
- Financial institutions can submit Questionnaire responses in a printed form (such as hardcopy attachments), in a secure electronic format (such as through FDICconnect), or in a combination or of paper and electronic documents. Upon receipt of Questionnaire responses, examiners should scan any printed forms into an electronic portable document format (pdf) file and convert any electronically received documents into a pdf file, to the extent not already in pdf format. Examiners should then import the pdf files of the documents into the Officer's Questionnaire folder in the Regional Automated Document Distribution and Imaging System (RADD).
- If an EIC believes an officer gave an answer in error due to oversight or misunderstanding, the signing officer may be permitted to correct the answer. The signing officer should initial all corrections.
- The Questionnaire may be submitted with the Report of Examination when appropriate. For example, the
- Questionnaire should be included if the examiner suspects that an officer knowingly provided incorrect information in the document.
- The Questionnaire should be retained for a minimum of ten years from the examination start date.
- The Questionnaire should be retained indefinitely when irregularities are discovered or suspected during the ten-year retention period.
- If management is given an electronic copy of the Questionnaire, examiners must carefully compare the returned questionnaire to ensure the wording in each question is identical to the wording in original documents.

Question 1

List all extensions of credit and their corresponding balances, which, since the last FDIC examination, have been renewed or extended under any of the following circumstances:

a) without full collection of interest due
b) with acceptance of separate notes for the payment of interest
c) with capitalization of interest to the balance of the note

For all listed loans, state which situation applies. Consumer credit/installment loans may be aggregated by number and total dollar volume.

The purpose of the question is to:

- Determine the extent of interest capitalization.
- Identify loans with potentially poor credit quality.
- Identify credit practices that may distort past-due information.
- Identify practices that may adversely affect the quality of the institution's reported earnings.

Forward affirmative answers to examiners reviewing loans. An excessive number of these loans may distort the institution's financial position by overstating earnings and understating the past-due ratios. If there is a lengthy response to this question, it may be appropriate to include comments regarding the accuracy of the past-due ratios on the RMA page. Excessive use of these practices may warrant an ECC page comment.

Question 2

List all extensions of credit secured by stock of other financial institutions, or financial institution holding companies, or their affiliates where the total of all shares held as collateral represents five percent or more of the entity's outstanding shares. Provide the following information for each listing:

- Name and location of entity
- Name of stockholder and borrower
- Number of shares held as collateral
- Percentage of ownership
- Certificate number(s)
- Original amount
- Current balance
- Origination date
- Maturity date
- Interest rate
- Purpose

The purpose of the question is to:

- Assist in determining compliance with the reporting requirements of Section 7(j) of the FDI Act.
- Assist in determining or assessing the extent of interbank activity, and assist in understanding relationships between entities and their management teams.
- Review insider relationships, when applicable.
- Assist in determining or assessing direct or indirect control issues, asset quality, and dividend requirements of other entities.
- Generate information necessary for bank correspondence cross-referencing and verifying the accuracy of information at other institutions.

References:

- Section 7(j) of the FDI Act
- Section 23A of the Federal Reserve Act
- Bank Holding Company Act
- Manual Section 4.3, Related Organizations

Question 3

List all extensions of credit made for the accommodation or direct benefit of anyone other than those whose names appear either on the note or on other related credit instruments. If any executive officer, principal shareholder, director, or their related interest (per Federal Reserve Board Regulation O definitions) is or was involved.

The purpose of the question is to:

- Determine compliance with applicable laws and regulations.
- Assist in reviewing legal lending limits.
- Assist in determining asset quality.
- Assist in determining concentrations.
- Assist in reviewing potential conflicts of interest.
- Identify straw borrowers, also known as bogus or pass-through borrowers. If loan proceeds went to the benefit of a person other than the person named on the note, or otherwise disclosed in bank records, it should be applied to the benefiting parties' aggregate debt for legal lending limit purposes.

References:

- Federal Reserve Board Regulation O
- Part 353 of the FDIC Rules and Regulations
- Manual Section 4.5, Violations of Laws and Regulations

Question 4

List all extensions of credit made by the bank (or its subsidiaries) to the officers, directors, (or their related interests) of other financial institutions or their affiliates. Provide the following information for each listing:

- Name and title of director, officer, or related interest
- Name and location of the entity
- Original amount
- Original date
- Current balance
- Maturity date
- Interest rate
- Security
- Purpose

The purpose of the question is to:

- Allow for the appropriate cross-referencing of files and verification of data at other institutions.
- Determine compliance with applicable laws and regulations.
- Assist in reviewing potential conflicts of interest and preferential treatment.
- Assist in determining the extent of such activities, and assist in better understanding the entities' business relationships with each other.
- Assist in reviewing asset quality.
- Assist in determining concentrations in this type of lending.

Reference: Section 106(b)(2) of the Bank Holding Company Act

Question 5

List all transactions between the institution and any of its executive officers, principal shareholders, directors, or their related interests, except for:

- Loans
- Deposits
- Bonuses
- Salaries
- Director fees

Include the insider's name, as well as the date and nature of the transaction.

The purpose of the question is to:

- Determine the extent, and allow for the review, of insider transactions.
- Assist in determining whether insider transactions harmed the institution.

Reportable transactions may involve equipment leases, leasing of bank premises, or insiders providing institution-related services such as appraisals, IT services, legal services, or insurance.

References:

- Manual Section 9.1, Fraud and Insider Abuse
- Manual Section 4.5, Violations of Laws and Regulations
- Manual Section 4.1, Management

Question 6

List any oral or written agreements with correspondent depository institutions that establish balances to be maintained, or other similar consideration, in connection with loans to either institution's directors, officers, employees, or principal shareholders.

The purpose of the question is to:

- Assist in reviewing potential conflicts of interest.
- Assist in determining if such transactions have an adverse effect on the institution.
- Assist in reviewing potential misapplication of funds.
- Assist in determining tying arrangements per Section 106 of the Bank Holding Company Act of 1956.
- Assist in assessing practices related to establishing or maintaining relationships via oral agreements, if any.

Reference: Manual Section 4.3, Related Organizations

Question 7

List all extensions of credit to accountants, lawyers, consultants, appraisers, or other similar individuals (including their related interests) who have provided professional services to the institution since the last FDIC examination. Exclude loans to directors, officers, or employees who perform these services, if such loans have been disclosed to examiners in other documents. Provide the following information for each listing:

- Name of borrower
- Borrower's relationship with the institution
- Current Balance

The purpose of the question is to:

- Assist in reviewing potential conflicts of interest.

Question 8

List all arrangements where the institution is obligated to make payments to a former institution-affiliated person (per Section 3 of the FDI Act) who has left the institution's employment, or has otherwise terminated his/her affiliation with the institution. Provide the following information for each listing:

- Name of person receiving payments
- Total amount of payments
- Basis for payment
- Explanation of the type of agreement (such as severance pay or deferred compensation)

If more than one person is covered by a single agreement, list the plan only once and summarize the plan's coverage.

The purpose of the question is to:

- Determine compliance with applicable laws and regulations regarding severance agreement payments.
- Identify poorly designed compensation structures that misalign incentives and induce excessive risk-taking.
- Determine potential abuse resulting from excessive compensation.
- Determine potential adverse effects on profitability.
- Assist in checking the accuracy of accounting issues and financial statements (that is, if the institution has booked appropriate liabilities).

This question looks for potential payments that may meet the definition of a golden parachute payment as defined by Section 18(k) of the FDI Act. Such payments might be prohibited if the institution becomes troubled. Examiners can also use the information provided in the response to review for excessive compensation.

References:

- Section 18(k) of the FDI Act
- Part 324 of the FDIC Rules and Regulations (Prompt Corrective Action)
- FIL-66-2010 Guidance on Golden Parachute Applications
- Part 364 of the FDIC Rules and Regulations
- Manual Section 4.1, Management

Question 9

List any written or oral contract or agreement (not included in responses to questions five and eight above) that obligates the institution to pay more than ten percent of its current equity capital over the life of the contract or agreement. Provide the following information for each listing:

- Name of the counter party or payee
- Date of the contract or agreement
- A brief description of the purpose, terms and conditions

The purpose of the question is to:

- Assist in identifying undesirable lengths of contracts and potential excessive liabilities.
- Assist in determining any impairment of capital.
- Review for adverse termination clauses.
- Determine impact on the institution's future profitability.
- Assist in assessing practices related to establishing or maintaining relationships via oral agreements, if any.

Use the Regulation O definition of equity capital when determining ten percent of equity capital.

This question is intended to identify contracts that may adversely affect the safety and soundness of the institution. Appropriate management review and approval should be recorded for large contracts.

Reference: Section 30 of the FDI Act

Question 10

List any director who has been ineligible or disqualified from serving as a director at any time. Also, furnish the reason for his/her ineligibility or disqualification.

The purpose of the question is to:

- Determine compliance with applicable state laws and regulations.
- Verify the directors' continued eligibility to serve on the bank's board. For example, many states require a director to own and maintain qualifying shares of stock in the institution. In addition, some state laws prohibit individuals from serving as a director, if their loan(s) have been adversely classified. State laws generally govern the meaning of disqualification for the response to this question. However, any current director that was ever deemed ineligible from serving as a director at an insured depository institution due to statutory or regulatory guidelines (state or federal), or internal (bank) restrictions, should be identified. Cross-check responses here with responses in question No. 12 for possible tie-ins.

Question 11

List all instances where a director, officer, or employee has committed a crime involving the institution's funds or property, including any funds or property for which the institution is responsible. Provide the following information for each listing:

- Name(s) of all individuals involved
- Date and nature of irregularities
- Extent of restitution made, if any
- Whether the proper law enforcement authorities and the fidelity bond carrier were promptly notified

If either law enforcement officials or the bond carrier was not notified, explain the situation in a separate memorandum to the examiner-in-charge.

The purpose of the question is to:

- Determine compliance with applicable laws and regulations.
- Ensure notification was given to proper authorities.
- Assist in reviewing recovery potential from the bonding company.
- Indicate possible internal routine and control deficiencies.

References:

- Section 8(e) of the FDI Act
- Part 353 of the FDIC Rules and Regulations
- Manual Section 4.5, Violations of Laws and Regulations

Question 12

List any director, officer, or employee who has been convicted of, or who is presently under indictment or similar action for, or has agreed to enter into a pretrial diversion or similar program in connection with the prosecution for any criminal offense involving dishonesty, breach of trust, or money laundering. Briefly describe the situation.

The purpose of the question is to:

- Determine compliance with applicable laws and regulations.
- Assess conformance with corporate codes of conduct and bank ethics policies
- Assess UFIRS Management component

References:

- Sections 8(e), 8(g), and 19 of the FDI Act
- FIL 105-2005, Corporate Codes of Conduct, Guidance On Implementing An Effective Ethics Program
- Manual Section 4.1- Management

Question 13

List all assets of value the institution owns but does not show on its books.

The purpose of the question is to:

- Assist in ensuring proper internal control and accounting over such items.
- Assist in determining the institution's capital position.

This question may encompass a variety of answers. Typical answers include charged-off assets of undetermined value.

Reference:

- Manual Section 2.1, Capital
- Manual Section 3.7, Other Assets and Liabilities
- Manual Section 4.1, Management
- Manual Section 4.2, Internal Routine and Controls

Question 14

If the institution is a defendant in any lawsuit, provide the following summary information:

- Names of the plaintiffs
- Amount sued for
- Nature of, or basis for, litigation
- Expected result, including any probable loss

If necessary, provide full details to examiners, in a separate memorandum.

The purpose of the question is to:

- Determine the impact of contingent liabilities, the likelihood of contingencies becoming direct liabilities, and the potential impact on capital.

In some instances, institutions incur significant costs in obtaining a formal attorney's letter. As such, examiners should not specifically request or require such a letter as a means of answering this question. Nonetheless, many institutions will obtain an attorney's letter. Normally, a summary should be provided here, and the attorney’s letter(s) should be retained in the examination workpapers. If the letter(s) are being included in the Report (with the Officer's Questionnaire), include the letters on a continuation page.

References: Manual Section 2.1, Capital - Contingent Liabilities

Question 15

List all organizations that are directly or indirectly affiliated with, or otherwise related to, the institution in any way, including fiduciary relationships. Related organizations may be corporations, partnerships, business trusts, or any similar organization. Provide the following information for each listing:

- Name of affiliate or related entity
- Location
- Type of business
- Current balance of all direct and indirect extensions of credit to the affiliate (per Section 23A ofthe
- Federal Reserve Act)
- Current balance of all loans to third parties, where the loans are collateralized with securities issued by the affiliate

The purpose of the question is to:

- Identify affiliated or related organizations.
- Identify loans to affiliates or related organizations.
- Reveal trust powers and the extent to which trust powers are exercised.
- Ensure all contingent liabilities are reviewed.

References:

- Section 303.7 of the FDIC Rules and Regulations
- Section 23A of the Federal Reserve Act
- Manual Section 4.3, Related Organizations
- Manual Section 12.1, Applications
- Trust Examination Manual, Section 10, Other Trust Matters

ABBREVIATIONS

←

The following are the principal abbreviations used in this Report of Examination.

et al	And Others
a/k/a	Also Known As
ABS	Asset-Backed Securities
ACH	Automated Clearing House
ACI	Adversely Classified Items
ACL	Allowance for Credit Losses
ADC	Acquisition, Development, and Construction
AFS	Available-for-Sale
AGI	Adjusted Gross Income
AL	Acres of Land
ALCO	Asset/Liability Committee
ALLL	Allowance for Loan and Lease Losses
AML	Anti-Money Laundering
AOCI	Accumulated Other Comprehensive Income
AP	Accounts Payable
AR	Accounts Receivable
ARM	Adjustable Rate Mortgage
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
ATM	Automated Teller Machine
AV	Appraised Value
AVP	Assistant Vice President
BIA	Business Impact Analysis
BCP	Business Continuity Plan
BHC	Bank Holding Company
BOLI	Bank-Owned Life Insurance
bp	Basis Point(s)
BSA	Bank Secrecy Act
BV	Book Value
Call Report	Reports of Condition and Income
CCO	Chief Credit Officer
CD	Certificate of Deposit
CDD	Customer Due Diligence
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CF	Cash Flow
CFP	Contingency Funding Plan
CFPB	Consumer Financial Protection Bureau
CFR	Code of Federal Regulations
C&I	Commercial and Industrial
CIP	Customer Identification Program
CISO	Chief Information Security Officer
COO	Chief Operations Officer
CRA	Community Reinvestment Act
CRE	Commercial Real Estate
CTR	Currency Transaction Report
CPA	Certified Public Accountant
CSV	Cash Surrender Value
DDA	Demand Deposit Account
DDoS	Distributed Denial of Service
DSC	Debt Service Coverage
DTA	Deferred Tax Asset
DTL	Deferred Tax Liability
d/b/a	Doing Business As
DPC	Debts Previously Contracted
DT	Deed of Trust
EBITDA	Earnings Before Interest, Taxes, Depreciation, and Amortization
EFT	Electronic Funds Transfer
EIC	Examiner-in-Charge
EVE	Economic Value of Equity
EVP	Executive Vice President
FA	Fixed Assets
FASB	Financial Accounting Standards Board
F&F	Furniture and Fixtures
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FHA	Federal Housing Administration
FHLB	Federal Home Loan Bank
FHLMC	Federal Home Loan Mortgage Corporation
FinCEN	Financial Crimes Enforcement Network
f/k/a	formerly known as
FNMA	Federal National Mortgage Association
FRB	Federal Reserve Bank
FS	Financial Statement
FSA	Farm Service Agency
FS-ISAC	Financial Services - Information Sharing and Analysis Center
FV	Fair Value
GAAP	Generally Accepted Accounting Principles
GNMA	Government National Mortgage Association
Gty	Guaranty or Guarantee
HTM	Held-to-Maturity
HVCRE	High Volatility Commercial Real Estate
ID	Income Data
Inc	Incorporated
IPO	Initial Public Offering
IRR	Interest Rate Risk
IRS	Internal Revenue Service
ISO	Information Security Officer
ISP	Information Secuirty Program
IT	Information Technology
JM	Joint Maker
LAN	Local Area Network
LLC	Limited Liability Company
LOC	Line of Credit

LP	Limited Partnership
LS	Livestock
LTV	Loan-to-Value
M	Thousands
M&E	Machinery & Equipment
MBS	Mortgage-Backed Security
MMDA	Money Market Deposit Account
MRBA	Matter Requiring Board Attention
MSA	Mortgage Servicing Asset
Mtg	Mortgage
MV	Market Value
NI	Net Income
NII	Net Interest Income
NIM	Net Interest Margin
NNCFD	Net Non-Core Funding Dependence
NOI	Net Operating Income
NOL	Net Operating Loss
NOW	Negotiable Order of Withdrawal
NP	Notes Payable
NR	Notes Receivable
NW	Net Worth
OD	Overdraft
OFAC	Office of Foreign Assets Control
ORE	Other Real Estate
PCA	Prompt Corrective Action
PD	Past Due
P&I	Principal & Interest
P&L	Profit & Loss Statement
PV	Present Value
RE	Real Estate
ROA	Return on Average Assets
RBC	Risk-Based Capital
RE	Real Estate
REM	Real Estate Mortgage
SVP	Senior Vice President
SA	Security Agreement
SAR	Suspicious Activity Report
SBA	Small Business Administration
SEC	U.S. Securities and Exchange Commission
SFR	Single-Family Residence
SLOC	Standby Letter of Credit
TA	Total Assets
TDR	Troubled Debt Restructure
TE	Tax Equivalent Basis
TL	Total Liabilities
TR	Tax Return
UBPR	Uniform Bank Performance Report
UCC	Uniform Commercial Code
USDA	United States Department of Agriculture
VA	Veteran’s Administration
VOIP	Voice Over Internet Protocol
VP	Vice President
WAN	Wide Area Network
YTD	Year-to-Date

CONFIDENTIAL – SUPERVISORY SECTION

←

Purpose

The purpose of this page is to communicate non-public information to regulatory personnel. Generally, information on this page should not duplicate information in the open section of the Report. Use descriptive headings to separate topics and improve readability.

Mandatory Comments

Institution Control and Relationships - Concisely identify the individuals or organizations that control the institution, material subsidiaries, and affiliates. Such information is important in tracking chain bank organizations and updating holding company records.

Examiners should interpret the word "controlled" broadly. Control may exist in an individual or group, through stock ownership, or other means. Depending on the situation, ownership of varying percentages of stock may result in control. In a mutual institution, effective control may exist in the form of a board, committee, or dominant individual. A concentration of decision-making power and a lack of oversight or accountability are keys to determining the level of control.

References:

- Change in Bank Control - Section 7(j) of the FDI Act
- Part 362 - Activities of Insured State Banks and Insured Savings Association

Director Involvement – Prepare a brief statement of any Director contacts with the examiners outside of the exit/board meetings. If no such contact takes place, no comment is necessary.

Dominant Management – Identify the dominant officials, if any, and describe the dominant official’s influence and effect on the institution, the board’s independence and oversight, and the effectiveness of mitigating controls, if no concerns are identified. If there is a dominant official, ensure this is indicated on the SAER page. If there is no dominant official present, indicate such on the SAER page and no comment is required in the confidential pages.

Examination Scope – Prepare a brief comment addressing any deviations greater than 15% between projected and actual hours or any material change in examination scope or procedures. If there are no significant deviations or any material changes, then no comment is necessary.

If applicable, address within the examination scope comment any increased Bank Secrecy Act/Anti-Money Laundering or Office of Foreign Asset Control risk that should be reviewed at subsequent examinations and/or address significant or material changes in examination scope or examination procedures. If there are no increased risks and/or significant variances from the original scope did not occur, no comment is necessary.

Specialty Examinations (Including Information Technology, Trust, Registered Transfer Agent, Government and Municipal Securities Dealers) – Comments should include:

- Specialty examination numbers (used for hours tracking)
- Discussion and explanation of any material change in examination scope or procedures, or deviations between projected and actual hours of 15% or greater.
- For Information Technology, note any participation by other regulatory agencies in the IT examination, including the name of the agency and examination hours, if applicable. Comments should also include a listing of serviced institutions, if applicable.
- For Trust examinations, note the component ratings and list any unique characteristics of the client base or services, unless already addressed elsewhere in the ROE.

Capital Enhancement Sources – This section is applicable if not addressed within the ECC pages and earnings retention of the bank is significantly insufficient to maintain adequate capital, and the sale of new equity may be necessary to address capital needs. This section would primarily address potential capital resources, including the perceived capacity and willingness of potential investors to purchase stock. The following items may also be addressed at the examiner's discretion:

- A complete list of present shareholders detailing the amount of stock held and their financial worth (small holdings may be aggregated if a complete listing is impractical),
- Individual director's capacity and willingness to purchase stock,
- A list of prominent customers and depositors who are not shareholders but who may be interested in acquiring stock,
- A list of other individuals or possible sources of support in the community who, because of known wealth or other reasons, might want to subscribe to new stock, and
- Any other information regarding new capital sources, along with the examiner's opinions regarding the most likely prospects for the sale of new equity.

Optional Comments

Questionnaires and Work Programs – Prepare a summary comment if any findings from a Questionnaire or Work Program completed during the examination identifies an increased risk or some other item that should be reviewed at a subsequent examination.

Express Determination Letters – Include a brief comment if management requests, and is provided or denied, an express determination letter for tax purposes. For additional details, refer to Section 3.2 (Loans), of the Manual.

Additional Items – The following topics may be addressed if relevant:

- Information supporting examination comments, recommendations, ratings, and/or sensitive information regarding management, strategic plans, offices, products, or services.
- Comments reconciling apparent discrepancies between the assigned rating and recommended supervisory actions (or lack of recommended actions),
- Sensitive or nonpublic information such as planned management changes and merger discussions, and other issues such as a lack of cooperation from management.
- Noting the name of the acting EIC if the examination served as a practice job

Suggestions and Comments for Future Examinations

Comments may include the following:

- Special Expertise requirements (e.g., capital markets experts),
- Dress code and locations and business hours,
- Records maintained at locations other than the main office,
- Working space limitations, and
- Any other information that may improve examination efficiencies.

Recommendations for Administrative Actions

Do not reference administrative actions on the Confidential Page. Address, in a separate memorandum, actions such as: (1) imposing or not imposing civil money penalties, (2) terminating insurance, (3) issuing a Cease and Desist Order or other formal action, (4) issuing a Memorandum of Understanding or other informal action (Board Resolution), and (5) releasing an institution from outstanding action.

When administrative action is contemplated, remember that Confidential-Supervisory Section comments may be a matter of record at an administrative hearing. All comments must be accurate, well supported, and able to withstand cross-examination.

DIRECTORS/TRUSTEES AND OFFICERS

←

Purpose

This confidential page provides information of interest to nonbank users of the ROE. The information assists Case Managers, other field, regional, or Washington Office management, and other regulatory authorities in their case management, applications processing, ROE review, and general bank supervision duties.

General

List all directors, executive officers, and principal shareholders (as defined in Federal Reserve Regulation O) under those respective subtitles. Other officers or employees (such as officers who head functional areas or the internal auditor) may be included at the discretion of the examiner-in-charge. Generally, detail functional responsibilities, banking experience, and post-secondary education for all officers listed. For directors, include their occupation, banking experience, and any other significant information relating to their contribution to the institution. When relevant, identify the related interests of all directors, executive officers, and principal shareholders.

Include holding company officers or directors who exert significant control over the institution's affairs (for example, when a holding company treasurer manages a subsidiary institution's investment portfolio), even though they are not official officers/directors of the institution.

While inclusion of this page in the ROE is discretionary, the information must be gathered and input into the automated examination tool for transmittal to reviewers. Retain copies of source documents in the workpapers.

Other

Net Worth - Directors' net worth should be obtained and included when relevant (for example, when an institution's capital position is inadequate and directors may be a source of additional capital). When estimated net worths are obtained, footnote the Date of Statement column to indicate the source of information (for example, net worths estimated by President Smith).

Attendance at Board Meetings - Board meeting attendance figures shown should be since the previous FDIC or state examination, unless otherwise noted.

Parent Company Ownership - If a holding company owns the institution, note ownership in the holding company. If relevant, examiners may include the percentage of shares owned below the number of shares owned. When informative, total the Number of Shares Owned column. Show the percentage of shares controlled by the directorate as a whole.

Salary and Bonus - Footnote the dates of salary and bonus information if it is not the current annual salary or most recent annual bonus.

Home Addresses of Directors - List the directors' complete home addresses here or on a separate continuation page when the following conditions exist:

- Formal or informal administrative action is contemplated,
- The institution is rated a composite 3, 4, or 5, or
- Civil money penalties may be recommended.

Memoranda - Note the following information:

- Number of board meetings since the previous FDIC or state examination
- Memberships in important committees (particularly audit)
- Directors' fees for board and committee meetings

APPENDIX A – GRAMMAR AND PUNCTUATION GUIDE

←

The general rules and standards contained in this appendix are applicable only to the Report of Examination. The rules and standards cover matters commonly encountered in Report comments and are intended to promote consistency. The general rules are not a substitute for writing and grammar guides. Refer to those resources for formal guidance.

HYPHENATION - ADJECTIVES:

General Rule: Two- and three-word modifiers that express a single thought should be hyphenated when they precede a noun (an out-of-date policy).

Do not use a hyphen if each of the words can modify the noun without the aid of the other modifying word or words (a new digital computer).

Do not hyphenate words that follow the noun they modify (the policy is out of date).

Examples:

A full-scope examination began on June 30.

The loan is secured by a single family residence.

The apartment complex has 50 units.

HYPHENATION - PREFIXES:

General Rule: Words containing prefixes generally do not require hyphens. Include the hyphen after the prefix if not doing so would cause confusion in sound or meaning.

Examples:

nonaccrual nonperforming subtotal

HYPHENATION - COMPOUND VERBS:

General Rule: Compound verbs can be separate, solid, or hyphenated. If you do not find a compound verb in a dictionary, write the components as separate words.

Report standards:

charge off paid off write off/ up/ down

HYPHENATION - COMPOUND NOUNS:

General Rule: Compound nouns may be separate, solid, or hyphenated. If you are not certain whether a compound word should be hyphenated, check a dictionary. If you do not find a compound noun in a dictionary, hyphenate the components.

Report Standards: charge-off pay-off write-off/-up/-down examiner-in-charge

HYPHENATION - SUSPENDING HYPHEN:

General Rule: When a series of hyphenated adjectives has a common basic element, and the element is shown only with the last term, insert a suspending hyphen after each of the incomplete adjectives to indicate a relationship with the last term.

Examples:

long- and short-term securities
private- and public-sector partnerships

HYPHENATION - ADVERBS:

General Rule: If the first word is an adverb ending in "ly," do not use a hyphen.

Examples:

publicly held widely held wholly owned

CAPITALIZATION:

General Rule: There are numerous exceptions to basic capitalization rules. The most important rule is to be consistent throughout a Report. Examiners may deviate from the following standards as long as they are consistent.

Report Standards: Do not capitalize bank unless it is used with the full name of the institution.

Capitalize Board of Directors, Board, or Directors when referring to a specific board.

Capitalize Call Report, Call Report Instructions, and Consolidated Reports of Condition and Income.

Do not capitalize examiner-in-charge unless it is followed by a specific person's name.

Capitalize account titles (for example, Other Borrowings).

Capitalize the word federal.

Capitalize only the word Federal in Federal funds sold or purchased (unless referring to an account title).

Capitalize Regional Director and Regional Office.

Capitalize Report of Examination and Report when referring to a specific report.

Do not capitalize the word State unless referring to a specific public agency or the word is being used in the same sentence as Federal.

Capitalize Substandard, Doubtful, Loss, and Special Mention when referring to FDIC asset classification titles.

Capitalize the specific titles of formal institution policies (for example, the Loan Administration Policy vs. the loan policy).

Capitalize the titles of specific institution committees (for example, the Audit Committee).

DATES:

Report Standard: A comma precedes and follows the year when the month and day precede the year. However, when the date consists only of month and year, commas are not necessary.

Examples: The examination that began on December 2, 1998, was completed in two weeks.

The report is due in January 1999.

NUMBERS:

General Rule: Write out numbers below 10. Use figures for numbers 10 and above.
Regardless of the number's size, use figures if they are followed by a unit of measure.
Write out numbers that begin a sentence.
Do not begin a sentence with a large number.

Examples: The bank employs five people.
The examiners cited 14 deficiencies.
Twenty-six examiners attended the field office meeting.

SPELLING:

Report Standards: installment totaling totaled

REPORT OF EXAMINATION INSTRUCTIONS

INTERNATIONAL REPORT PAGES

GENERAL INSTRUCTIONS

←

Purpose

Examiners use international report schedules to document the level of foreign exposure risk, the adequacy of risk management systems for controlling country exposures, the risks associated with commonly controlled foreign institutions, and the effect of international activities and risk management practices on the institution's overall condition.

When to Include

Examiners should complete these schedules if the level of country risk is material or the composition of international operations changed significantly since the previous examination.

General

Complete the following ROE report pages and include them after the domestic Items Listed for Special Mention page:

- Transfer Risks Subject to Classification
- Analysis of the Country Exposure Management System
- Selected Concentrations of Country Exposure
- Parallel-Owned Banking Organizations (PBO)

The first three pages listed above focus on an assessment of the impact of country risks and the adequacy of country risk management systems. The PBO page should be completed when the examiner determines the institution is part of a PBO. Refer to RMS Manual Section 11.1, International Banking, for information and guidance on PBOs.

Instructions for completing the schedules listed above are discussed on the following pages. In addition, the International Workpapers section contains instructions for completing a series of optional workpapers that may assist examiners in reviewing specialized areas of an institution's international operations (e.g., foreign exchange trading). The workpapers are not part of the ROE, but if completed, should be retained in the workpapers.

Note: Insert International report pages in the order shown above after the Items Listed for Special Mention page, and use the EDR (International) page in lieu of the standard EDR page in the core section of the Report.

INTERNATIONAL REPORT PAGE

TRANSFER RISKS SUBJECT TO CLASSIFICATION

←

Purpose

The purpose of this page is to identify assets that are adversely classified because of transfer risk considerations.

When to Include

Include this page when the institution has claims subject to transfer risk. The amount extended for adverse classification or comment should be as of the asset review date if possible, particularly if there has been a material change in the outstanding exposure balance since the date of the last quarterly Country Exposure Report (FFIEC Form 009).

General

In general, countries are adversely classified for transfer risk when an interruption in payments has occurred or appears imminent. The Interagency Country Exposure Review Committee (ICERC) makes the decision to adversely classify countries for transfer risk. If a financial institution has claims extended to entities within a classified country, the claims (e.g., loans) are subject to transfer risk and classified accordingly. Examiners have the discretion to assign a more severe classification than assigned by the ICERC when appropriate, but cannot assign a less severe classification. The ICERC also prepares the ROE write-ups supporting the adverse transfer risk classifications. Adverse transfer risk classifications used by ICERC are Substandard, Value Impaired, or Loss. For additional information on the committee's policies, practices, and procedures, refer to the most recent Guide to the ICERC Process (www.fdic.gov/regulations/safety/guide/Icerc.pdf). For assistance, contact the International Affairs Branch of the Division of Insurance and Research.

Write-ups are available through the FDIC representative to ICERC and generally should be included in the ROE. Include a paragraph detailing the composition of the institution's claims subject to transfer risk. Report exposures alphabetically by country and total each classification category. Examiners should follow the same instructions contained in the Items Subject to Adverse Classification page as a guide to determine when the transfer risk write-ups can be omitted from the ROE. If transfer risk write-ups are omitted from the ROE, examiners should provide the write-ups to bank management during the examination.

Some or all of the assets adversely classified for transfer risk may also be adversely classified for credit risk. Duplicate classifications should be eliminated on an asset-by-asset basis, or through a single line item at the end of page(s) detailing the adverse classifications. In all cases, the most severe criticism should prevail. For example, if an asset is classified Doubtful for credit risk and Substandard for transfer risk, make the adjustment for the duplication before calculating a total for adverse classification due to transfer risk. Apply the same procedure if both transfer risk and credit risk bear the same adverse classification. For example:

TRANSFER RISK	SUB STANDARD	VALUE IMPAIRED	LOSS
Subtotal assets classified due to transfer risk	5,000,000		
Less-amount classified due to commercial credit risk	500,000		
Total adversely classified assets due to transfer risk	4,500,000		

On the other hand, if the transfer risk classification is more severe, eliminate the amount classified for transfer risk from the Items Subject to Adverse Classification page(s) where credit classifications are calculated, and list the amount classified for transfer risk on this page. In addition, examiners should reduce the amount extended for classification by the amount of the allocated transfer risk reserve (ATRR). *Note: Manual adjustments to automated examination tools may be necessary to net the ATRR from the amount extended for adverse classification.* Exposures adversely classified due to transfer risk (less duplication adjustments) are included in the Asset Quality section of the Examination Data and Ratios page, under a separate line item, Other Transfer Risk.

When evaluating an institution's asset quality and other measures of financial soundness, including capital adequacy and ALLL sufficiency, examiners should combine classified credits with exposures that have been adversely classified due to transfer risk. Certain types of exposures in a given country (e.g. trade credit) may not be rated or adversely classified, while other portions (e.g. term loans) might warrant adverse classification. To facilitate uniform treatment, ICERC has defined *short-term credit* as credits maturing within one year, and *trade credit* as credit extensions that are directly related to imports and exports and will be liquidated through the proceeds of international trade (e.g. commercial letters of credit, acceptances, etc.). Past due or extended acceptances are considered loans.

Report split designations under the proper columns. Extend for adverse classification, all contingent liabilities subject to transfer risk (including commercial and standby letters of credit, as well as loan commitments) that will result in a concomitant increase in an institution's assets if the contingencies convert into an actual liability. Classify contingent liabilities extended for adverse classification according to the type and tenor of the asset that would result from conversion of the contingency into an actual liability. For example, classify commercial import/export letters of credit the same as trade credit, and classify commitments to fund long-term project loans the same as long-term loans. In cases where the type or tenor is not easily discernible and exposure is accorded a split classification, the more severe classification should prevail.

Commitments include the institution's obligations to participate in debt facilities (e.g., underwriting bonds) and syndicated credits that are managed by other institutions. Commitments should only include those for which a legally binding commitment exists, a commitment fee charged, or other consideration given. Adversely classified underwriting commitments should be shown net of firm third-party commitments to purchase the assets without recourse within a short period. Similarly, when adversely classifying syndicated loan commitments, extend only the institution's proportional share of the commitment.

(Continued on next Page)

Allocated Transfer Risk Reserve

Pursuant to the International Lending Supervision Act (ILSA), the federal banking agencies require institutions to establish and maintain a special reserve when:

(1) The value of international loans has been impaired by the protracted inability of the borrowers in a country to make payments on external indebtedness, or

(2) No definite prospects exist for orderly restoration of debt service.

In either case, these assets are typically classified as Value Impaired. Determination of the level of the special reserve, known as the Allocated Transfer Risk Reserve (ATRR), is the responsibility of the ICERC.

The ATRR is a contra-asset to the international asset, and must be established by a charge to current income and segregated from the institution's general allowance for possible loan losses. The ATRR should be netted from amounts extended for adverse classifications. Do not include the ATRR as a part of bank capital. The institution has the option to charge off the required amount rather than set up the ATRR. Examiners should ascertain whether the appropriate percentage ATRR, or charge-off, of outstanding Value Impaired exposures has been made. The amount of charge-off or ATRR required is the amount equal to the appropriate percentage of outstanding exposures, as illustrated in the following examples:

	EXPOSURE TO COUNTRY X	EXPOSURE TO COUNTRY Y
Outstanding Balance	1,000,000	3,000,000
Previous ATRR (ICERC set a 15% requirement for Country X)	150,000 (ATRR or Charge-off)	
New ATRR (ICERC sets a 10% requirement for Country Y)		300,000
New ATRR (ICERC increases ATRR requirement for Country X to 20%)	50,000 (ATRR or Charge-off)	
Final ATRR (These are the only amounts that should be reflected in the ROE)	200,000 (ATRR or Charge-off)	300,000 (ATRR or Charge-off)

If an ATRR or charge-off for the required amount has not been established by the bank, the amount should be deducted on the Capital Calculations page. This deficiency should be addressed on the Examination Conclusions and Comments page and cited on the Violations of Laws and Regulations page (refer to Part 347 of the FDIC Rules and Regulations).

The required ATRR or charge-off is based on the original amount of exposure to a country less payments received. Loans extended after the initial amount, as determined for ATRR purposes, are generally not subject to an ATRR or charge-off if the new money was extended pursuant to economic reforms and if the credits are performing.

INTERNATIONAL REPORT PAGE

ANALYSIS OF THE COUNTRY EXPOSURE MANAGEMENT SYSTEM

←

Purpose

The purpose of this schedule is to present analysis of the institution's system for monitoring and controlling country exposure.

When to Include

Complete this schedule when the institution has material cross-border exposures and examiners conduct an analysis of its country risk management systems. Guidelines for conducting such analysis are incorporated in the RMS Manual, Section 11.1, International Banking. Also, the joint Statement on Sound Risk Management Practices (FIL 23-2002), describes the elements of an effective country risk management process and the leading factors affecting country risk.

General

The analysis should include evaluations of the institution's:

- Procedures for measuring exposure,
- System for establishing country lending limits,
- Ability to analyze country risk, and
- Adherence to internal policies in this area.

The evaluation of the institution's international loan portfolio (including loans made to domestic borrowers to facilitate international transactions) and the institution's country exposure management program may warrant commentary on the Examination Conclusions and Comments page. Examples might include excessive concentrations of transfer risk in one or more countries, concentrations in certain classes of countries, such as emerging economies, large amounts of assets classified because of transfer risk, or an ineffective country exposure management system.

INTERNATIONAL REPORT PAGE

SELECTED CONCENTRATIONS OF COUNTRY EXPOSURES

←

Purpose

The purpose of this schedule is to present concentrations in crossborder exposures that are considered large relative to the institution's capital, or of special interest in terms of the economic, social, political, or geographical circumstances. The latter may include countries experiencing adverse events, countries with developing economies, countries with membership in troubled monetary unions or economic blocks, countries located within a region of special interest, etc.

When to Include

Use this schedule when the institution's exposure in any given country exceeds 25 percent of Tier 1 Capital. Examiners should also consider listing any countries of significance or special interest where exposures exceed 5 percent of Tier 1 Capital. In addition, list all exposures to adversely classified countries regardless of the percentage of Tier 1 Capital.

General

Schedule the exposures by country in alphabetical order and add any necessary explanatory remarks, including the percentage of Tier 1 Capital, reason for presenting the concentration, and any concerns regarding individual country risks or circumstances.

The Country Exposure Report (FFIEC 009), which is filed quarterly, provides detailed information on the bank's exposures by individual country. If the institution is required to prepare the report, obtain the information from the most recently filed report. Compiling the required data as of the examination start date is unnecessary unless the institution's exposure has changed materially since the last quarterly report. Examiners may wish to verify the accuracy of the report against internal bank records by sampling the data provided for one or more of the countries reported by the bank.

Some banks have significant country exposures but are not required to submit the FFIEC 009 report because the institution does not maintain a foreign office (i.e. branch, subsidiary, Edge Act or Agreement subsidiary, international banking facility, etc.). However, institutions are required to file monthly reports with the U.S. Treasury, under the Treasury International Capital System, if they have international claims to one country in excess of $25 million, or aggregate claims in excess of $50 million to all countries. These reports may be useful when determining the volume of foreign lending activity and concentrations of country exposures.

Examiners should describe concentrations of country exposure and assess related risk management practices on the Examination Conclusions and Comments page. The placement and length of comments should be commensurate with level of exposure(s) and any related examination recommendations. Also, examiners should include concentrations of country exposure on the appropriate lines of the Summary Analysis of Examination Report (SAER) page.

INTERNATIONAL REPORT PAGE

PARALLEL-OWNED BANKING ORGANIZATIONS

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Purpose

The purpose of this schedule is to detail the information used in ascertaining whether a parallel-owned banking organization (PBO) exists and to document any concerns noted with the organization or commonly controlled foreign institutions. The fundamental risk presented by these organizations is that they may be acting in a de facto organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision.

When to Include

Complete this schedule when the institution and at least one foreign bank appear to be controlled either directly or indirectly by the same person or group of people and the organizations are not subject to comprehensive consolidated supervision. Examiners should consider whether a person or group of people control an institution if the person or group controls 10 percent or more of any class of voting shares of the depository institution.[1] (Refer to the International Banking section of the RMS Manual and the Joint Agency Statement on Parallel-Owned Banking Institutions (FIL-35-2002) for additional information.) This schedule must be included in the ROE if control equals or exceeds 25 percent of any class of voting stock. In situations where control is rebuttable, inclusion of this schedule is discretionary; however, if the examiner concludes that a PBO does not exist, this page should be maintained in the examination workpapers to document the basis of that conclusion.

General

The FDIC does not typically request or review information on foreign banks or foreign bank holding companies during the examination process. However, examiners should consider all of the issues detailed in the Parallel-Owned Banking Organizations page when determining if a PBO exists. If a PBO relationship is suspected, the examiner should request and review information to ensure they understand the ownership/control structure of any foreign entities. The requested information about foreign banks or foreign bank holding companies may include, but is not limited to:

- Shareholder list of the foreign bank(s) and any of the companies that own/control it,
- Minutes of the most recent shareholder meeting(s),
- Annual reports,
- Composition of the board(s) of directors and executive management,
- Organizational charts,
- Website addresses,
- Policies that the bank in the U.S. has been instructed to follow,
- Products or services that the bank in the U.S. has been instructed to offer, and
- Cross-border transactions or services.

Bank And/Or Bank Holding Company Information

The first section of this schedule instructs examiners to list the bank(s) and bank holding company(s) within the PBO. Information for U.S. bank(s) should be listed first and then the foreign entities in the PBO. The examiner may add rows to the table to accommodate the requested information. Alternatively, the examiner may limit the list to key organizations; however, examiners must footnote the schedule with the basis of any omissions. For example,

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[1] Note: PBOs do not include structures in which one depository institution is a subsidiary of the other, or the organization is controlled by a company subject to the Bank Holding Company Act.

examiners may include a footnote for organizations that regularly engage in transactions with the U.S. bank and list the name, city, and country of those entities. The examiner may also footnote the schedule for any bank or bank holding companies that are wholly owned subsidiaries.

Stock Ownership

Detail the stock ownership of the bank(s) and bank holding company(s) in the U.S. and foreign country that provide the primary connection for the PBO. Since the connection may contain more than one bank or bank holding company, the examiner may need to add rows to the table. To the right of the labels *U.S. Name* and *Foreign Name*, list the name of the entity for which information on beneficial ownership is being provided. To the right of the *Beneficial Owner* label, list the owner's name and corresponding ownership information (number of shares owned, percentage of ownership, and type of control). Footnote any pertinent information, for example, indirect control of ownership shares.

Factors Considered

Comment on each of the factors or attributes that are listed on the PBO page. These factors, in addition to common stock ownership, help the examiner determine if sufficient control is exercised to conclude that a PBO relationship exists. If items are not applicable, so state.

Summarize The Examination's Findings

Detail any affiliate or insider relationships (as defined by Section 23A of the Federal Reserve Act and Regulation O). Cross-reference any concerns or criticisms here and on the appropriate ROE page(s). Additionally, discuss the availability and quality of financial information for the other parallel-owned banks and note any apparent concerns with their financial condition. Refer to the International Banking section of the RMS Manual for additional information.

Confidential Information

The examiner should use discretion in detailing information on this page. If the information provided is of a sensitive nature, or obtained through confidential sources (e.g., foreign regulators), the information should not be included in the open section of the ROE.

INTERNATIONAL WORKPAPERS

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The **optional** workpapers discussed below may assist examiners in forming conclusions about the institution's international activities. If used, the workpapers should be retained, but not included in the Report of Examination. Address any material issues identified on the ECC, RMA, or other appropriate ROE page(s).

- International Loans, Acceptances, and Letters of Credit - Distribution
- International Loans, Acceptances, and Letters of Credit - Questionnaire
- Eurocurrency Operations
- Foreign Exchange Activities
- Position Analysis - Major Currency Positions
- Position Analysis - Other Currencies
- Maturity Distribution (GAP) Analysis
- Revaluation and Income/Loss Analysis
- Income Loss Schedule
- Policy and Procedures
- Audit and Internal Controls - Audit
- Audit and Internal Controls - Internal Controls

INTERNATIONAL WORKPAPER

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INTERNATIONAL LOANS, ACCEPTANCES, AND LETTERS OF CREDIT-DISTRIBUTION

This schedule is intended to help the examiner identify the level of lending, letters of credit, and acceptance financing between the institution and obligors and/or guarantors living outside the U.S., its territories, and possessions. The inclusion of obligations guaranteed by foreign-domiciled individuals or entities in this definition is based on the concept that ultimate liability for repayment rests with the guarantor. Therefore, the basic objective is to designate transactions where repayment channels cross international boundaries. This approach is consistent with the method used in the Country Exposure Report (FFIEC 009) to reallocate claims to the country of the individual or entity ultimately liable for repayment.

For this schedule, guaranteed instruments are those for which a third party legally obligates itself to repay the institution's claim on the direct obligor if the latter fails to do so. Documents such as *comfort letters* or *letters of awareness* or *intent* are not considered guarantees for this schedule. The term *guaranteed* covers collateralized instruments if the collateral meets the following requirements:

- The collateral is liquid and readily realizable, and
- Realizable outside of the country of residence of the borrower.

Using the foregoing guidelines, include in the schedule obligations of residents or entities domiciled in the U.S. bearing a guarantee from a resident or entity in a foreign country. Similarly, exclude from the schedule direct obligations of foreign residents or entities with guarantees from domestically domiciled residents or entities.

Loans:

Base the distribution of loans in this schedule on the nature of the direct obligor on the indebtedness.

Mortgage loans include liens or deeds of trust on real property, aircraft, or ships. Shipping loans included in this category will be secured by first or second preferred-ship mortgages. Exclude loans collateralized solely by bareboat, time, or consecutive charter agreements, which are more properly shown in the *Loans to commercial, industrial, and agricultural interests* category.

Other Loans (Describe) should include credits not properly categorized in the five preceding captions in the workpapers that are made to obligors with similar characteristics and represent a material percentage of total international loans (approximately 10 percent of international loans is a reasonable criteria).

Use the footnote "Loans to U.S. subsidiaries of foreign corporations not included above." to show the aggregate of loans to borrowers that are not shown in categories above in the Distribution schedule.

Other:

Syndication and consortium financing should include the institution's investment in syndicated credits. These loans differ from the customary participation loan as multiple institutions participate at the outset and are known to the borrower. As such, the loan must be structured to meet both the requirements of the participating institutions and the needs of the borrowing entity. The function of packaging the credit to satisfy the needs of all parties to the transaction is the responsibility of the syndicate leader.

Other (Describe) is for special types of international lending or financing activity deemed worthy of separate listing. For example, a separate listing of the aggregate volume of syndicated loans originated by the institution as syndicate leader or loans in certain geographic areas may be warranted.

INTERNATIONAL WORKPAPER

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INTERNATIONAL LOANS, ACCEPTANCES, AND LETTERS OF CREDIT-QUESTIONNAIRE

The questions in this workpaper are intended to assist examiners with identifying risk management weaknesses in a bank's international operations. Significant concerns should be addressed on the ECC, RMA, or other appropriate ROE page (e.g. the Analysis of the Country Exposure Management System page).

INTERNATIONAL WORKPAPER

EUROCURRENCY OPERATIONS

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The questions in this workpaper are intended to assist the examiner with identifying risk management weaknesses in the bank's international operations. Significant concerns should be addressed in the ECC, RMA, or other appropriate ROE page (e.g. the Analysis of the Country Exposure Management System page).

INTERNATIONAL WORKPAPER

FOREIGN EXCHANGE ACTIVITIES

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This workpaper should be used in conjunction with other workpapers that address risks associated with foreign exchange activities. Other workpapers might include Position Analysis - Major Currency Positions, Position Analysis - Other Currencies, Maturity Distribution (GAP) Analysis, Revaluation and Income/Loss Analysis, and the Income/Loss Schedule. Significant concerns should be addressed in the ECC, RMA, or other appropriate ROE page(s).

INTERNATIONAL WORKPAPER

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POSITION ANALYSIS - MAJOR CURRENCY POSITIONS

This worksheet may be useful for determining the institution's position in various currencies, calculating unrealized profits or loss, and assessing foreign exchange policies and risk management practices. Significant concerns should be brought forward as needed to the ECC, RMA, or other appropriate ROE page.

Position Analysis

If an institution has assets or liabilities denominated in a foreign currency, or the institution has commitments to purchase or sell foreign exchange with a future delivery date, a net position for each foreign currency must be calculated. This calculation facilitates the analysis of exposure to fluctuations in exchange rates and aids in determining unrealized profits or loss. Further, the position analysis enables examiners to ascertain the institution's practice of periodically adjusting U. S. dollar equivalents of foreign currency accounts.

To analyze the position on each foreign currency, make a trial balance of each asset and liability account denominated in a foreign currency. Asset accounts (long position) include, but are not limited to, foreign currency on hand, due from bank accounts (nostro), demand and time loans, investments, accrued interest receivable, and commitments to purchase exchange on a spot or future basis. Liabilities (short position) include due to accounts (vostro) with other institutions (including nostro overdrafts), demand and time deposits, cash collateral, accrued interest payable, accounts payable, and commitments to sell exchange on a spot or future basis. These accounts or subsidiary records will normally contain both the amount of foreign currency and an equivalent amount expressed in U.S. dollars. The examiner's trial balance of foreign currency should prove to the institution's position sheet, and dollar equivalents should correspond to the general ledger. Certain transactions, such as the previous day's spot or future exchange transactions may not have been recorded on the institution's books. Obtain these *holdover items* from the foreign exchange trader, and include them in the calculation of the currency position.

Major Currency Position

This schedule is reserved primarily for the currency posing the greatest exposure to the institution's total capital and reserves. If the institution maintains substantial positions in several currencies, the schedule should be completed separately for each currency.

Derive the entries for foreign currency and dollar equivalents for each asset and liability category from the institution's records (using the examination as of date). **Do not revalue these accounts at current exchange rates.** Deduct the lesser of long/short position from the larger figure to arrive at the net position in foreign currency and dollar equivalent. The net-position dollar equivalent should be evaluated in comparison to capital and reserve levels.

INTERNATIONAL WORKPAPER

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POSITION ANALYSIS - OTHER CURRENCIES

This worksheet may be useful for determining the institution's position in various currencies, calculating unrealized profits or loss, and assessing foreign exchange policies and risk management practices. Significant concerns should be addressed as needed to the ECC, RMA, or other appropriate ROE page.

Position Analysis

If an institution has assets or liabilities denominated in a foreign currency, or the institution has commitments to purchase or sell foreign exchange with a future delivery date, a net position for each foreign currency must be calculated. This calculation facilitates the analysis of exposure to fluctuations in exchange rates and aids in determining unrealized profits or loss. Further, the position analysis enables examiners to ascertain the institution's practice of periodically adjusting U. S. dollar equivalents of foreign currency accounts.

To analyze the position on each foreign currency, prepare a trial balance (using the examination as of date) of each asset and liability account denominated in a foreign currency. Asset accounts (long position) include, but are not limited to, foreign currency on hand, due from bank accounts (nostro), demand and time loans, investments, accrued interest receivable, and commitments to purchase exchange on a spot or future basis. Liabilities (short position) include due to accounts (vostro) with other institutions (including nostro overdrafts), demand and time deposits cash collateral, accrued interest payable, accounts payable, and commitments to sell exchange on a spot or future basis. These accounts or subsidiary records will normally contain both the amount of foreign currency and an equivalent amount expressed in U.S. dollars. The examiner's trial balance of foreign currency should prove to the institution's position sheet, and dollar equivalents should correspond to the general ledger. Certain transactions, such as the previous day's spot or future exchange transactions may not have been recorded on the institution's books. Obtain these *holdover items* from the foreign exchange trader, and include them in the calculation of the currency position.

Other Currencies

For each currency, aggregate the assets and purchase commitments (long position) and the liabilities and sale commitments (short position) and deduct the smaller figure to arrive at the net position for each currency. The net dollar equivalent should be evaluated in comparison to capital and reserve levels.

If the foreign currency total is net long and the U.S. dollar equivalent is net short, a split position exists. This so-called split position usually results from a heavy volume of activity flowing through the institution's nostro accounts, which will subsequently require adjustment to restore balance to the relationship between the foreign currency and U.S. dollar equivalent.

In calculating the aggregate position (U.S.) for all currencies, add all U.S. equivalent figures regardless of sign (that is, short positions are added to long positions as a positive number).

QUESTIONS 1a. and 1b.

These questions help determine whether the institution's net position appears unwarranted, excessive, or speculative. The following criteria may be used in evaluating the institution's position:

- Competency of the trading and executive officers,
- Purpose of the position,
- Volatility of the individual currencies,
- Volume of business in the country, and
- Size of the institution.

Negative responses to these questions may suggest the need for commentary in the ROE.

INTERNATIONAL WORKPAPER

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MATURITY DISTRIBUTION (GAP) ANALYSIS

When using this worksheet, examiners should complete a maturity distribution for all major currencies outlined in the Position Analysis - Major Currency Positions worksheet. At the discretion of the examiner, material currency positions enumerated in the Position Analysis - Other Currencies worksheet may be detailed. Show each currency on a separate form. Question No. 2 at the bottom of this Maturity Distribution worksheet applies to all currencies listed.

In arranging the maturity distribution, it is recommended that at least the first two weeks of activity subsequent to the examination start date be detailed on a daily basis. (In active departments, a daily enumeration for the first month following the examination start date may be appropriate). Thereafter, semi-monthly or monthly intervals may be used depending on the institution's method of pricing forward commitments and the volume of activity. Longer-range maturities may be grouped by years.

The preparation of this schedule requires the inclusion of all currency ledger accounts. Show ledger accounts not bearing a maturity date in the first day's maturities. Show spot contracts as of the date the settlement is expected to occur. The total of assets and purchases (long), liabilities and sales (short), and the net amount of these two columns should correspond to the foreign currency amounts shown in the position sheet. Compare the net gap for each period to limits imposed by institution management. Further, review the cumulative gap position (the addition of gaps for each time interval) for conformance to policy and the incidence of excessive periods of positive or negative gaps. Such events may require comment if potential exposures appear excessive in relation to liquidity, earnings, or capital.

It is normally unnecessary to complete a profit and loss revaluation on this worksheet (in the right three columns) unless a position results in a material profit or loss. Refer to the example in the Revaluation and Income/Loss Analysis worksheet instructions. Price future contracts at the given premium or discount rate. Price spot contracts and ledger accounts at the spot rate. When one or more rates are used to price a position at a point in time, type *various* in the Spot Rate column. All swap contracts should be removed before valuing the position since the profit/loss is fixed at the time of the transaction and reflected in the return on the asset for which the swap was effected. In any event, the schedule can be used as a workpaper to calculate the future profit/loss adjustment in the Revaluation and Income/Loss Analysis worksheet.

INTERNATIONAL WORKPAPER

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REVALUATION AND INCOME/LOSS ANALYSIS

The purpose of this worksheet is to determine the unrealized profit or loss for the institution in connection with positions undertaken in foreign currency. The computation is based on the assumption that the entire position will be liquidated (that is, all long foreign currency positions will be sold and all short positions will be covered).

The primary input for this schedule comes from the Position Analysis - Other Currencies schedule. List each currency under the Monetary Unit column. Insert in the Book Value column the institution's net position in the foreign currency amount and U.S. dollar equivalent less any swap contracts included in the position. (Refer to the following paragraph for an explanation of these transactions). Obtain the spot exchange rate from the Wall Street Journal or similar publications containing foreign exchange rates. Express the exchange rates in terms of the U.S. dollar cost per unit of foreign currency (for example, one Euro sells for $x.xxxx) with the values carried to four decimal places or four-digit level of significance (i.e., one Japanese yen equals $.004560). Multiply the net amount of foreign currency by the spot rate to arrive at the current market value of the position. Apply the following rules when determining the spot rate profit or loss on each position:

1. Long foreign currency position combined with long U.S. dollar equivalent: profit is excess of market value over book value; loss is the excess of book over market.
2. Long foreign currency position combined with short U.S. dollar equivalent: profit is the current market value plus the short U.S. dollar book value.
3. Short foreign currency position combined with short U.S. dollar equivalent: profit is the excess of book value over current market value; loss is the excess of market value over book value.
4. Short foreign currency position combined with long U.S. dollar equivalent: loss is the current market value plus the long U.S. dollar book value.

Rules No. 2 and No. 4 refer to split positions discussed in the Position Analysis - Other Currencies worksheet instructions for calculating the net open position. In rule No. 2, the position can only result in a profit. In rule No. 4, the position can only result in a loss.

A financial swap combines a spot purchase or sale of a foreign currency and a forward sale or purchase of the currency. Through this arrangement, the institution effectively locks in the potential gain or loss by entering into a transaction involving the temporary movement of funds into another currency and back again. For example, the institution has an investment opportunity to lend 1,000,000 pounds sterling for three months. The institution will purchase necessary exchange spot for $1.8660 per pound sterling ($1,866,000) to make the loan. Simultaneously, the institution will enter into a forward exchange contract to sell 1,000,000 pounds sterling at the anticipated maturity date for $1.8690 per pound sterling ($1,869,000). Customarily, the institution will sell forward the expected interest income as well. Accordingly, the institution has realized a $3,000 profit on the transaction at the inception of the loan. Customarily, the profit (or alternatively cost) is applied to the rate of interest on the loan to determine the true yield on the investment. The profit (or loss) is accrued to income and expenses monthly. In these circumstances, it is inappropriate to allocate the profit to the exchange function. A review of the institution's records will facilitate the identification of swap transactions and, as previously stated, these amounts should not be included in the revaluation schedule.

Adjust the spot-rate profit (loss) for discounts or premiums on forward exchange contracts, which are included in the net currency position. A discount is a rate of exchange lower than the spot rate expressed in terms of percentage per annum or points on which a dealer buys or sells foreign exchange for forward delivery. For example, if a dealer quotes $186 and $191 (bid and asked) for spot sterling, and the discounts for six-month forward exchange contracts are .0300 and .0275, the forward quotes would be modified to $183 and $1.8825. In most cases, the discount reflects an interest rate differential in the U.S. vis-à-vis the U.K., although in periods of downward market pressure on a currency a discount may indicate market anticipation of a lower price for the currency. A premium is a rate of exchange higher than the spot rate. Again, interest rate trends and upward market pressure will play a role in this situation. The premium situation works exactly opposite to the discount example. That is, premium quotes are added to the applicable spot rates quoted.

The calculation of future profit (loss) adjustments will require the listing of all contracts by maturity or value dates from near-term to longer-term. Certain contracts are made on an option basis because of uncertainty as to the date when foreign currency will be received or needed. In option contracts involving the purchase of exchange, list contracts with premiums at the earliest date and contracts with discounts as of the latest date. Conversely, show contracts involving the sale of exchange at premiums at the latest date and those at a discount at the earliest date. The format of the maturity distribution will depend on the system used by the institution in providing future rates. A summary of contracts on a monthly basis can be prepared provided the rates supplied by the institution are based on a monthly scale. If rates are on a semi-monthly basis, prepare the summary figures by the first and second halves of the month. To calculate the profit and loss on futures, the following rules apply:

1. A long position at a discount reflects a loss.
2. A short position at a discount reflects a profit.
3. A long position at a premium reflects a profit.
4. A short position at a premium reflects a loss.

In the absence of a significant profit or loss from the revaluation of the foreign currencies, it is not necessary to adjust book capital.

Question 3 - Significance Of Profit Or Loss

In weighing the significance of profit or loss from foreign exchange operations, it is important to consider the amount in relation to the capital account of the institution, the volume of exchange activity, and the institution's history in sustaining profits and/or losses. The criteria enumerated as guidance in responding to questions 1a and 1b of the Position Analysis - Other Currencies worksheet would also warrant consideration.

INTERNATIONAL WORKPAPER

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INCOME/LOSS SCHEDULE

This worksheet is self-explanatory. Information required to complete the worksheet should be readily available from the bank's financial records.

INTERNATIONAL WORKPAPER

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POLICIES AND PROCEDURES

These nine questions discuss the institution's policies, reporting mechanisms, and procedures in relation to foreign exchange activities. Significant concerns should be addressed as needed on the ECC, RMA, or other appropriate ROE page.

INTERNATIONAL WORKPAPER

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AUDIT AND INTERNAL CONTROLS-AUDIT

This section of the workpaper is primarily designed to assist examiners evaluate the institution's audit function. The questionnaire is designed for use at institutions with relatively sophisticated trading operations.

Examiners should consider an institution's risk profile, size, and complexity when assessing the overall adequacy of audit programs. Additionally, examiners should consider the cost and effectiveness of an audit or control feature before making recommendations to add or improve features, especially at institutions with less complex trading operations.

Nevertheless, all institutions should implement appropriate audit programs and internal controls to prevent, identify, and/or report irregularities. Basically, all of the audit and control standards and procedures used in domestic departments apply to the foreign exchange function. Examiners should bring forward address any significant concerns with the institution's international audit program on the ECC, RMA, or other appropriate ROE page.

Reference: Manual Section 4.2, Internal Routine and Controls

INTERNATIONAL WORKPAPER

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AUDIT AND INTERNAL CONTROLS-INTERNAL CONTROLS

This section of the workpaper is primarily designed to assist examiners evaluate the institution's internal controls. The questionnaire is designed for use at institutions with relatively sophisticated trading operations.

Examiners should consider an institution's risk profile, size, and complexity when assessing the overall adequacy of internal control programs. Additionally, examiners should consider the cost and effectiveness of controls before making recommendations to add or improve controls, especially at institutions with less complex trading operations.

Nevertheless, all institutions should implement appropriate internal controls to prevent, identify, and/or report irregularities. Basically, all of the control standards and procedures used in domestic departments apply to the foreign exchange function. Examiners should address any significant concerns with internal controls on the ECC, RMA, or other appropriate ROE page.

Reference: Manual Section 4.2, Internal Routine and Controls

INTERNATIONAL WORKPAPER

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PRE-EXAMINATION QUESTIONNAIRE

Examiners can use this optional questionnaire, in whole or part, during the pre-examination to facilitate their preliminary risk assessment. This workpaper includes a list of questions that examiners can ask management to help identify international activities, develop document request lists, and scope examination activities.

Briefly summarize significant discussion topics in the pre-examination planning memorandum. Summarize items such as material changes since the prior examination, economic conditions in the institution's area of operation, new products or services, and areas of perceived risk. Include any other information useful for allocating examination resources. Document the name and title of any officer with whom disccusion(s) were held, and note the discussion date(s).

This Bank of Anytown provides sample comments for an institution that has adopted the Current Expected Credit Losses (CECL) methodology.

The Bank of Anytown illustrates the application of ROE instructions when presenting examination findings. The Bank of Anytown does not cover all possible examination circumstances and should not be used as boilerplate language. The Bank of Anytown is not intended to inhibit examiner judgment in situations that require other presentation methods due to unique situations.

BANK OF ANYTOWN

ANYTOWN ANYCOUNTY ANYSTATE

Region: Any Region Certificate Number: 99999
Examiner-In-Charge: Sandra E. Smart

Examination Start Date: August 01, 20x6
Examination As Of Date: June 30, 20x6

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All dollar amounts are reported in thousands, unless otherwise indicated.

Abbreviations within the report are included inside the back cover and can also be found at https://www.fdic.gov/regulations/safety/manual/section16-1.pdf

The following practices or financial conditions or operations require Board attention and corrective actions. Unsatisfactory conditions and practices identified during this examination, and recommendations from the previous examination that were not satisfactorily addressed, are described more fully throughout this Report of Examination (ROE).

MEMORANDUM OF UNDERSTANDING (MOU)

The MOU provisions relating to the Allowance for Credit Losses (ACL) related to loans and leases, Reports of Condition and Income (Call Report), and credit extensions to borrowers with charged-off loans remain outstanding and uncorrected. Failure to satisfactorily address the Memorandum of Understanding (MOU) provisions will likely impede progress in returning the bank to a satisfactory condition. The Board should take additional action to ensure full remediation of the unsatisfactory conditions addressed by the MOU.

ALLOWANCE FOR CREDIT LOSSES RELATED TO LOANS AND LEASES

The ACL related to loans and leases is at an insufficient level requiring an estimated allocation of $325M due to elevated loan losses and deficiencies in the methodology for establishing the ACL related to loans and leases. The Board's attention is needed to ensure a sound process for maintaining an appropriate ACL related to loans and leases is developed and implemented to protect the institution and accurately report earnings and capital.

INTERAGENCY GUIDELINES ESTABLISHING SAFETY AND SOUNDNESS STANDARDS - APPENDIX A OF PART 364 OF THE FDIC RULES AND REGULATIONS

The institution is not in conformance with established safety and soundness standards contained in Appendix A of Part 364, in the areas of internal controls and information systems, internal audit system, loan documentation, credit underwriting, and asset quality. Failure to appropriately address these deficiencies and improve risk management practices may result in further deterioration in the bank's financial condition. In particular, the Board's attention is necessary to ensure the following inadequate risk management practices are corrected to prevent future financial deterioration:

- Asset Quality, Credit Administration, and Loan Underwriting: Inaccurately graded credits contributed to the insufficient level of the ACL related to loans and leases. In addition, poor credit administration practices (relating to weak participation loan underwriting, the lack of construction loan inspections, and lack of on-going cash-flow analysis for commercial real estate loans) inhibit management's ability to make sound credit decisions, hamper collection efforts, and could lead to further loan losses. Also, procedures to identify and monitor asset concentrations are inadequate. Poor controls over concentrated asset positions can lead to disproportionately higher losses in the event of problems.

- Internal Controls and Internal Audit: Internal controls have not been sufficient to provide for operations in compliance with rules and regulations. For example, the Board approved loans in apparent violation of the Federal Reserve Board's Regulation O, and senior management purchased investments above its Board-approved investment authority. Moreover, the internal audit function lacks independence, as the internal auditor reports directly to the bank's president. Weak internal controls prevent the Board and management from adequately identifying, monitoring, and controlling risks, potentially exposing earnings and capital.

STRATEGIC PLANNING

Despite the continued decline of the local fishing industry and the increase of local financial service providers, the bank's strategic plan does not adequately address regional economic conditions or local competition. Therefore, the plan may not provide the Board or management with adequate information to assess business opportunities or to adjust strategies and practices in light of changing conditions. The Board should direct correction of the deficiencies in the strategic plan and ensure supporting data is current and comprehensive.

SUMMARY

The Board should address the weaknesses and recommendations highlighted above. The FDIC and Any State will monitor the remediation of these matters between examinations.

For additional details, including management's responses to these matters, refer to related comments included in this ROE.

Examination Conclusions and Comments	99999

Uniform Financial Institutions Rating System

	Current Exam	Prior Exam	Prior Exam
Examination Start Date	08/01/20x6	11/13/20x5 / S	10/21/20x4
Examination As Of Date	06/30/20x6	09/30/20x5	09/30/20x4
Composite Rating	**3**	**3**	**3**
Component Ratings:			
Capital	**3**	**2**	**2**
Asset Quality	**4**	**4**	**3**
Management	**3**	**3**	**3**
Earnings	**4**	**4**	**3**
Liquidity	**2**	**2**	**2**
Sensitivity to Market Risk	**2**	**2**	**2**
Information Technology	**2**	**1**	**2**
Trust	**2**	**2**	**2**
Compliance[1]	**2**		
Community Reinvestment Act[1]	**S**		

1 Examination dated xx/xx/xxxx

OVERALL CONDITION AND RISK PROFILE

This $80 million community bank is a locally owned, full-service commercial bank offering traditional deposit and credit products with particular focus on customers directly and indirectly reliant upon maritime-related businesses. The trade area is centered in a regional economic area heavily dependent upon a depressed fishing industry. Assets consist primarily of commercial and real estate loans to small, local businesses. Similarly, the bank's depositors are mostly business loan clients and local retail customers. In efforts to diversify from maritime-related businesses, management has purchased commercial loan participations, primarily from Other Bank, Othertown, Other State. In addition, the bank has a trust department that manages approximately $3.3 million in assets, most of which is in non-discretionary accounts.

The bank remains in less than satisfactory condition due to the lingering effects of poor risk selection and underwriting during an aggressive growth campaign in commercial real estate (CRE) and particularly acquisition development and construction (ADC) loans identified at the previous examination. Significant and increasing weaknesses in the local economy have further exacerbated credit risk problems. Numerous workout credits and further deterioration in CRE due to poor credit administration have resulted in an insufficient level of the ACL related to loans and leases and have negatively impacted earnings. Capital levels are less than satisfactory in relation to the heightened risk profile. Management needs to make additional efforts to comply with the outstanding Memorandum of Understanding (MOU). Information Technology, Trust, and Bank Secrecy Act (BSA)/Anti-Money Laundering programs are adequately managed as findings identified during the examination are limited and correctable in the normal course of business. Compliance and Community Reinvestment Act programs are also satisfactory.

MEMORANDUM OF UNDERSTANDING

The bank entered into a MOU on January 21, 20x5, based on the October 21, 20x4, FDIC examination findings. Management and the Board have not fully addressed three MOU provisions, relating to the appropriateness of the ACL related to loans and leases, accuracy of the Reports of Condition and Income, and documentation for credit extensions to previously classified borrowers. Refer to the Compliance with Enforcement Actions page for additional details.

ASSET QUALITY – 4

Asset quality remains weak and is the primary impediment to improving the bank's overall financial condition. As reflected on the Examination Data and Ratios page, the volume of adversely classified items (ACI) has decreased by 12 percent since the prior examination, with the volume of adversely classified loans dropping by 24 percent. Despite these improvements, adverse classifications still represent 84 percent of Tier 1 Capital and the ACLs. Additionally, the volume of Loss classifications increased from $194M at the 20x4 examination to $1,015M at the current examination. (Asset Review Date: 6/30/20x6.)

Loans

Examination classifications are centered in the CRE portfolio. Loans adversely classified Loss (portions of three relationships totaling $890M) are CRE loans that were adversely classified Substandard at the prior examination. Most troubled credits reflect liberal lending practices exacerbated by the depressed regional economy, particularly the local fishing industry. In response to past regulatory criticisms, management has taken affirmative steps to strengthen credit administration by tightening overall underwriting standards, strengthening collection efforts, decreasing CRE advance rates from 90 percent to 75 percent, and avoiding financing for speculative real estate acquisition and development projects. These actions have longer-term positive implications, but present credit quality remains hindered by numerous workout situations and the deterioration of existing credits not previously subject to adverse classification. Moreover, underwriting weaknesses are evident in participations purchased, and credit administration weaknesses were noted in the areas of construction loan inspections and cash-flow analysis. Additional details regarding trends in the level of adversely classified loans are included on the Analysis of Loans Subject to Adverse Classification page.

Loan Review and Internal Grading System

The institution's internal loan review and grading program is not producing timely or accurate information about the condition of the loan portfolio. Management has been unable to comply with internal review frequency standards due to elevated personnel demands associated with problem asset workouts. Assigned credit grades for several larger credits were inaccurate, as exemplified by examiner identification of the partial Loss classification of the Irma Deat, Ltd. and Last Chance Motel credits. In both cases, the credits were internally rated Substandard. Additionally, several credits adversely classified Substandard by examiners were internally rated Watch. Failure to accurately grade credits on a timely basis has resulted in an insufficient level of the ACL related to loans and leases, and may hinder management's ability to take appropriate and timely corrective action. To address this issue, management needs to provide additional resources to improve performance of this function.

President Allie C. Lincoln stated that management would add staff by year-end 20x6, and meet review frequency standards by mid-20x7.

Allowance for Credit Losses

The ACL related to loans and leases is at an insufficient level requiring an estimated allocation of $325M, primarily due to inaccurate internal credit grading. Additionally, the ACL related to loans and leases allocation for non-watch list credits is inappropriate based upon recent loan loss experience on non-watch list loans. Specifically, the institution's average loss rate on non-watch list loans since 20x4 is 0.75 percent; however, management only allocates 0.1 percent for residential mortgages and 0.5 percent for all other non-watch list loans.

Institutions are expected to maintain an ACL methodology in accordance with Generally Accepted Accounting Principles (GAAP), which reflects consideration of the risk profile of the loan portfolio. Moreover, due to the deficiencies in the loan grading system, earnings and capital could be exposed should future credit loss provisions prove insufficient. Refer to the Risk Management Assessment page for additional details.

President Lincoln indicated management intends to file amended June 30, 20x6, Reports of Condition and Income to address reporting issues (see comments below) and will include a $325M loan loss provision in the amended filings. President Lincoln also initiated a review of the loan grading system during the examination and stated that all existing loss-rate percentages would be reviewed and updated to ensure full conformance with GAAP.

Credit Underwriting and Administration

Credit underwriting and administration, although improving, requires further attention. The Robert Rain, LLC., credit is representative of deficiencies in the monitoring of construction loans and performing cash flow (CF) analysis; refer to the Items Listed as Special Mention for further details. As detailed on the Assets with Credit Data or Collateral Documentation Exceptions pages, the number of loans possessing potential weaknesses and documentation exceptions remains high. In particular, the following underwriting and credit administration weaknesses should be promptly addressed:

- *Credit Analysis on Participations Purchased* - The bank does not perform pre-purchase credit analysis on participations purchased. Pre-purchase analysis is necessary for management to assess the repayment capacity of the borrower(s) and assign an appropriate loan grade. An institution purchasing all or part of a loan should perform the same degree of independent credit analysis as if it were the originator.

- *Financial Statements (FSs)* - Loan officers have not obtained updated FSs from all repayment sources to perform global CF analysis and verify assets of guarantors. Obtaining current FSs allows a loan officer to analyze and document a guarantor's source of strength to a loan or borrowing relationship.

- *Inspections and Lien Waivers* - The bank does not perform inspections or obtain mechanic's lien waivers prior to making construction loan advances. Timely inspections and lien waivers protect the institution's collateral and lien positions and allow management to make informed decisions regarding the ACL related to loans and leases.

- *Rent Rolls* - Loan officers do not obtain rent rolls and vacancy figures on an ongoing basis for loans secured by CRE. Rent rolls and vacancy information allow management to properly monitor these types of loans if conditions are changing, understand any changes in the condition, and make informed and timely credit decisions.

- *Lien Perfection* - The bank periodically allows perfected interests in collateral to lapse by not filing timely Uniform Commercial Code (UCC-1) continuation statements. Use of a system to assist in keeping filings current protects collateral positions determined to be appropriate in original loan underwriting.

President Lincoln stated loan officers would immediately begin performing pre-purchase analyses on participations purchased. She also stated that the volume of documentation deficiencies is primarily due to understaffing and indicated management is in the process of hiring an additional loan clerk to assist in this area.

Other Real Estate (ORE)

Management maintains appropriate policies and procedures for acquiring, holding, and disposing of ORE. However, due to deterioration in existing credits, the dollar volume of adversely classified ORE increased $535M, or 78 percent, since the previous examination. The ORE portfolio primarily consists of CRE previously written down to fair value. The $100M ORE Loss classification reflected in this Report is based on the recently obtained (August 3, 20x6), appraised value of the Rolly property.

Concentrations

Several asset concentrations, including a fishing industry concentration, are listed on the Concentrations page. Management does not currently have procedures in place to adequately identify and monitor such concentrations. Concentrations that are not monitored and managed through sound risk management practices can expose a bank's capital and earnings to disproportionately higher losses in the event of a borrower's financial problems or an industry downturn, such as is currently being experienced by the local fishing industry. Given the potential for increased risk posed by asset concentrations, appropriate policies and procedures should be established to ensure these risks are properly identified, monitored, and managed.

President Lincoln indicated that management will develop procedures for identifying, monitoring, and managing the risk of concentrations and present them to the Board for its review and approval by year-end 20x6.

Disposition of Assets Classified Loss

President Lincoln stated that assets classified Loss totaling $1,015M will be charged off by September 30, 20x6.

EARNINGS – 4

Earnings performance remains poor. As detailed on the Analysis of Earnings page of this Report, the bank experienced significant operating losses in 20x4 and 20x5. Although the bank shows net operating income of $103M for the first six months of 20x6, profits are substantially overstated due to insufficient provisions for loan losses. As reflected in the footnote on the Examination Data and Ratios page, the bank will show a negative 0.58 percent Return on Average Assets, based on a net operating loss of $222M, after amending the June 30, 20x6 Call Report for the additional $325M provision to the ACL related to loans and leases.

The poor earnings performance is a direct result of persistent poor asset quality and increasing ORE levels. Although improving, the high level of nonperforming assets has required high ACL provisions related to loans and leases and increased overhead expenses. In spite of the volume of nonaccruals and other nonearning assets remaining high, the net interest margin for the first six months of 20x6 improved to 4.74 percent from 4.37 percent at year-end 20x5. This improvement is primarily the result of management's ability to maintain average interest rates in the loan portfolio above 8 percent, while reducing the average cost of funds to below 3 percent.

Total Noninterest Expense as a percentage of Average Assets has steadily increased over the last three years and reached 3.82 percent as of June 30, 20x6. Overhead expenses are nearly 100 basis points above comparable institutions, primarily due to expenses associated with ORE. Given the composition and level of problem assets, management does not expect ORE-related expenses to diminish in the near future. Overhead expenses will also increase due to the planned hiring of additional credit administration personnel. However, in an effort to reduce overhead, management plans to close the institution's only branch office on September 30, 20x6.

The 20x6 budget forecasts net income of $226M. With the exception of inaccurate assumptions related to the level of provision expense, the budgeting process is adequate and the assumptions used are reasonable. Future profitability is primarily dependent on improved asset quality and controlled overhead expenses.

Chairman of the Board Roger White stated that the directorate and senior management would revise the budget to depict provision expense levels more accurately. He directed President Lincoln to have the revised budget ready for Board review and approval at the November 20x6 Board meeting.

MANAGEMENT – 3

The overall performance of senior management and the Board of Directors remains less than satisfactory. The bank's weak financial condition is primarily the result of liberal lending policies and poor credit administration practices. As documented in prior examination reports, the present management team aggressively pursued loan growth without regard for prudent lending standards and, ultimately, asset quality. Although initial signs of more prudent loan underwriting and improved credit administration are evident, asset quality remains weak and significant aspects of the credit function remain deficient.

<u>Board Supervision</u>

A director's duty to oversee the conduct of a bank's business necessitates that each director exercise independent judgment in evaluating management's actions and competence. Directors need to critically evaluate the issues before them, rather than routinely deferring to management. However, Board minutes lack evidence to demonstrate that directors are exercising their independent judgment. Instead, Board minutes indicate that Chairman White and President Lincoln dominate policy discussions and decisions. Moreover, Director Michael D. Brown attended only 5 of the 12 Board meetings held since the previous examination. Regular attendance at Board and committee meetings is a prerequisite to fulfilling the duty to oversee the conduct of the bank's business, and directors who are unable to meet this obligation should consider resignation. Weaknesses in the strategic planning process and the inadequacy of certain written policies are additional indicators that the Board needs to improve its oversight of the bank's operations and management's actions.

Chairman of the Board White indicated that directors are more engaged in discussions regarding the bank's business than is reflected in the minutes and that future minutes will be more descriptive regarding the input from various directors. Director Brown stated that he frequently travels out of town on business; however, he committed to attending Board meetings on a more regular basis.

Apparent Violations of Laws and Regulations

Examiners cited apparent violations of the Treasury Department's BSA regulations for late currency transaction report (CTR) filings, the Federal Reserve Board's Regulation O for two insider loans that did not receive full Board approval, and exceeding the state's legal lending limit statute. An apparent violation of the BSA was also cited at the last FDIC examination, and although the number of late filings of currency transaction reports (CTRs) has declined, repeat infractions reflect unfavorably on the Board and management. The Board of Directors should implement improved controls and procedures to ensure timely CTR filings, appropriate Regulation O loan approvals, and identification of concentrations of loans to one borrower. Additionally, the institution is in nonconformance with multiple parts of the Interagency Guidelines Establishing Standards for Safety and Soundness, Appendix A to Part 364 of the FDIC Rules and Regulations.

Chairman of the Board White committed to improve BSA and Regulation O controls and promised future conformance with all Safety and Soundness standards detailed in Appendix A to Part 364.

Strategic Planning

The 20x4 five-year strategic plan has not been updated, and is therefore inconsistent with the present condition of the bank, the regional economy, and the local competitive environment. Specifically, the plan's assumptions do not consider the continuing decline of the local fishing industry, the potential impact of a new commercial bank in town, or the recent merger of two local savings and loan associations. Based on these factors, many of the goals and strategies in the plan may be unrealistic. Setting a bank's strategic focus, in conjunction with executive management, is one of the key responsibilities of a bank's Board. An effective strategic planning process provides for regular reviews to determine whether assumptions and strategies remain valid or should be revised. The Board and management should update the strategic plan to reflect current conditions and should adopt a process to periodically review the plan going forward.

Chairman of the Board White stated that the strategic plan would be reviewed and updated before the end of 20x6 and annually thereafter.

Audit and Internal Control

The audit and internal control functions lack independence. While the scope and frequency of the internal audit program are adequate, Internal Auditor Mary Jackson reports directly to President Lincoln. Since President Lincoln is ultimately responsible for most of the day-to-day operations reviewed by the internal auditor, this situation compromises the independence of the internal audit program. The internal auditor should report directly to the Board of Directors or the Audit Committee of the Board to ensure the independence and effectiveness of the audit function. President Lincoln is also a member of the Audit Committee, which oversees the external audit function. Her presence on the committee further limits audit independence. Lack of independence in the internal control structure exposes the institution to operational and financial risks and could impact management and the Board's ability to appropriately control risks. Several outside directors are qualified to serve on the Audit Committee, and it is recommended that the Board strengthen the audit function by limiting committee membership to outside directors.

Several internal control deficiencies are detailed under Item 5 of the Risk Management Assessment section of this Report. While these deficiencies are relatively minor, management incorrectly reported that two of these items were corrected in the response to the last internal audit. Failure to accurately monitor and track corrective actions of audit findings decreases the Board's ability to fulfill their oversight responsibilities.

Chairman of the Board White stated that the Board would consider these recommendations at its next meeting. He also stated the internal control deficiencies would be addressed by the end of 20x6.

Reports of Condition and Income (Call Report)

Material errors were noted in the last three quarterly Reports of Condition and Income. In numerous cases, examiners were unable to reconcile bank records with the quarterly filings. The most significant errors relate to inaccurately reported interest and fee income on loans, the inappropriate inclusion of gains on the sale of repossessed assets in interest and fee income, and the shortfall in the ACL related to loans and leases. These errors misrepresent financial performance and negatively affect management's ability to make informed decisions. Management should investigate these errors and amend prior Reports of Condition and Income as appropriate.

Executive Vice President/Cashier John M. Gutierrez stated he will file amended June 30, 20x6, Reports of Condition and Income, prior to September 30, 20x6, to address these issues.

Bank Secrecy Act (BSA)

The BSA program is generally satisfactory; however, examiners cited apparent violations of Title 31 C.F.R. Chapter X Section 1010.306(a)(1) of the Treasury Department's BSA regulations. The apparent violations relate to CTRs that were not filed within prescribed periods; refer to the Violations of Laws and Regulations page for additional details. Management should establish procedures to ensure CTRs are filed within prescribed timeframes.

President Lincoln indicated procedures would be implemented within 90 days to ensure CTRs are submitted in a timely manner.

Office of Foreign Assets Control (OFAC)

Effective policies, procedures, and controls are in place to ensure satisfactory compliance with OFAC regulations.

CAPITAL - 3

Capital is less than satisfactory in relation to the bank's risk profile. The ACI Coverage Ratio remains high at approximately 84 percent. In addition, after adjustments for provisions to fund the ACL related to loans and leases appropriately, the bank has had net operating losses over the past two and a half years. The existing concentration in fishing industry loans, considering the industry's current depressed condition and anticipated continuing decline, adds to capital concerns. The Leverage Capital ratio of 7.44 percent, detailed on the Examination Data and Ratios page, reflects current examination adjustments for assets classified Loss and the provision expense needed to fund the ACL related to loans and leases appropriately.

President Lincoln stated that dividends have not been paid for five years. She further stated that no dividends would be paid until the Tier 1 Leverage Capital ratio exceeds eight percent and earnings become positive and stable.

LIQUIDITY - 2

The bank's liquidity position is satisfactory. Asset growth has been minimal since the prior examination and the loan portfolio is shrinking. Management has increased the volume of investments in mortgage-backed securities, with the portfolio maintaining slight appreciation. Non-core funding has increased slightly but management is using these funds appropriately. Management could further strengthen funds management practices by developing a written funds management policy and a contingency funding plan (CFP) commensurate with the bank's risk profile. Clearly articulated policies reflective of the bank's characteristics help ensure that the institution is operating within Board-approved risk tolerances, which can mitigate the negative impact of overreliance on volatile funding sources in an adverse economic environment. Off-balance sheet commitments are minimal.

President Lincoln stated a written funds management policy and a CFP would be developed by year-end 20x6.

SENSITIVITY TO MARKET RISK - 2

Sensitivity to market risk is moderate and risk management practices are satisfactory. Funding sources reasonably match the bank's asset repricing structure, and the loan portfolio includes a high volume of adjustable-rate commercial loans. Over the past two years, depositors have moved funds out of maturing time deposits and into money market demand accounts. Management actively manages rates on these deposits, as the local market is very competitive. The bank does not engage in off-balance sheet derivative activity.

Management regularly monitors the bank's rate sensitivity position using income simulations and an economic value of equity model, and presents detailed quarterly reports to the Board. However, the Board and management should establish interest rate risk (IRR) policy limits. If not properly controlled, IRR can impact an institution's earnings, capital, and its underlying economic value. Setting policy limits helps control this risk by establishing a baseline for the institution's tolerance for interest risk. Monitoring compliance with these limits ensures that the level of IRR is maintained at prudent levels and in accordance with the Board's expectations. Refer to the Risk Management Assessment page for additional details.

For additional information on prudent IRR management principles, refer to the Joint Agency Policy Statement on Interest Rate Risk.

Chairman of the Board White stated that management and the Board would establish IRR policy limits by year-end 20x6.

TRUST - 2

The Board and management's performance and risk management practices are satisfactory relative to the size of the department and the complexity of trust activities. Account administration is generally in compliance with governing documents. Oversight of the asset management function is satisfactory. Operations, internal controls, and audit are generally satisfactory in relation to the trust business model. The earnings component was not rated due to the department's size. Only moderate weaknesses are present and within management's ability to correct. Recommendations and management responses are noted below and further detailed on the Fiduciary Activities Assessment pages.

Account administration is generally in compliance with originating documents. However, potential conflicts of interest exist from the trust department using own-bank deposits, as well as from holding stock of the parent holding company and an affiliate in one trust account. Trust Officer Hannah Hancock surveys local deposit rates to ensure competitive rates are being paid on deposits, but does not maintain documentation of her surveys. Appropriate policies, procedures, and practices should be developed and implemented to effectively control conflicts of interest and manage own-bank deposits and stock holdings. Without proper policies, procedures, and practices, the bank is exposed to potential litigation risk, which could negatively affect earnings and capital.

Trust Officer Hancock stated she would maintain documentation of comparable rates in the future.

Asset management practices are generally satisfactory. All account transactions, including discretionary disbursements, are included in monthly Board reports, and the Board reviews all accounts annually. However, management should annually document its needs assessment for each applicable account and/or beneficiary, and indicate whether the account's investment mix is meeting those needs. Failure to adequately document needs assessments, evaluate the mix, and document the review exposes the bank to litigation risks.

Trust Officer Hancock committed to documenting annual needs assessments for each trust account.

INFORMATION TECHNOLOGY - 2

Overall, IT operations, risk management practices, and cybersecurity are satisfactory. The IT audit program is generally adequate. Management and Board oversight of IT programs are generally satisfactory as demonstrated by adequate policies and risk management practices. The bank is in general conformance with Appendix B to Part 364 - Interagency Guidelines Establishing Information Security Standards. Management adequately assesses its cybersecurity risk exposure including its inherent risks, and cyber maturity levels.

While the overall IT department is satisfactory, exceptions were noted related to:

- Audit reporting lines and scoping,
- Patch Management,
- Financial and audit review of critical vendors,
- Control assessments on third party providers,
- Detail in project documentation, and
- Business Continuity Plan parameters.

Management attention to the aforementioned areas will strengthen the institution's IT security, operating and control environment, and better prepare the institution to respond to business disruptions. These areas are further discussed on the Information Technology and Operations Risk Assessment pages.

Findings of the IT examination were discussed in detail on August 27, 20x6, with Information Technology Manager William Robbins and President Lincoln, during which they indicated agreement with all findings. Refer to the Information Technology and Operations Risk Assessment pages for details on the exceptions and management commitment and timeframes for corrective action.

MEETING WITH THE DIRECTORATE

A Board of Directors meeting was held on September 18, 20x6. All directors were present with the exception of Director Henry P. Black. William E. Smith, partner in the bank's auditing firm, was also present. Deputy Commissioner of Banking Cynthia B. Jones represented the State Department of Banking. Field Supervisor James D. Gilmore, Examiner-in-Charge Sandra E. Smart, and Financial Institution Examiner Monica D. Powers represented the FDIC. All matters listed above were discussed with the Board. Most of the discussion concerned the increase in severity of adverse classifications, the need to improve the ACL methodology, and management's efforts to improve loan administration procedures. The Directorate and management's commitments for corrective action are noted within this report. Chairman of the Board White asserted that due to the improvement in the bank's overall condition, the MOU should be removed.

DIRECTORATE RESPONSIBILITY

Each member of the Board of Directors is responsible for reviewing this Report of Examination. Each Director must sign the Signatures of Directors page, which affirms that he or she reviewed the Report in its entirety.

Examiner (Signature)	Reviewing Official (Signature) and Title
Sandra E. Smart	*Dale K. Watson, Assistant Regional Director*

A Memorandum of Understanding (MOU) between the FDIC and the bank became effective on January 21, 20x5. Provisions of the MOU that require further efforts or are of a continuing nature are detailed below.

2(b). The bank shall maintain Allowances for Credit Losses at an appropriate level.

Based on this examination's findings, the ACL related to loans and leases is at an insufficient level requiring an estimated allocation of at least $325M.

3(a). The bank shall maintain a Leverage Capital ratio equal to or greater than 7 percent.

As of June 30, 20x5, the Leverage Capital ratio, adjusted for the additional $325M provision for credit loss expense, approximates 7.44 percent.

3(d). The bankshall maintain a Total Capital ratio equal to or greater than 10 percent.

As of June 30, 20x6, the Total Capital ratio, adjusted for the additional $325M provision for loan and lease loss expense is 11.75 percent.

4. The bank shall file accurate Call Reports.

Examiners noted significant errors in the December 31, 20x5, March 31, and June 30, 20x6, Call Reports which require amendments.

5. The bank shall not extend or renew, directly or indirectly, credit to, or for the benefit of, any borrower who has a loan or other extension of credit with the bank that has been charged off or classified, in whole or in part, Loss, Doubtful, or Substandard, unless rationale for the extension is noted in the official Board minutes and the appropriate creditfile.

On January 30, 20x6, the bank extended a $50M loan to U. R. Worth. The borrower was adversely classified Loss at the previous examination. The Board did not specifically document the reason(s) for the extension in the official Board minutes or in the appropriate credit file.

6. The bank shall not declare or pay any dividends without the written consent of the FDIC.

No dividends have been declared or paid since the previous examination.

1. **Are risk management processes adequate in relation to economic conditions and asset concentration levels?**

   No. As discussed on the Examination Conclusions and Comments (ECC) pages, the Board's strategic plan is outdated and does not reflect the institution's current condition or operating environment. In addition, management does not adequately identify, evaluate and monitor asset concentrations as exemplified by the deficiencies noted in managing the correspondent bank, fishing industry, and individual borrower concentrations identified in this report. Establishment of appropriate concentration risk policies and procedures would enhance management's ability to identify and control risks and avoid potential violations of law. Refer to the Concentrations pages for additional details.

   President Lincoln stated that management will develop procedures to identify, evaluate, and monitor concentrations.

2. **Are risk management policies and practices for the credit function adequate**?

   No. Internal credit review and grading procedures are weak, and credit administration practices are deficient. Recommendations for improvement are included under Asset Quality on the ECC page.

   Due to the deficiencies noted in the institution's internal credit grading system and the use of inaccurate loan loss rates, the ACL related to loans and leases is at an insufficient level. In addition, management utilized an inappropriate loan loss experience to establish a reserve rate for its non-watch list loans, which contributed to the insufficient level of the ACL related to loans and leases. Management should ensure controls are in place to consistently determine the ACL related to loans and leases is maintained in accordance with GAAP and should maintain supporting documentation for the techniques used to develop the historical loss rate for each group of loans and the resulting estimated credit losses. For additional information, refer to the Interagency Policy Statement on the Allowance for Credit Losses.

   President Lincoln committed to filing Call Report amendments prior to the September 30, 20x6 submission and to reviewing the loan grading system.

   Additionally, although the bank's loan policy is generally adequate, it does not address the following matters:

   <u>Participation Loans</u> - The bank regularly purchases loans or portions of loans from other institutions. These specialized lending activities are not covered in the loan policy.

   <u>Construction Loans</u> - The bank finances the construction of 1- to 4-family residences and mixed use commercial property. While practices are generally adequate, a large construction loan listed for Special Mention reflects several weaknesses in construction lending. The policy lacks specific guidelines pertaining to construction lending.

   Development of comprehensive loan policy guidance provides management and staff with clear expectations for administering the lending function and facilitates sound risk management practices.

   President Lincoln stated that management would develop guidelines for purchased loans and construction lending and revise the loan policy by December 31, 20x6.

3. **Are risk management policies and practices for asset/liability management and the investment function adequate?**

   Generally, yes. Management's liquidity management practices are generally adequate; but could be improved by implementing a formal funds management policy or a contingency funding plan. Overall practices for Sensitivity to Market Risk are generally adequate; however, policy parameters should be established that reflect the Board's tolerance for interest rate risk (IRR). The Board should establish and guide the bank's tolerance for IRR, including approving relevant risk limits and other key policies, identifying lines of authority and responsibility for managing risk, and ensuring adequate resources are devoted to IRR management. Implementing appropriate limits strengthens management's ability to manage IRR and monitor actual risk taking activity.

   President Lincoln stated that IRR policy limits would be established by year-end 20x6.

   Investment policy guidelines are adequate; however, management's adherence to its written investment policy is inconsistent. On at least three occasions since the previous examination, President Lincoln exceeded her purchasing authority when she purchased securities over $250M without prior Board approval. Failure to adhere to Board approved purchasing authority could increase the risk profile of the institution above Board approved risk tolerances.

   The Board should ensure management purchases investments in conformance with existing policy standards or determine if it would be prudent to revise the standards to meet purchasing needs.

   President Lincoln stated that she was presented with the opportunity to purchase these securities at a good price and could not wait for Board approval. She further stated she would comply with the policy in the future or discuss modifying the policy with the Board at the next Board meeting.

4. **Are risk management processes adequate in relation to, and consistent with, the institution's business plan, competitive conditions, and proposed new activities or products?**

   No. As discussed on the ECC pages, risk management practices regarding the credit portfolio are insufficient for the institution's business model and risk profile.

5. **Are internal controls, audit procedures, and compliance with laws and regulations adequate (includes compliance with the Bank Secrecy Act [BSA] and related regulations)?**

   No. As indicated on the ECC page, apparent violations of BSA regulations, Regulation O, and the state legal lending limit were cited during this examination. Additionally, the bank is not in conformance with the Interagency Guidelines Establishing Safety and Soundness Standards. Full details of these citations can be found on the Violations of Laws and Regulations pages. In addition, the audit and internal control functions lack independence.

   <u>Internal Controls</u>

   Examiners noted the weaknesses below in the bank's system of internal controls. Maintaining strong internal controls helps ensure the integrity of operations and discourages potential insider abuse.

- *Vacation Policy* – The bank's vacation policy requires employees to be absent from their normal duties for an uninterrupted period of two weeks each calendar year. Executive Vice President Leslie S. Cook did not remain absent during her two-week vacation in 20x5 as she returned daily to reconcile the Federal funds sold account. Management should enforce the policy, particularly for employees who are responsible for sensitive transactions.

- *Reconcilement of Correspondent Bank Accounts* - Management has not reconciled the correspondent bank accounts for the past three months. While personnel reconciled these accounts during the examination, they should be reconciled at least monthly

President Lincoln stated she would take action to address these deficiencies before year-end 20x6.

6. Is Board supervision adequate, and are controls over insider transactions, conflicts of interest, and parent/affiliate relationships acceptable?

No. Board supervision is less than satisfactory. Numerous underwriting weaknesses and credit administration deficiencies remain uncorrected from prior examinations, and the Board has not established an effective independent internal audit function. Refer to comments under Management on the ECC page for more details. Additionally, examiners cited two loans as apparent violations of the Federal Reserve Board's Regulation O because management did not obtain the prior approval of the Board on loans to the related interests of President Lincoln and Director Larry G. Green. Refer to the Violations of Laws and Regulations page of this Report for details.

APPARENT VIOLATIONS OF LAWS AND REGULATIONS

BANK SECRECY ACT

Title 31 C.F.R. Chapter X Section 1010.306(a)(1) of the Treasury Department's Bank Secrecy Act regulations requires a covered financial institution to file a CTR (FinCEN Form 104) within the prescribed period.

Examiners identified numerous instances where CTRs were not filed within the required 15-day period. This infraction was also cited at the previous FDIC examination. Between October 20x5 and July 20x6, 289 of 944 CTRs (31 percent) were filed late. In many cases, CTRs were signed by the approving official more than 15 days after the transaction date. The time between the transaction date and receipt by the Treasury Department on these late filings was generally around 20 to 25 days, with a few exceeding 70 days.

BSA Officer Donna Ludlow stated that some of the late CTRs were filed after an internal audit noted that the forms had not been submitted; however, she could offer no explanation as to why the remaining CTRs were filed late. President Lincoln stated that new procedures would be implemented within 90 days to ensure all CTRs are submitted in a timely manner in the future.

REGULATION O

The Federal Reserve Board's Regulation O, which implements Section 22(h) of the Federal Reserve Act and is made applicable to insured nonmember institutions by Section 18(j)(2) of the Federal Deposit Insurance Act, covers transactions with bank insiders. Section 215.4(b)(1) of Regulation O requires extensions of credit by an institution to a director or related interest exceeding the greater of $25M or five percent of unimpaired capital and surplus to have prior approval by a majority of the institution's board of directors.

The bank is in apparent violation of this section for extending the following loans with the prior approval of the Executive Loan Committee, which is composed of only three Board members, rather than prior approval by a majority of the Board.

Borrower	Date of Note	Original Amount
Lincoln, Allie C.	12/11/20x5	$500M
Any Body, Inc.	12/28/20x5	$250M
(A related interest of President Lincoln and Director Green.)		

President Lincoln stated that these exceptions were the result of oversight. She further indicated that bank policy requires that all insider loans receive the prior approval of the full Board. Examiners noted that all other insider loans received prior Board approval. President Lincoln and the Board of Directors promised future compliance.

LEGAL LENDING LIMIT

Section 1127 of the State Banking Code provides that the total direct or indirect loans and extension of credit or lease by a bank to one obligor or guarantor at no time shall exceed 15 percent of "statutory capital" (equivalent to total capital) of the bank, except upon approval by two-third vote of its board of directors, the limit may be increased up to 25 percent of the statutory capital of the bank. On January 2, 20x6, the bank extended an additional $650M to J&M Realty Trust, guaranteed by John and Mary Smith, which increased total outstanding debt to the Smiths and their companies to $1,950M, or 31 percent of statutory capital. The extension of additional credit was made without approval by the board of directors, and represents an apparent violation of Section 1127.

President Lincoln stated that the extension of credit over the lending limit was the result of oversight.

<u>NONCONFORMANCE WITH GUIDELINES INCORPORATED INTO REGULATIONS</u>

INTERAGENCY GUIDELINES ESTABLISHING STANDARDS FOR SAFETY AND SOUNDNESS APPENDIX A TO PART 364 OF THE FDIC's RULES AND REGULATIONS (APPENDIX A)

Appendix A sets out the safety and soundness standards that the FDIC uses to identify and address problems at insured depository institutions before capital becomes impaired. The institution is in nonconformance with the following sections of the Operational and Managerial Standards of Appendix A to Part364.

A. Internal controls and information systems. An institution should have internal controls and information systems that, in part, are appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for timely and accurate financial, operational, and regulatory reports and compliance with applicable laws and regulations.

Material errors were noted in the institution's quarterly Call Report filings over the last three quarters, which necessitates restatement of the institution's most recent Call Report. Additionally, three apparent violations of laws and regulations were noted, including a repeat violation regarding untimely CTR filings.

B. Internal audit system. An institution should have an internal audit system that is appropriate to the size of the institution and the nature and scope of its activities and that provides for, in part: independence and objectivity; adequate testing and review of information systems; and adequate documentation of tests and findings and any corrective actions.

The audit and internal control functions lack independence, which jeopardizes the effectiveness of the internal audit program. Further, the lack of independence coupled with inadequate monitoring of audit findings status reports resulted in previously identified deficiencies being inaccurately reported as corrected.

C. Loan documentation. An institution should establish and maintain loan documentation practices that, in part: enable the institution to make an informed lending decision and to assess risk, as necessary, on an ongoing basis; identify the purpose of a loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner; ensure that any claim against a borrower is legally enforceable; and demonstrate appropriate administration and monitoring of loans.

Credit administration, although improving, remains deficient. Noted weaknesses include lapses in UCC-1 filings, absence of inspections or mechanic's lien waivers prior to construction advances, and absence of rent roll information. As noted on the Assets with Credit Data or Collateral Documentation Exceptions page, one-third of the dollar volume of loans reviewed had documentation exceptions that impaired management's ability to make an informed lending decision and to assess risk, as necessary on an ongoing basis.

D. Credit underwriting. An institution should establish and maintain prudent credit underwriting practices that: are commensurate with the types of loans the institution will make and, in part, provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed; establish a system of independent, ongoing credit review and appropriate communication to management and to the board of directors; and take adequate account of concentration of credit risk.

Management does not conduct pre-purchase credit analysis for participations purchased, which precludes its ability to evaluate the underlying creditworthiness of these credits and the borrower's ability to repay. Additionally, inadequate staffing of the credit review function contributed to inaccurate loan grading for several large credits. Moreover, management does not have adequate procedures in place to identify and monitor concentrations.

G. Asset quality. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should, in part, estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses.

As detailed on the ECC page, inaccurate internal loan grading resulted in an insufficient level of the ACL related to loans and leases.

President Lincoln stated that all noted deficiencies will be added to the Audit Findings Tracking Report and that applicable executive officers would begin action to address deficiencies immediately.

Uniform Rating System for Information Technology

	Current Exam	Prior Exam	Prior Exam
Examination Start Date	08/01/20x6	11/13/20x5 / S	10/21/20x4
Composite Rating	**2**	**1**	**2**
Component Ratings:			
Audit	**2**		
Management	**2**		
Development & Acquisition	**2**		
Support & Delivery	**2**		

Overall, IT, operations, risk management, and security are generally satisfactory. Management's attention is directed to the items below.

Audit - 2

The IT audit program is generally adequate, and internal auditors promptly identify and report deficiencies and risks. Identified issues are formally tracked and resolved in a timely fashion, and the IT audit plan is based on a thorough risk assessment of IT assets and internal and external threats.

The majority of critical IT areas were reviewed in recent IT audits; however, examiners identified a concern with the current audit scope. Specifically, patch management and cybersecurity are not included in the bank's IT audits. Management should ensure all critical IT areas are included in the scope of IT audits, with the frequency being based on the audit risk assessment. Including all critical IT areas in the internal audits may have reduced the number of items noted in the recent external vulnerability assessment and will help ensure operations continue functioning as needed going forward.

Examiners also noted a concern with the audit reporting structure. At present, internal auditors report to President Lincoln rather than the Board's Audit Committee. In order to increase the auditors' independence and help ensure the Board is able to fulfill its oversight responsibilities, the internal auditors should report directly to the Board's Audit Committee.

President Lincoln stated that the omission of patch management and cybersecurity from the recent IT General Controls audit was an oversight and agreed to include the areas in future audits. President Lincoln also stated that she would recommend to the Board that they modify the IT audit reporting structure so auditors report directly to the Board's Audit Committee.

Management - 2

Overall IT management provides adequate guidance and direction. The oversight and supervision of the information security program and related practices are supported by adequate Board approved policies and risk management practices. Managers are well qualified and tenured for their respective positions.

<u>Vendor Management</u>

Overall, management monitors service providers to confirm they satisfied their contractual obligations; however, management did not review the financial statements or the Statement on Standards for Attestation Engagements (SSAE 16) reports of two critical service providers. To help ensure all service providers are appropriately monitored and to improve the effectiveness of management's monitoring activities, management should formally document all required reviews.

President Lincoln indicated the missing reviews were an oversight and stated that a tickler system would be developed to remind the vendor -review officer of upcoming vendor reviews.

Conformance with Information Security Standards

Management is in general conformance with Appendix B to Part 364 - Interagency Guidelines Establishing Information Security Standards of the FDIC Rules and Regulations. Management identified the location of all non-public personal information, both electronic and hard copy. Threats to each type of information were identified, adequate controls are in place, and an annual report of the program is presented to the Board. While the overall program is adequate, management did not conduct control assessments on all third-party providers that obtain, use, or process non-public personal information. Management should expand the scope of the control assessments to include all applicable third-party providers. Including all applicable third parties in the assessments will help ensure the providers are appropriately identified and risk rated, and will help confirm third parties have adequate internal controls to protect non-public information.

President Lincoln stated that the vendor management program would be updated to identify all vendors with access to non-public personal information and that control assessments would be conducted on all identified vendors before March 31, 20x7.

Cybersecurity Preparedness

Management's assessment of the bank's cybersecurity risk exposure appropriately identifies inherent risks; however, cybersecurity preparedness could be strengthened by determining whether cyber-related controls are sufficient. By identifying cyber-related controls and determining whether they mitigate the identified inherent risks to an acceptable level, management will be better able to identify cybersecurity weaknesses and implement appropriate controls.

President Lincoln indicated that the assessment process would be expanded to include targeted maturity levels by June 30, 20x7.

Development and Acquisition - 2

Development and acquisition practices, which include hardware and software implementation and change-management practices, are appropriate for the institution's size and complexity. Overall, project management processes are adequate and provide sufficient guidance to manage projects. Currently, any project exceeding $20M is rated as a major project and requires specific project documentation. However, not all project documentation complies with the internal bank guidelines. For example, the documentation of three recent projects did not include reviews of alternative project solutions or explanations of why the solutions recommended in the project proposals were the most appropriate solutions. Management should comply with internal bank guidelines to ensure project requirements are met and consistent project documentation is in place.

President Lincoln indicated the project management program was relatively new and that project requirements were being introduced in a phased approach to not overwhelm employees. However, she agreed to follow internal project guidelines on future projects.

Support and Delivery - 2

Overall computer operations and information security practices are adequate, and management has improved its business continuity and disaster recovery plans. Management established an information security group to set standards, monitor trends, and review system logs and alerts. Although overall operations are adequate, examiners identified areas that require management's attention such as system-log monitoring, vulnerability assessments, patch management, and business continuity planning.

Logging and Monitoring

Management uses different logging platforms for firewalls, internal servers, and routers, and data are not shared or correlated among the logging systems. While servers and base operating systems are logged, logging is not enabled for virtual operating system environments. Management should review its current logging program to ensure all critical systems are included and that there is sufficient data correlation between the systems. Improving the logging program will help ensure all necessary information is obtained and provide the information security group with data in a more effective, centralized format.

Vulnerability Assessments

Management contracts an outside third party to conduct annual, internal vulnerability assessments as part of an overall security review. The scope of the vulnerability assessment is adequate; however, having only one assessment per year could result in vulnerabilities not being promptly identified. Management should review the frequency of its vulnerability assessment to ensure the frequency of the assessments is based on appropriate risk analysis.

President Lincoln committed to revisiting the logging and monitoring program to ensure that all needed information is logged and, to the extent possible, centralized. Additionally, she stated that management would review the frequency of the vulnerability assessments and conduct more frequent assessments based on appropriate risk analysis. President Lincoln stated the reviews would be completed by the end of 20x6, and appropriate corrective actions would be implemented by March 31, 20x7.

Business Continuity Planning (BCP)

Management changed the structure of its BCP this year. Most elements of the new program are adequate, but some should be improved. The areas of business impact analysis (BIA) and disaster recovery (DR) testing require further refinement.

The BIA and risk assessments are out-of-date, but are being updated to include new recovery time objectives (RTO) and to identify reasonably foreseeable threats, including cybersecurity threats. Currently, the shortest RTO is 24 hours. The 24-hour RTO may be too extended for the application, and there are several systems that may benefit from RTOs of four hours or less. The current extended RTOs may significantly affect multiple business lines and the institution's ability to restore critical systems after a disaster. Management should ensure RTOs are appropriate so that critical operations can be restored promptly after a disaster or business interruption. While some disaster recovery (DR) testing has occurred, management has not sufficiently tested a few critical systems. Management should review its testing universe and implement a risk-based testing approach to ensure all necessary testing is completed in a timely manner. Failure to conduct appropriate tests could result in material delays in restoring critical systems if a disaster occurs.

President Lincoln agreed to conduct the BIA and risk assessments, review RTOs, and implement risk-based DR testing by March 31, 20x7.

Uniform Interagency Trust Rating System

	Current Exam	Prior Exam	Prior Exam
Examination Start Date	08/01/20x6	11/13/20x5 / S	10/21/20x4
Composite Rating:	2	2	2
Management	2	2	2
Operations, Internal Controls and Auditing	2	2	2
Earnings Compliance	0	0	0
Asset Management	2	2	2
Management	2	2	2

A Trust Department Rating of "2" is assigned. Overall risk management practices are satisfactory relative to the institution's size and complexity. There are no material supervisory concerns. Fiduciary activities are conducted in substantial compliance with laws and regulations. Examination recommendations and management's responses are detailed below.

Compliance – 2

Account administration is generally in compliance with originating documents. Potential conflicts of interest exist from the trust department using own-bank deposits, as well as from holding stock of the parent holding company and an affiliate in one trust account. Trust Officer Hancock surveys local deposit rates to ensure competitive rates are being paid on deposits, but does not maintain documentation of her surveys. Appropriate policies, procedures, and practices should be in place to effectively control conflicts of interest and manage own-bank deposits and stock holdings. Without proper policies, procedures, and practices, the bank is exposed to potential litigation risk, which could negatively affect earnings and capital.

Trust Officer Hancock stated she would maintain documentation of comparable rates beginning immediately.

Regarding the trust account with holding company and affiliate stock, the party in interest of that account is informed of the trust officer's proxy vote and attends annual stockholder meetings; however, these facts are not documented in the trust files. Failure to adequately document voting rights could be viewed as a breach of trust and expose the bank to a potential conflict of interest.

Trust Officer Hancock indicated that since the party in interest to that account is a member of the Lincoln family, and stockholder meeting minutes of the holding company and the affiliate could be produced should the need arise, the risk is minimal.

Asset Management – 2

Asset management practices are generally satisfactory. All account transactions, including discretionary disbursements, are included in monthly Board reports, and the Board reviews all accounts annually. However, management should document in the annual account reviews an assessment of the needs of each applicable account and/or beneficiary, and whether the account's investment mix is meeting those needs. In addition, three trust accounts use fixed income and/or equity mutual funds. Qualified staff should annually review each mutual fund's investment mix, performance relative to competing mutual funds, and any other related criteria. These mutual fund reviews should also consider the ongoing needs and objectives of the respective trust accounts. Failure to adequately document needs assessments, evaluate the mix, and document the review exposes the bank to litigation risks.

Trust Officer Hancock committed to documenting annual needs assessments for each trust account, as well as annual mutual fund reviews going forward.

Management – 2

The Board's and management's performance and risk management practices are satisfactory relative to the size of the department and the complexity of trust activities. Only moderate weaknesses are present and are within management's capabilities and willingness to correct. The full Board acts as the Trust Committee and reviews department activity reports monthly. Trust Officer Hancock is the primary administrator and record keeper for personal trust accounts, while President Lincoln administers the farm management agency account.

The Board has adopted a general Trust Policy. The Directorate should consider adding policy criteria regarding environmental reviews of real estate that may be held in current or future trust accounts. Such policy guidance would help ensure that department management can identify and take mitigating action on potential environmental concerns on real estate held in managed accounts.

Trust Officer Hancock agreed to develop such guidance for the Board's consideration at its next meeting.

Operations, Internal Controls and Auditing – 2

Operations, internal controls, and audit are satisfactory in relation to the volume and character of trust business. Moderate weaknesses exist, but in general are effectively identified and monitored. The bank's audit program includes an annual review of trust department activity, including the verification of trust assets.

Trust department records are maintained manually, which limits internal control capability. Trust Officer Hancock is implementing a computerized trust record keeping system as time permits. The computerized system has the capacity to allow for the separation of record keeping and data entry functions from the account administration function. Limited staff restricts full segregation of duties. Despite this, check writing and account reconciliation procedures should be separated to reduce the risk of error or inappropriate activity going undetected.

Trust Officer Hancock stated she would enhance the deposit account reconcilement procedures by the end of the third quarter.

Earnings – 0

This small department is operating primarily as a service to current customers rather than as a profit center. Due to this aspect of the trust department's operations, and the limited volume of $3.3 million assets under management, the earnings component is not rated.

Meeting With Management

A meeting was held on September 8, 20x6, with President Lincoln and Trust Officer Hancock to discuss examination findings in detail. An overview of these findings was also presented to the bank's Board of Directors at its meeting on September 18, 20x6.

Examination Data and Ratios — 99999

ASSET QUALITY		ADVERSELY CLASSIFIED			
		Substandard	Doubtful	Loss	Total
Loans and Leases		4,290	140	890	5,320
Securities		45			45
Other Real Estate Owned		1,125		100	1,225
Other Assets				25	25
Other Transfer Risk					
Subtotal		5,460	140	1,015	6,615
Contingent Liabilities		230			230
Totals at Exam Date	06/30/20x6	5,690	140	1,015	6,845
Totals at Prior Exam	09/30/20x5	7,345	220	194	7,759
Totals at Prior Exam	09/30/20x4	6,655	177	67	6,899

	Exam Date 06/30/20x6	Prior Exam 09/30/20x5 (S)	Prior Exam 09/30/20x4
Total Special Mention	854	515	
Adversely Classified Items Coverage Ratio	84.41	102.71	94.92
Total Adversely Classified Assets/Total Assets	8.21	9.93	8.20
Past Due and Nonaccrual Loans and Leases/Gross Loans and Leases	6.74	8.42	9.12
Adversely Classified Loans and Leases/Total Loans	9.86	12.68	11.30
ACL on Loans and Leases/Total Loans and Leases	3.67	3.15	2.50

CAPITAL	Exam Date 06/30/20x6	Prior Exam 09/30/20x5 (S)	Prior Exam 09/30/20x4
Tier 1 Capital/Average Total Assets	7.44	7.55	7.67
Common Equity Tier 1 Capital/Risk-Weighted Assets[1]	10.48		
Tier 1 Capital/Risk-Weighted Assets[1]	10.48	9.88	9.90
Total Capital/Risk-Weighted Assets[1]	11.75	8.42	11.40
Prompt Corrective Action Capital Category	W	W	W

PCA Categories: W – Well-capitalized, A – Adequately capitalized,
U – Undercapitalized, S – Significantly undercapitalized,
C – Critically undercapitalized

	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Retained Earnings[1]/Average Total Equity	3.37	9.32	(2.05)	(3.86)
Asset Growth Rate	2.66	6.78	0.42	0.20
Cash Dividends/Net Income		32.65		

EARNINGS	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Income (After Tax)/Average Assets [*]	0.27	1.03	(0.15)	(0.30)
Net Interest Income (TE)/Average Earning Assets	4.74	4.64	4.37	4.64
Total Noninterest Expense/Average Assets	3.82	2.90	3.62	3.54

LIQUIDITY	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Non-Core Funding Dependence	14.71	1.02	8.69	6.66
Net Loans and Leases/Assets	64.45	66.20	68.79	69.24

[1] Institutions under the CBLR framework do not calculate Risk-Weighted Assets or Tier 2 Capital. For such institutions, Tier 1 Capital equals Total Capital under Part 324.
[*] After management's planned $325M adjustment to the ACL related to loans and leases, the 6/30/20x6 Ratio will drop to (0.58)%.

Comparative Statements of Financial Condition | 99999

ASSETS	6/30/20x6	12/31/20x5
Total Loans and Leases	53,931	55,545
Less: Allowance for Credit Losses on Loans and Leases	1,979	1,748
Loans and Leases (net)	51,952	53,797
Interest-Bearing Balances	20	
Federal Funds Sold and Securities Purchased Under Agreements to Resell	4,000	9,100
Trading Account Assets		
Securities: Held-to-Maturity (at Amortized Cost)	2,787	5,993
Available-for-Sale (at Fair Value)	9,969	
Equity Securities with readily determinable fair values not held for trading	919	
Total Earning Assets	**69,647**	**68,890**
Cash and Noninterest-Bearing Balances	5,895	4,754
Premises and Fixed Assets	2,530	2,709
Other Real Estate Owned	1,225	690
Intangible Assets		
Other Assets	1,307	1,175
TOTAL ASSETS	**80,604**	**78,207**

LIABILITIES		
Deposits	67,815	66,221
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	441	516
Other Borrowed Money	5,857	5,136
Other Liabilities	301	307
Subordinated Notes and Debentures		
Total Liabilities	**74,414**	**72,180**
EQUITY CAPITAL		
Perpetual Preferred Stock		
Common Equity Capital	6,190	6,027
Includes net unrealized holding gains (losses) on available-for-sale securities.		
Other Equity Capital		
Total Bank Equity Capital	**6,190**	**6,027**
Minority Interest in Consolidated Subsidiaries		
Total Equity Capital	**6,190**	**6,027**
TOTAL LIABILITIES AND EQUITY CAPITAL	**80,604**	**78,207**

DERIVATIVES AND OFF-BALANCE SHEET ITEMS		
Unused Commitments	4,333	5,893
Letters of Credit	209	824
Other Off-Balance Sheet Items		
Notional Amount of Derivative Contracts		

Footnotes:

Loans and Lease Financing Receivables | 99999

Date: 06/30/20x6

Category:	Amount	Percent
Real Estate Loans	21,938	40.53
Installment Loans	7,058	13.04
Credit Card and Related Plans	90	0.17
Commercial Loans	22,292	41.18
All Other Loans and Leases	2,753	5.09
Gross Loans and Leases	54,121	100.00

PAST DUE AND NONACCRUAL LOANS AND LEASES

Date: 06/30/20x6

Category	Past Due 30 through 89 Days and Accruing	Past Due 90 Days or More and Accruing	Total Past Due and Accruing	Percent of Category	Nonaccrual	Nonaccrual Percent of Category
Real Estate Loans	800	44	844	3.85	1,402	6.39
Installment Loans	125		125	1.77	107	1.52
Credit Card and Related Plans	3		3	3.33		
Commercial and All Other Loans and Leases	626		626	2.50	554	2.21
Totals	1,554	44	1,598	2.95	2,063	3.81
Memorandum						
Restructured Loans and Leases Included in the Above Totals						

Footnotes:

Recapitulation of Securities

99999

Description	HELD-TO-MATURITY		AVAILABLE-FOR-SALE	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. Treasury securities	1,537	1,593		
U.S. Government agency obligations			2,550	2,554
Securities issued by U.S. states & political subdivisions	250	250		
Mortgage-backed securities (MBS)				
Residential pass-through securities:				
Issued or guaranteed by FNMA, FHLMC, or GNMA			7,322	7,415
Other residential MBS (inc. CMOs, REMICs, & stripped MBS):				
Issued or guaranteed by U.S. Government agencies or sponsored agencies				
Collateralized by MBS issued or guaranteed by U.S. Government agencies or sponsored agencies				
All other residential MBS				
Commercial MBS				
Commercial mortgage pass-through securities:				
Issued or guaranteed by FNMA, FHLMC, or GNMA				
Other pass-through securities				
Other Commercial MBS:				
Issued or guaranteed by U.S. Government agencies or sponsored agencies				
All other commercial MBS				
Asset-backed Securities (ABS) and structured financial products				
Asset-backed securities				
Structured financial products:				
Other Debt Securities				
Other Domestic Debt Securities				
Foreign Debt Securities	1,000	1,000		
Totals:	2,787	2,843	9,872	9,969

SECURITIES APPRECIATION (DEPRECIATION)

Description	Held-to-Maturity	Available-for-Sale	Total
Securities Appreciation (Depreciation)	56	97	153
As a Percent of Amortized Cost	2.01	0.90	1.13
Allowances for Credit Losses (ACLs) on HTM and AFS Debt Securities			
As a Percent of Amortized Cost			

MEMORANDUM: EQUITY SECURITIES WITH READILY DETERMINABLE FAIR VALUES NOT HELD FOR TRADING

Description	Fair Value
Investments in mutual funds & other equity securities with readily determinable fair values not held for trading	919

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

AMOUNT, DESCRIPTION AND COMMENTS	CATEGORY		
	Substandard	Doubtful	Loss

These sample write-ups do not reflect required or preferred formats, but simply illustrate various ways to present the required analytical elements.

LOANS

Amount	No.	Status	Past Due	Substandard	Doubtful	Loss
500	(1)	Nonaccrual	96 Days Past Due			
250	(2)	Nonaccrual	96 Days Past Due			
750				750		

AMHILL TOOL & DIE, INC.
By: Robert E. Hill, President
Gty: Roger S. Barrett

Amhill Tool & Die, Inc. manufactures custom plastic-forming dies and provides injection-molding services.

(1) Note originated 1/7/20x2 at $500M to refinance a $450M mortgage on the obligor’s manufacturing plant and provide $50M working capital. The note matures 1/7/20x9 and requires interest-only payments, with principal due on demand. (2) Term note originated 6/10/20x3 at $280M, matures 6/11/20x0, and was extended to refinance a working capital note at another financial institution. The primary source of repayment for both notes is operating CF.

The loans are cross-collateralized by a first mortgage on the manufacturing plant, located in Anytown, Anystate, and a first security interest in all business assets. A 12/7/20x1 appraisal reflects a property value of $625M; however, the valuation appears stale given downward trends in local RE values. As of 12/31/20x5, management estimated the value of account receivables and inventory at $100M and assigned an estimated liquidation value of $125M to machinery and equipment. Reliance on the machinery and equipment as a secondary repayment source is restricted by their highly specialized nature and limited marketability.

Amhill Tool & Die, Inc. has been negatively impacted by cancelled contracts and high employee turnover. Weak CFs have caused on-going delinquency problems and management placed the notes on nonaccrual on 3/31/20x6. The obligor's 12/31/20x5 income statement reported gross income of $800M and a NOI of $100M. Gross sale revenues declined steadily since year-end 2012 and operating losses of $123M and $234M were reported as of 12/31/20x3 and 12/31/20x4, respectively. NW declined to $125M at year-end 20x5, and DSC was calculated at 0.91 as of 12/31/20x5. The guarantor’s 12/31/20x4 personal FS reflects liquid assets of $30M, a NW of $375M, and TA of $890M centered in his ownership interest in Amhill Tool & Die, Inc.

EVP/SLO Leslie S. Cook indicated managerial conflicts contributed to the loss of several lucrative contracts and numerous highly trained employees; however, he stated production output is increasing due to the addition of two knowledgeable managers and improved employee training. He also stated management intends to obtain a new

AMOUNT, DESCRIPTION AND COMMENTS	CATEGORY		
	Substandard	Doubtful	Loss

property appraisal, restructure the notes to better match the corporation's cash flows, and to require principal and interest payments on the modified mortgage note.

Debts classified Substandard based on inadequate cash flows, continuing delinquencies, and marginal collateral protection.

Internal Rating: 6 (Watch)
Originating/Servicing Officer: Cook
Examiner: T. Hinojosa

Amount, Description and Comments	Substandard	Doubtful	Loss
340 BROOKS, JAMES	200	140	
1,250 IRMA DEAT, LTD.	750		500
290 KING, CHRISTOPHER Gty: Sam King, Inc.	290		
865 LAST CHANCE MOTEL, INC.	500		365
275 RAMIREZ, PETER	250		25
1,550 EIGHT LOANS LESS THAN $250,000 List left with management.	1,550		
TOTAL ADVERSELY CLASSIFIED LOANS	4,290	140	890
SECURITIES			
45 ANYCOUNTY MUNICIPAL GENERAL OBLIGATION	45		
TOTAL ADVERSELY CLASSIFIED SECURITIES	45		

AMOUNT, DESCRIPTION AND COMMENTS	CATEGORY		
	Substandard	Doubtful	Loss
OTHER REAL ESTATE OWNED			
550 ONE WAY HOME, INC. PROPERTY	550		
675 ROLLY PROPERTY	575		100
TOTAL ADVERSELY CLASSIFIED ORE	1,125		100
OTHER ASSETS			
25 SUN, RAYMOND Repossessed Heavy Equipment			25
TOTAL ADVERSELY CLASSIFIED OTHER ASSETS			25
CONTINGENT LIABILITIES			
230 KING, CHRISTOPHER Amount represents unfunded portion of loan commitment for construction of a single-family residence.	230		
TOTAL ADVERSELY CLASSIFIED CONTINGENT LIABILITIES	230		
TOTAL ADVERSELY CLASSIFIED ITEMS	5,690	140	1,015

Items Listed for Special Mention	**99999**

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

DESCRIPTION	AMOUNT

LOANS

854 RAIN, ROBERT, L.L.C. GTY: Robert Rain	854

Debt represents the balance outstanding on a $1,600M construction/permanent facility, dated 3/7/20x6, to refinance an existing $1,200M loan at subject bank granted 1/5/20x5. The original loan was granted to develop a 3-story mixed-use commercial and apartment building in Neighboring Town. The new loan provided the borrower with an additional $400M in funds to accommodate a revised construction budget stemming from plan modifications. Loan terms require interest-only payments at 4.375% for a 10-month period. Principal and interest payments of $8,231 based on a 25-year amortization are to commence on 1/7/20x7, with the loan to mature in 20x1. Collateral consists of a first mortgage on the property under construction appraised at $1,000M "as is" and $2,000M "as complete."

The following credit concerns are associated with the indebtedness:

- The project encountered numerous delays due to difficulty in obtaining permits resulting from the changes in construction plans and due to the need for additional financing.
- Guarantor analysis is inadequate, as liquid assets were not verified and a global CF analysis was not prepared.
- Monitoring of the project has been weak. As a result, the loan has been 53 percent funded, but the project is only 40 percent completed, with the difference representing construction funds used for soft costs.
- No feasibility analysis was performed to support the 20x5 origination.
- The guarantor's experience as a construction manager is questionable considering the delays, revisions, and cost overruns.
- The appraised value may need to be updated, as it is based on the project being completed within the revised budget and assumes that projected operating results will materialize.

Given the concerns noted above and weaknesses associated with this indebtedness, a Special Mention designation is warranted. To strengthen the credit, close management oversight and monitoring is required, along with the following actions:

- Monitor construction progress and compare to budget to ensure percentage completion is brought in line with funding.
- Verify the guarantor's liquid assets and obtain financial information to perform a global CF analysis.
- Obtain an updated appraisal if actual rental rates significantly diverge from the appraisal's projections, if project costs outstrip the revised budget, or if further delays ensue.

Internal Rating: 3
Originating/Servicing Officer: Cook
Examiner: V. Stewart

TOTAL LOANS LISTED FOR SPECIAL MENTION	854

Analysis of Loans Subject to Adverse Classification	99999

DESCRIPTION	SUBSTANDARD	DOUBTFUL	LOSS	TOTAL
Book Value at Last Examination: 09/30/20x5	6,641	220	176	7,037
Reductions:				
Payments	1,030	58		1,088
Not Now Adversely Classified	955	162		1,117
Now Classified Substandard				
Now Classified Doubtful	140			140
Now Classified Loss	890			890
To Other Real Estate or Other Assets				
Charged-Off	209		176	385
TOTAL REDUCTIONS	3,224	220	176	3,620
Additions:				
Not Adversely Classified Previously	873			873
Further Advances – Loans				
Not Adversely Classified Previously				
Further Advances – Loans				
Adversely Classified Previously				
Credits Newly Extended				
Previously Classified Substandard		140	890	1,030
Previously Classified Doubtful				
Previously Classified Loss				
TOTAL ADDITIONS	873	140	890	1,903
Book Value at This Examination: 06/30/20x6	4,290	140	890	5,320

Analysis of Other Real Estate Owned Subject to Adverse Classification | 99999

DESCRIPTION	SUBSTANDARD	DOUBTFUL	LOSS	TOTAL
Book Value at Last Examination: 09/30/20x5	672		18	690
Reductions:				
Not Now Adversely Classified				
Sales With Outside Financing				
Sales With Financing				
Provided By Subject Institution				
Now Classified Substandard				
Now Classified Doubtful				
Now Classified Loss	100			100
Charged-Off			18	18
TOTAL REDUCTIONS	100		18	118
Additions:				
Not Adversely Classified Previously	550			550
Further Advances - ORE or Loans Not Adversely Classified Previously				
Transferred from Previously Adversely Classified Loans				
Further Advances - ORE or Loans Adversely Classified Previously	3			3
ORE From Credits Newly Extended				
Previously Classified Substandard ORE			100	100
Previously Classified Doubtful ORE				
Previously Classified Loss ORE				
TOTAL ADDITIONS	553		100	653
Book Value at This Examination: 06/30/20x6	1,125		100	1,225

Assets with Credit Data or Collateral Documentation Exceptions	**99999**

This Page includes assets with technical defects not corrected during the examination. The appropriate number or description is noted in the "Deficiency Description" column.

1 - Appraisal
2 - Title Search or Legal Opinion
3 - Borrowing Authorization
4 - Recordation
5 - Insurance
6 - Collateral Assignment
7 - Financial Statement
8 - Inadequate Income/Cash Flow Information
9 - Livestock Inspection
10 - Crop Inspection

Name or Description	Amount	Date of Most Recent Financial Statement	Deficiency Description
LOANS			
AMHERST, MARY	400	None	7
BODY, CHARLES	1,932	12/31/2014	7
C&C MARINA	1,973	6/30/2014	7
GOETZ, MICHAEL	1,538	None	1
IRMA DEAT, LTD.	750		4, 6
JENNINGS, JENNIFER	1,906		5, 6
KING, CHRISTOPHER	290		4, 5, 6
Gty: Sam King		None	7
LAST CHANCE MOTEL, INC.	500		3, 4, 6
TOTAL	9,289		

Total represents 33 percent of the dollar volume of loans reviewed.

Name or Description	Amount	Date of Most Recent Financial Statement	Deficiency Description
OTHER REAL ESTATE OWNED			
ONE WAY HOME, INC. PROPERTY	550		5
TOTAL	550		

Total represents 45 percent of the dollar volume of ORE reviewed.

DESCRIPTION	DETAIL	AMOUNT EXTENDED

CORRESPONDENT BANK CONCENTRATIONS

FIRST NATIONAL BANK
Anothercity, Anotherstate

Due From Account	4,025	
Federal Funds Sold	5,000	
		9,025

- Concentration to First National Bank (FNB) represents 111 percent of Tier 1 Capital plus the allowance for credit losses for loans and leases.
- Aggregate monthly balances have averaged over $9 million for the past six quarters.
- Management does not formally measure or track the level of this concentration.
- Management does not perform formal financial analysis of FNB.
- Management stays abreast of the FNB's financial condition through routine business contacts and review of publicly available financial data.
- The overall health of regional banks is satisfactory.
- Credit risk is relatively low due to FNB's current financial strength.
- Concentration risk is moderate due to a lack of formal monitoring procedures.
- Deterioration in FNB's financial position could negatively affect daily operations as the Bank of Anytown uses the Due From FNB account to clear transactions and the federal funds sold account is a primary liquidity source.
- Policies and procedures for ensuring compliance with the Federal Reserve's Regulation F are satisfactory; however, management has not established formal guidelines for identifying or limiting overall correspondent concentrations.

Summary

This correspondent bank concentration presents moderate risk to the institution and is generally adequately managed, though President Lincoln indicated that more formal correspondent bank risk management guidelines would be developed. See Question 1 on the Risk Management Assessment Page.

INDIVIDUAL BORROWER CONCENTRATION

John and Mary Smith Relationship

John and Mary Smith		
RE mortgage	500	
JMS Corporation		
JM: John and Mary Smith		
Secured commercial loans (3)	785	
Commercial letters of credit (2)	315	
J&M Realty Trust		
Gty: John and Mary Smith		
Commercial RE mortgage	750	
		2,350

The Smiths own JMS Corporation (JMS), which repairs and resells used wood pallets, and J&M Realty Trust, which holds their commercial property. This credit concentration represents 29 percent of Tier 1 Capital plus the allowance for credit losses for loans and leases.

The wood pallet industry is facing increased competition from the plastic pallet industry. However, JMS's recycling of scrap wood has allowed it to maintain solid sales and profitability levels to offset the effect of the increased competition. The borrowers have had a very positive, long-term credit relationship with the bank, the notes are well collateralized by diverse and marketable collateral, and the concentration poses limited risk to the bank.

The Loan Policy includes appropriate credit limits to one borrower, and management reports large credit relationships to the Board each month. However, the Smith's residential mortgage was not identified in the bank's relationship analysis and the Smith relationship has not been reported to the Board as a concentration. The most recent annual loan review for this credit relationship included adequate analysis of the economic and competitive factors that may affect this concentration's risk profile, and the internal risk rating is appropriate. However, the origination of the J&M Realty Trust mortgage on 1/2/20x6, caused the outstanding balances for this relationship to exceed the Anystate legal lending limit statute, as discussed previously on the Violations of Laws and Regulations page for further discussion.

Summary

The concentration poses limited risk to the institution. However, concentration identification and reporting practices need improvement. See Question 1 on the Risk Management Assessment Page.

INDUSTRY CONCENTRATION

Shellfish Fishing Industry (NAICS Code 114112) 8,694

Identification - This credit concentration consists of loans to borrowers who specialize in shell fishing or the sale of customized fishing vessels and equipment. Although loans to the shell fishing industry represent 107 percent of Tier 1 Capital plus the allowance for credit losses for loans and leases, management does not measure or track the credits as a concentration of risk.

Economic and Competitive Factors - Management stays abreast of general factors and economic trends relating to the industry through local news reports and discussions with borrowers. However, management does not maintain a formal process for obtaining and disseminating economic, competitive, or regulatory information to the Board or loan staff. Given the informality of the process, management was unaware of some key factors adversely affecting the industry, such as federal efforts to reduce overfishing through lower fuel subsidies and State proposals to reduce daily catch limits and shorten permissible fishing hours.

Risk Stratification and Vulnerability Assessment - Most of the borrowers are fishermen that share the same fishing grounds, as there are no alternative grounds readily available. The collateral consists of specialized fishing vessels and equipment that are not easily converted to other purposes, thereby limiting their marketability.

Borrower CF is heavily influenced by catch volumes, market price, and operating costs. Although sustained demand has contributed to higher per-pound prices, lower catch volumes and higher fuel costs have reduced profitability levels and increased repayment risk associated with this industry.

Underwriting standards are heavily reliant on collateral values, with limited analysis of projected CFs. Delinquencies remain relatively low, but have been increasing. Internal risk ratings, which appear to accurately reflect the characteristics of individual loans, have not been aggregated for analysis of the fishing portfolio. Additionally, as management does not formally monitor industry risks, there has been no analysis of the potential impact to the institution's asset quality, earnings, or capital if adverse trends continue.

Risk Management and Control Processes - Management relies on general loan delinquency reports and periodic discussions with borrowers to monitor loans to the fishing industry. Although the strategic plan identifies fishing as an important factor in the local economy, it does not address any of the unique risks or mitigating risk management practices associated with lending to this industry. Also, as noted above, management has not established formal procedures to identify, aggregate, or track loans to the fishing industry, and the loan policy does not address portfolio concentration limits.

<u>Summary</u>

Monitoring of this concentration has been relatively informal, given management's long term experience in lending to this industry, but given the size of the concentration and vulnerabilities in the industry, risk management should be more robust. President Lincoln stated that plans are to continue to lend in this industry at the current levels; however, she stated that oversight and administration of the concentration would be strengthened. See Question 1 on the Risk Management Assessment Page.

Capital Calculations — 99999

COMMON EQUITY TIER 1 CAPITAL (CET1)		
Common Stock and Surplus net of Treasury Stock and unearned ESOP shares	6,027	
Retained Earnings	103	
Accumulated Other Comprehensive Income	60	
Common Equity Tier 1 Minority Interest includable in Common Equity Tier 1		
Subtotal: Common Equity Tier 1 Capital Before Adjustments and Deductions		6190
Adjustments and Deductions to CET1		
Less: Goodwill net of Associated Deferred Tax Liabilities		
- Intangible Assets (other than Goodwill and Mortgage Servicing Assets), net of associated deferred tax liabilities		
- Deferred Tax Assets that arise from net operating loss and tax credit carryforwards, net of any related valuation allowances and net of deferred tax liabilities		
- AOCI-related Adjustments[1]	60	
- Unrealized net gain (loss) related to changes in the fair value of liabilities that are due to changes in own credit risk		
- All other deductions from (additions to) CET1 capital before threshold-based deductions		
- Investments in the capital of unconsolidated financial institutions in the form of common stock that exceeds the 25 percent CET1 Capital deduction threshold		
- MSAs, net of associated DTLs that exceed the 25 percent CET1 capital deduction threshold		
- DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTLs that exceed the 25 percent CET1 deduction threshold[3]		
- Deductions for insufficient amounts of Additional Tier 1 and Tier 2 capital to cover deductions		
Subtotal: Adjustments and Deductions to CET1		60
Less: Assets Other than Held-for-Investment Loans and Leases Classified Loss	125	
- Additional Provision (to be Transferred to Tier 2 Capital, if applicable)[2]	325	
- Other Adjustments to and Deductions from Common Equity Tier 1 Capital[3]		
Subtotal: Other Adjustments and Deductions to CET1		450
Common Equity Tier 1 Capital		5,680
ADDITIONAL TIER 1 CAPITAL		
Noncumulative Perpetual Preferred Stock and related Surplus		
Non-qualifying capital instruments subject to phase-out from Additional Tier 1 capital		
Tier 1 Minority Interest not included in CET1 Capital		
Subtotal: Additional Tier 1 Capital before Deductions		
Less: Additional Tier 1 Capital Deductions		
Additional Tier 1 Capital		
Tier 1 Capital		5,680

TIER 2 CAPITAL [2]

Tier 2 Capital instruments and related surplus		
Non-qualifying capital instruments subject to phase-out from Tier 2 Capital		
Total capital minority interest that is not included in Tier 1 capital		
Adjusted Allowance for Credit Losses (AACL)	1,979	
Less: Held-for-Investment Loans and Leases Classified Loss	890	
Add: Additional Provision Transferred from Common Equity Tier 1 Capital	325	
Examination Adjusted AACL	1,414	
Less: Excess AACL (If Applicable)	728	
AACL Includable in Tier 2 Capital	686	
Subtotal: Tier 2 Capital Before Deductions	686	
Less: Tier 2 Capital Deductions		
Tier 2 Capital		686
TOTAL CAPITAL[2]		6,366

RISK-WEIGHTED ASSETS AND AVERAGE TOTAL ASSETS CALCULATIONS[2]

Risk-Weighted Assets Before Deductions for Excess AACL and Allocated Transfer Risk Reserve	55,920	
Less: Excess AACL	728	
Less: Allocated Transfer Risk Reserve		
Less: Risk-Weighted Asset Amounts Deducted from Capital	1,015	
Total Risk-Weighted Assets		54,177
Average Total Assets	76,803	
Less: Deductions from Common Equity Tier 1 Capital and Additional Tier 1 Capital[3]	450	
Average Total Assets for the Leverage Ratio		76,353

MEMORANDA

Capital Conservation Buffer[2]		N/A
Securities Appreciation (Depreciation)		1,126
Contingent Liabilities/Potential Loss	130,787 / 0	

Footnotes:

(1) Includes AOCI adjustments by banks making the AOCI opt-out election and the adjustment for certain accumulated gains (losses) on cash flow hedges by banks not making the AOCI opt-out election as outlined in Part 324.

(2) Institutions under the CBLR framework do not calculate Tier 2 Capital. For such institutions, Tier 1 Capital equals Total Capital under Part 324. In addition, these institutions do not calculate Risk-Weighted Assets or the Capital Conservation Buffer.

(3) Includes adjustment for financial subsidiaries as defined by the Gramm-Leach-Bliley Act of 1999, if applicable.

Analysis of Earnings

99999

Comparative Statement of Income

	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Interest Income	2,519	5,582	7,329
Interest Expense	894	2,452	3,850
Net Interest Income	1,625	3,130	3,479
Noninterest Income	304	589	643
Noninterest Expense	1,467	2,902	2,904
Provision for Credit Losses	300	1,025	1,580
Securities Gains (Losses)	15	48	
Net Operating Income (Pre-Tax)	177	(160)	(362)
Applicable Income Taxes	74	(36)	(117)
Net Operating Income (After-Tax)	103	(124)	(245)
Discontinued Operations Net of Applicable Income Taxes			
Net Income (Loss) Attributable to Noncontrolling (Minority) Interests			
Net Income	103	(124)	(245)
Other Increases/Decreases	60		
Includes changes in the net unrealized holding gains (losses) on Available-For-Sale Securities			
Cash Dividends			
Net Change in Equity Accounts	163	(124)	(245)

Reconcilement of Allowance for Credit Losses on Loans and Leases

	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Beginning Balance	1,748	1,407	950
Gross Loan and Lease Losses	181	884	1274
Recoveries	112	200	151
Provision for Credit Losses on Loans and Leases	300	1025	1580
Other Increases (Decreases)			
Ending Balance	1,979	1,748	1,407

Other Component Ratios and Trends

<u>**Ratio**</u>	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Interest Income (TE)/Average Earning Assets	4.74	4.37	4.64
Total Noninterest Expense/Average Assets	3.82	3.62	3.54
Net Income/Average Total Equity	3.39	-2.05	-3.87
Net Losses on Loans and Leases/Average Total Loans and Leases	0.025	1.24	1.88
Earnings Coverage of Net Losses (X)	6.7	-1.19	-1.08
ACL on Loans and Leases/Total Loans and Leases	3.67	3.15	2.5
Noncurrent Loans and Leases/ACL on Loans and Leases	106.47	143.88	100.64

Footnotes:

Comparative Statements of Income and Changes in Equity Capital Accounts | 99999

ITEMS	06/30/20x6	12/31/20x5	12/31/20x4
INTEREST INCOME:			
Interest and fee income on loans	2,185	4,826	6,305
Income from lease financing			
Interest on balances with depository institutions			
Income on Federal funds sold and repos	66	350	512
Interest from assets held in trading accounts			
Interest and dividends on securities	268	406	512
Other Interest Income			
TOTAL INTEREST INCOME	2519	5582	7,329
INTEREST EXPENSE:			
Interest on deposits	858	2,434	3,832
Expense on Federal funds purchased and repos	5	18	18
Other interest expense	31		
TOTAL INTEREST EXPENSE	894	2,452	3,850
NET INTEREST INCOME	1,625	3,130	3,479
NONINTEREST INCOME:			
Services charges on deposit accounts	234	461	415
All other noninterest income	70	128	228
TOTAL NONINTEREST INCOME	304	589	643
NONINTEREST EXPENSE:			
Salaries and employee benefits	750	1,422	1,342
Premises and fixed assets expense (net of rental income)	271	549	584
Amortization expense of intangible assets (including goodwill)			
Other noninterest expense	446	931	978
TOTAL NONINTEREST EXPENSE	1,467	2,902	2,904
Provision for credit losses	300	1,025	1,580
Securities gains (losses)	15	48	
NET OPERATING INCOME (PRETAX)	177	(160)	(362)
Applicable income taxes	74	(36)	(117)
NET OPERATING INCOME (AFTERTAX)	103	(124)	(245)
Discontinued operations net of applicable income taxes			
Net income (loss) attributable to noncontrolling (minority) interests			
NET INCOME	103	(124)	(245)
Other increases in equity capital accounts	60		
Other decreases in equity capital accounts			
Cash dividends declared on common stock			
Net change in equity capital accounts for the period	163	(124)	(245)
Equity capital accounts at beginning of the period	6,027	6,151	6,396
Equity capital accounts at end of the period	6,190	6,027	6,151

Footnotes:

HOLDING COMPANY RATIOS AND TRENDS

CONSOLIDATED HOLDING COMPANY	HOLDING COMPANY		
	(Date)	(Date)	(Date)
Net Operating Income to Average Assets			
Total Risk-Based Capital Ratio			
Leverage Capital Ratio			
This Institution's Assets to Consolidated Holding Company Assets			
PARENT ONLY			
Pre-Tax Operating Income and Interest Expense to Interest Expense (X) (Fixed Charge Coverage)			
Operating Income - Tax + Non-Cash Items to Total Operating Expense and Dividends Paid (Cash Flow Match)			
Total Liabilities to Equity			
Equity Investments in Subsidiaries to Equity (Double Leverage)			
Equity Investment in Subsidiaries - Equity Capital/Net Income - Dividends (Double Leverage Payback in Years)			

EXTENSIONS OF CREDIT TO AFFILIATED ORGANIZATIONS

DESCRIPTION	DIRECT	INDIRECT	TOTAL
A. Affiliated organizations including securities issued byaffiliated organizations.	250		250
B. Indebtedness of others, or portions of such indebtedness, collateralized by securities issued by affiliated organizations.			0
Total	250	0	250
Less duplications within and between groups			0
Net Total	250	0	250

Comments:

HOLDING COMPANY

Any Company, Inc.
Anytown, Anystate

SUBSIDIARY

Any Time, Inc.
Anytown, Anystate

OTHER AFFILIATES

Any Body, Inc.
Anytown, Anystate

Extensions of Credit to Directors/Trustees, Officers, Principal Shareholders, and Their Related Interests	99999

Description	Total
A. Executive Officers and their related interests	1,200
B. Directors/Trustees and Principal Shareholders and their related interests	250
TOTAL	1,450
Less duplications within and between groups	250
NET TOTAL	1,200
Capital and unimpaired surplus as of last Call Report date (Per Regulation "O")	7,094
Net total insider borrowing as a percentage of unimpaired capital and surplus	16.92%

NAME AND COMMENTS (Designate all duplications with a "D")	Detail	% of Unimpaired Capital & Surplus
Group A		
LINCOLN, ALLIE C. Director and President	500	7.05%
GUTIERREZ, JOHN M. Executive Vice President and Cashier	450	6.34%
ANY BODY, INC. Duplication debt guaranteed by President Lincoln and Director Green.	250 D	3.52%
TOTAL	1,200	
Group B		
ANY BODY, INC. A related interest of President Lincoln and Director Green. Both individuals guarantee the debt.	250 D	3.52%

Safety and Soundness

Composite 3. Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Information Technology

Composite 2. Financial institutions and service providers rated composite "2" exhibit safe and sound performance but may demonstrate modest weaknesses in operating performance, monitoring, management processes, or system development. Generally, senior management corrects weaknesses in the normal course of business. Risk management processes adequately identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are defined but may require clarification, better coordination, or improved communication throughout the organization. As a result, management anticipates, but responds less quickly to changes in market, business, and technological needs of the entity. Management normally identifies weaknesses and takes appropriate corrective action. However, greater reliance is placed on audit and regulatory intervention to identify and resolve concerns. The financial condition of the service provider is acceptable and while internal control weaknesses may exist, there are no significant supervisory concerns. As a result, supervisory action is informal and limited.

Trust

Composite 2. Administration of fiduciary activities is fundamentally sound. Generally, no component rating should be more severe than 3. Only moderate weaknesses are present and are well within management's capabilities and willingness to correct. Fiduciary activities are conducted in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Compliance

Composite 2. An institution in this category is in a generally strong compliance position. Management is capable of administering an effective compliance program. Although a system of internal operating procedures and controls has been established to ensure compliance, violations have nonetheless occurred. These violations, however, involve technical aspects of the law or result from oversight on the part of operating personnel. Modification in the bank's compliance program and/or the establishment of additional review/audit procedures may eliminate many of the violations. Compliance training is satisfactory. There is no evidence of discriminatory acts or practices, reimbursable violations, or practices resulting in repeat violations.

Community Reinvestment Act (CRA)

A CRA rating of "Satisfactory" is assigned. An institution in this group has a satisfactory record of helping to meet the credit needs of its assessment area, including low- and moderate income neighborhoods, in a manner consistent with its resources and capabilities.

Refer to http://www.fdic.gov/regulations/examinations/ratings/index.html for definitions of all composite ratings.

Signatures of Directors/Trustees	**99999**

We the undersigned directors/trustees of Bank of Anytown, Anytown, Anystate, have personally reviewed the contents of the Report of Examination dated June 30, 20x6

Signatures of Directors/Trustees	**Date**
Henry P. Black	
Michael D. Brown	
Larry G. Green	
Kerry A. Jones	
Allie C. Lincoln	
Jaime S. Martin	
John D. Scott	
Roger White	

NOTE: This form should remain attached to the Report of Examination and be retained in the institution's file for review during subsequent examinations. The signatures of committee members will suffice only if the committee includes outside directors and a resolution has been passed by the full board delegating the review to such committee.

CONTROL AND RELATIONSHIPS

Any Company, Inc., a one-bank holding company, continues to own 100 percent of the bank's common stock. Bank directors own or control a combined 908,584 shares or 56 percent of holding company stock. President Lincoln is the largest individual stockholder, controlling 500,326 shares or 31 percent of the outstanding stock. Any Time, Inc. is a subsidiary of the bank and holds title to ORE. Any Body, Inc., is an on-premise insurance agency owned by President Lincoln and Director Green that sells credit life, auto, fire, and disability insurance but does not utilize bank employees or equipment. President Lincoln stated that no ownership or management changes are planned. President Lincoln notified the bonding company of the nonbank activity being conducted on the premises and received an acknowledgement letter from the bonding company dated November 9, 20x5. On January 20, 20x6, the board of directors of Any Company reviewed the operations of Any Body, Inc., and approved its continued operations and lease of bank space for another year.

DIRECTOR INVOLVEMENT

One of the bank's directors contacted the EIC during the examination to discuss his concerns with the current committee structure of the bank. Director John Scott indicated that he felt the Loan Committee membership should be expanded and that the committees were dominated by Chairman White and President Lincoln.

DOMINANT MANAGEMENT

Chairman of the Board Roger White and President Allie Lincoln exhibit a dominant influence over the bank's affairs. Their dominance over policy discussion and decisions has negatively impacted the condition of the institution as noted throughout the report of examination. Both Chairman White and President Lincoln were responsive to regulatory concerns and promised prompt corrective actions to implement the current exam recommendations and outstanding MOU.

EXAMINATION SCOPE

Examination Number 12345

The examination scope was expanded from the pre-exam planning (EP) memo in the following areas:

- Construction Lending – Expanded due to administrative problems identified in the original loan sample. Ten additional construction loans serviced by the two construction lenders and originated in 20x6 were reviewed.
- BSA Review – Expanded to include a review of all Currency Transaction Reports filed in 20x6 due to indications that they were being filed late.
- Call Report Review – Expanded to include year-end 20x5 in response to the volume of errors noted with the original review.

As a result, examination hours, totaling 760, are 150 over budget (25 percent). Other examination procedures were not modified from those identified in the EP memo and no significant variances between projected and actual examination hours, scope, or procedures were noted in the BSA/AML (Exam #12346), Trust (Exam #12347), or IT (Exam #12348) reviews.

SUGGESTIONS FOR FUTURE EXAMINATIONS

There is sufficient working space for seven examiners.
Management accommodated working hours of 7:30am to 5:30pm.
The examination crew should contain at least one examiner with experience in construction loan analysis.

List alphabetically all directors/trustees, senior officers, and principal stockholders. Also indicate their titles. Number of shares owned is not rounded. (J – indicates stock jointly owned; P – indicates preferred stock owned; H – indicates holding company stock owned; C – indicates stock controlled but not owned)

Names and Comments	Net Worth		Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
	Amount	Date of Statement					
Biographical and background information on directors, officers, and other key management officials listed on this page should be prepared in accordance with the Report of Examination Instructions.							
DIRECTORS/TRUSTEES							
BLACK, HENRY P. Attorney *Address*	501	3/1/20x5	1980	1961	12	50,992 (H)	
BROWN, MICHAEL D. Commercial RE Consultant (1) *Address*	7,890	6/1/20x5	1983	1959	5	5,005 (H)	
GREEN, LARRY G. Automobile Dealership Owner (1) *Address* *Estimated by President Lincoln.	10,000	8/1/20x6*	1981	1955	12	200,150 (H)	
JONES, KERRY A. Retired Doctor *Address*	2,500	6/1/20x5	1979	1933	12	1,010 (H)	
LINCOLN, ALLIE C. President (1)(2) *Address*	1,357	2/1/20x5	1982	1951	12	500,326 (H)	100 25(B)
MARTIN, JAIME S. Economist *Address*	3,565	3/1/20x5	1981	1950	11	150,500 (H)	
SCOTT, JOHN D. Certified Public Accountant (2) *Address*	7,234	8/7/20x5	1982	1954	11	101 (H)	
WHITE, ROGER Chairman of the Board (1)(2) *Address* *Estimated by Money Magazine.	5,000	6/24/20x6*	1980	1960	12	500 (H)	24(B)
OFFICERS, NOT DIRECTORS/TRUSTEES							
COOK, LESLIE S. Executive Vice President - Commercial Lending (1)			1983	1960			85

Names and Comments	Net Worth		Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
	Amount	Date of Statement					
GUTIERREZ, JOHN M. Executive Vice President / Cashier (2)			1983	1958			70
PRINCIPAL SHAREHOLDERS, NOT DIRECTORS/TRUSTEES OR OFFICERS							
ANY COMPANY, INC. Anytown, Anystate						162,247	

(1) Loan Committee
(2) Investment Committee

Total Holding Company shares owned by the Directorate: 908,584
Percentage Holding Company ownership by the Directorate: 56 percent

There have been 12 regular Board meetings since the last regulatory examination.
Director fees are $250 per Board meeting attended.
Committee fees are $100 per committee attended.

The Bank of Anytown illustrates the application of ROE instructions when presenting examination findings. The Bank of Anytown does not cover all possible examination circumstances and should not be used as boilerplate language. The Bank of Anytown is not intended to inhibit examiner judgment in situations that require other presentation methods due to unique situations.

BANK OF ANYTOWN

ANYTOWN **ANYCOUNTY** **ANYSTATE**

Region:	Any Region	Certificate Number: 99999
Examiner-In-Charge:	Sandra E. Smart	
Examination Start Date:	August 01, 20x6	
Examination As Of Date:	June 30, 20x6	

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All dollar amounts are reported in thousands, unless otherwise indicated.

Abbreviations within the report are included inside the back cover and can also be found at https://www.fdic.gov/regulations/safety/manual/section16-1.pdf

The following practices or financial conditions or operations require Board attention and corrective actions. Unsatisfactory conditions and practices identified during this examination, and recommendations from the previous examination that were not satisfactorily addressed, are described more fully throughout this Report of Examination (ROE).

MEMORANDUM OF UNDERSTANDING (MOU)

The MOU provisions relating to the Allowance for Loan and Lease Losses (ALLL), Reports of Condition and Income (Call Report), and credit extensions to borrowers with charged-off loans remain outstanding and uncorrected. Failure to satisfactorily address the Memorandum of Understanding (MOU) provisions will likely impede progress in returning the bank to a satisfactory condition. The Board should take additional action to ensure full remediation of the unsatisfactory conditions addressed by the MOU.

ALLOWANCE FOR LOAN AND LEASE LOSSES

The ALLL is at an insufficient level requiring an estimated allocation of $325M due to elevated loan losses and deficiencies in the methodology for establishing the ALLL. The Board's attention is needed to ensure a sound process for maintaining an appropriate ALLL is developed and implemented to protect the institution and accurately report earnings and capital.

INTERAGENCY GUIDELINES ESTABLISHING SAFETY AND SOUNDNESS STANDARDS - APPENDIX A OF PART 364 OF THE FDIC RULES AND REGULATIONS

The institution is not in conformance with established safety and soundness standards contained in Appendix A of Part 364, in the areas of internal controls and information systems, internal audit system, loan documentation, credit underwriting, and asset quality. Failure to appropriately address these deficiencies and improve risk management practices may result in further deterioration in the bank's financial condition. In particular, the Board's attention is necessary to ensure the following inadequate risk management practices are corrected to prevent future financial deterioration:

- <u>Asset Quality, Credit Administration, and Loan Underwriting:</u> Inaccurately graded credits contributed to the insufficient ALLL level. In addition, poor credit administration practices (relating to weak participation loan underwriting, the lack of construction loan inspections, and lack of on-going cash-flow analysis for commercial real estate loans) inhibit management's ability to make sound credit decisions, hamper collection efforts, and could lead to further loan losses. Also, procedures to identify and monitor asset concentrations are inadequate. Poor controls over concentrated asset positions can lead to disproportionately higher losses in the event of problems.

- <u>Internal Controls and Internal Audit:</u> Internal controls have not been sufficient to provide for operations in compliance with rules and regulations. For example, the Board approved loans in apparent violation of the Federal Reserve Board's Regulation O, and senior management purchased investments above its Board-approved investment authority. Moreover, the internal audit function lacks independence, as the internal auditor reports directly to the bank's president. Weak internal controls prevent the Board and management from adequately identifying, monitoring, and controlling risks, potentially exposing earnings and capital.

STRATEGIC PLANNING

Despite the continued decline of the local fishing industry and the increase of local financial service providers, the bank's strategic plan does not adequately address regional economic conditions or local competition. Therefore, the plan may not provide the Board or management with adequate information to assess business opportunities or to adjust strategies and practices in light of changing conditions. The Board should direct correction of the deficiencies in the strategic plan and ensure supporting data is current and comprehensive.

SUMMARY

The Board should address the weaknesses and recommendations highlighted above. The FDIC and Any State will monitor the remediation of these matters between examinations.

For additional details, including management's responses to these matters, refer to related comments included in this ROE.

Uniform Financial Institutions Rating System

	Current Exam	Prior Exam	Prior Exam
Examination Start Date	08/01/20x6	11/13/20x5 / S	10/21/20x4
Examination As Of Date	06/30/20x6	09/30/20x5	09/30/20x4
Composite Rating	**3**	**3**	**3**
Component Ratings:			
Capital	**3**	**2**	**2**
Asset Quality	**4**	**4**	**3**
Management	**3**	**3**	**3**
Earnings	**4**	**4**	**3**
Liquidity	**2**	**2**	**2**
Sensitivity to Market Risk	**2**	**2**	**2**
Information Technology	**2**	**1**	**2**
Trust	**2**	**2**	**2**
Compliance[1]	**2**		
Community Reinvestment Act[1]	**S**		

1 Examination dated xx/xx/xxxx

OVERALL CONDITION AND RISK PROFILE

This $80 million community bank is a locally owned, full-service commercial bank offering traditional deposit and credit products with particular focus on customers directly and indirectly reliant upon maritime-related businesses. The trade area is centered in a regional economic area heavily dependent upon a depressed fishing industry. Assets consist primarily of commercial and real estate loans to small, local businesses. Similarly, the bank's depositors are mostly business loan clients and local retail customers. In efforts to diversify from maritime-related businesses, management has purchased commercial loan participations, primarily from Other Bank, Othertown, Other State. In addition, the bank has a trust department that manages approximately $3.3 million in assets, most of which is in non-discretionary accounts.

The bank remains in less than satisfactory condition due to the lingering effects of poor risk selection and underwriting during an aggressive growth campaign in commercial real estate (CRE) and particularly acquisition development and construction (ADC) loans identified at the previous examination. Significant and increasing weaknesses in the local economy have further exacerbated credit risk problems. Numerous workout credits and further deterioration in CRE due to poor credit administration have resulted in an insufficient ALLL level and have negatively impacted earnings. Capital levels are less than satisfactory in relation to the heightened risk profile. Management needs to make additional efforts to comply with the outstanding Memorandum of Understanding (MOU). Information Technology, Trust, and Bank Secrecy Act (BSA)/Anti-Money Laundering programs are adequately managed as findings identified during the examination are limited and correctable in the normal course of business. Compliance and Community Reinvestment Act programs are also satisfactory.

MEMORANDUM OF UNDERSTANDING

The bank entered into a MOU on January 21, 20x5, based on the October 21, 20x4, FDIC examination findings. Management and the Board have not fully addressed three MOU provisions, relating to the appropriateness of the ALLL, accuracy of the Reports of Condition and Income, and documentation for credit extensions to previously classified borrowers. Refer to the Compliance with Enforcement Actions page for additional details.

ASSET QUALITY – 4

Asset quality remains weak and is the primary impediment to improving the bank's overall financial condition. As reflected on the Examination Data and Ratios page, the volume of adversely classified items (ACI) has decreased by 12 percent since the prior examination, with the volume of adversely classified loans dropping by 24 percent. Despite these improvements, adverse classifications still represent 84 percent of Tier 1 Capital and the ALLL. Additionally, the volume of Loss classifications increased from $194M at the 20x4 examination to $1,015M at the current examination. (Asset Review Date: 6/30/20x6.)

Loans

Examination classifications are centered in the CRE portfolio. Loans adversely classified Loss (portions of three relationships totaling $890M) are CRE loans that were adversely classified Substandard at the prior examination. Most troubled credits reflect liberal lending practices exacerbated by the depressed regional economy, particularly the local fishing industry. In response to past regulatory criticisms, management has taken affirmative steps to strengthen credit administration by tightening overall underwriting standards, strengthening collection efforts, decreasing CRE advance rates from 90 percent to 75 percent, and avoiding financing for speculative real estate acquisition and development projects. These actions have longer-term positive implications, but present credit quality remains hindered by numerous workout situations and the deterioration of existing credits not previously subject to adverse classification. Moreover, underwriting weaknesses are evident in participations purchased, and credit administration weaknesses were noted in the areas of construction loan inspections and cash-flow analysis. Additional details regarding trends in the level of adversely classified loans are included on the Analysis of Loans Subject to Adverse Classification page.

Loan Review and Internal Grading System

The institution's internal loan review and grading program is not producing timely or accurate information about the condition of the loan portfolio. Management has been unable to comply with internal review frequency standards due to elevated personnel demands associated with problem asset workouts. Assigned credit grades for several larger credits were inaccurate, as exemplified by examiner identification of the partial Loss classification of the Irma Deat, Ltd. and Last Chance Motel credits. In both cases, the credits were internally rated Substandard. Additionally, several credits adversely classified Substandard by examiners were internally rated Watch. Failure to accurately grade credits on a timely basis has resulted in an insufficient ALLL level, and may hinder management's ability to take appropriate and timely corrective action. To address this issue, management needs to provide additional resources to improve performance of this function.

President Allie C. Lincoln stated that management would add staff by year-end 20x6, and meet review frequency standards by mid-20x7.

Allowance for Loan and Lease Losses

The ALLL is at an insufficient level requiring an estimated allocation of $325M, primarily due to inaccurate internal credit grading. Additionally, the ALLL allocation for non-watch list credits is inappropriate based upon recent loan loss experience on non-watch list loans. Specifically, the institution's average loss rate on non-watch list loans since 20x4 is 0.75 percent; however, management only allocates 0.1 percent for residential mortgages and 0.5 percent for all other non-watch list loans.

Institutions are expected to maintain an ALLL methodology in accordance with Generally Accepted Accounting Principles (GAAP), which reflects consideration of the risk profile of the loan portfolio. Moreover, due to the deficiencies in the loan grading system, earnings and capital could be exposed should future loan and lease loss provisions prove insufficient. Refer to the Risk Management Assessment page for additional details.

President Lincoln indicated management intends to file amended June 30, 20x6, Reports of Condition and Income to address reporting issues (see comments below) and will include a $325M loan loss provision in the amended filings. President Lincoln also initiated a review of the loan grading system during the examination and stated that all existing loss-rate percentages would be reviewed and updated to ensure full conformance with GAAP.

Credit Underwriting and Administration

Credit underwriting and administration, although improving, requires further attention. The Robert Rain, LLC., credit is representative of deficiencies in the monitoring of construction loans and performing cash flow (CF) analysis; refer to the Items Listed as Special Mention for further details. As detailed on the Assets with Credit Data or Collateral Documentation Exceptions pages, the number of loans possessing potential weaknesses and documentation exceptions remains high. In particular, the following underwriting and credit administration weaknesses should be promptly addressed:

- *Credit Analysis on Participations Purchased* - The bank does not perform pre-purchase credit analysis on participations purchased. Pre-purchase analysis is necessary for management to assess the repayment capacity of the borrower(s) and assign an appropriate loan grade. An institution purchasing all or part of a loan should perform the same degree of independent credit analysis as if it were the originator.

- *Financial Statements (FSs)* - Loan officers have not obtained updated FSs from all repayment sources to perform global CF analysis and verify assets of guarantors. Obtaining current FSs allows a loan officer to analyze and document a guarantor's source of strength to a loan or borrowing relationship.

- *Inspections and Lien Waivers* - The bank does not perform inspections or obtain mechanic's lien waivers prior to making construction loan advances. Timely inspections and lien waivers protect the institution's collateral and lien positions and allow management to make informed decisions regarding the ALLL.

- *Rent Rolls* - Loan officers do not obtain rent rolls and vacancy figures on an ongoing basis for loans secured by CRE. Rent rolls and vacancy information allow management to properly monitor these types of loans if conditions are changing, understand any changes in the condition, and make informed and timely credit decisions.

- *Lien Perfection* - The bank periodically allows perfected interests in collateral to lapse by not filing timely Uniform Commercial Code (UCC-1) continuation statements. Use of a system to assist in keeping filings current protects collateral positions determined to be appropriate in original loan underwriting.

President Lincoln stated loan officers would immediately begin performing pre-purchase analyses on participations purchased. She also stated that the volume of documentation deficiencies is primarily due to understaffing and indicated management is in the process of hiring an additional loan clerk to assist in this area.

Other Real Estate (ORE)

Management maintains appropriate policies and procedures for acquiring, holding, and disposing of ORE. However, due to deterioration in existing credits, the dollar volume of adversely classified ORE increased $535M, or 78 percent, since the previous examination. The ORE portfolio primarily consists of CRE previously written down to fair value. The $100M ORE Loss classification reflected in this Report is based on the recently obtained (August 3, 20x6), appraised value of the Rolly property.

Concentrations

Several asset concentrations, including a fishing industry concentration, are listed on the Concentrations page. Management does not currently have procedures in place to adequately identify and monitor such concentrations. Concentrations that are not monitored and managed through sound risk management practices can expose a bank's capital and earnings to disproportionately higher losses in the event of a borrower's financial problems or an industry downturn, such as is currently being experienced by the local fishing industry. Given the potential for increased risk posed by asset concentrations, appropriate policies and procedures should be established to ensure these risks are properly identified, monitored, and managed.

President Lincoln indicated that management will develop procedures for identifying, monitoring, and managing the risk of concentrations and present them to the Board for its review and approval by year-end 20x6.

Disposition of Assets Classified Loss

President Lincoln stated that assets classified Loss totaling $1,015M will be charged off by September 30, 20x6.

EARNINGS – 4

Earnings performance remains poor. As detailed on the Analysis of Earnings page of this Report, the bank experienced significant operating losses in 20x4 and 20x5. Although the bank shows net operating income of $103M for the first six months of 20x6, profits are substantially overstated due to insufficient provisions for loan losses. As reflected in the footnote on the Examination Data and Ratios page, the bank will show a negative 0.58 percent Return on Average Assets, based on a net operating loss of $222M, after amending the June 30, 20x6 Call Report for the additional $325M provision to the ALLL.

The poor earnings performance is a direct result of persistent poor asset quality and increasing ORE levels. Although improving, the high level of nonperforming assets has required high ALLL provisions and increased overhead expenses. In spite of the volume of nonaccruals and other nonearning assets remaining high, the net interest margin for the first six months of 20x6 improved to 4.74 percent from 4.37 percent at year-end 20x5. This improvement is primarily the result of management's ability to maintain average interest rates in the loan portfolio above 8 percent, while reducing the average cost of funds to below 3 percent.

Total Noninterest Expense as a percentage of Average Assets has steadily increased over the last three years and reached 3.82 percent as of June 30, 20x6. Overhead expenses are nearly 100 basis points above comparable institutions, primarily due to expenses associated with ORE. Given the composition and level of problem assets, management does not expect ORE-related expenses to diminish in the near future. Overhead expenses will also increase due to the planned hiring of additional credit administration personnel. However, in an effort to reduce overhead, management plans to close the institution's only branch office on September 30, 20x6.

The 20x6 budget forecasts net income of $226M. With the exception of inaccurate assumptions related to the level of provision expense, the budgeting process is adequate and the assumptions used are reasonable. Future profitability is primarily dependent on improved asset quality and controlled overhead expenses.

Chairman of the Board Roger White stated that the directorate and senior management would revise the budget to depict provision expense levels more accurately. He directed President Lincoln to have the revised budget ready for Board review and approval at the November 20x6 Board meeting.

MANAGEMENT – 3

The overall performance of senior management and the Board of Directors remains less than satisfactory. The bank's weak financial condition is primarily the result of liberal lending policies and poor credit administration practices. As documented in prior examination reports, the present management team aggressively pursued loan growth without regard for prudent lending standards and, ultimately, asset quality. Although initial signs of more prudent loan underwriting and improved credit administration are evident, asset quality remains weak and significant aspects of the credit function remain deficient.

Board Supervision

A director's duty to oversee the conduct of a bank's business necessitates that each director exercise independent judgment in evaluating management's actions and competence. Directors need to critically evaluate the issues before them, rather than routinely deferring to management. However, Board minutes lack evidence to demonstrate that directors are exercising their independent judgment. Instead, Board minutes indicate that Chairman White and President Lincoln dominate policy discussions and decisions. Moreover, Director Michael D. Brown attended only 5 of the 12 Board meetings held since the previous examination. Regular attendance at Board and committee meetings is a prerequisite to fulfilling the duty to oversee the conduct of the bank's business, and directors who are unable to meet this obligation should consider resignation. Weaknesses in the strategic planning process and the inadequacy of certain written policies are additional indicators that the Board needs to improve its oversight of the bank's operations and management's actions.

Chairman of the Board White indicated that directors are more engaged in discussions regarding the bank's business than is reflected in the minutes and that future minutes will be more descriptive regarding the input from various directors. Director Brown stated that he frequently travels out of town on business; however, he committed to attending Board meetings on a more regular basis.

Apparent Violations of Laws and Regulations

Examiners cited apparent violations of the Treasury Department's BSA regulations for late currency transaction report (CTR) filings, the Federal Reserve Board's Regulation O for two insider loans that did not receive full Board approval, and exceeding the state's legal lending limit statute. An apparent violation of the BSA was also cited at the last FDIC examination, and although the number of late filings of currency transaction reports (CTRs) has declined, repeat infractions reflect unfavorably on the Board and management. The Board of Directors should implement improved controls and procedures to ensure timely CTR filings, appropriate Regulation O loan approvals, and identification of concentrations of loans to one borrower. Additionally, the institution is in nonconformance with multiple parts of the Interagency Guidelines Establishing Standards for Safety and Soundness, Appendix A to Part 364 of the FDIC Rules and Regulations.

Chairman of the Board White committed to improve BSA and Regulation O controls and promised future conformance with all Safety and Soundness standards detailed in Appendix A to Part 364.

Strategic Planning

The 20x4 five-year strategic plan has not been updated, and is therefore inconsistent with the present condition of the bank, the regional economy, and the local competitive environment. Specifically, the plan's assumptions do not consider the continuing decline of the local fishing industry, the potential impact of a new commercial bank in town, or the recent merger of two local savings and loan associations. Based on these factors, many of the goals and strategies in the plan may be unrealistic. Setting a bank's strategic focus, in conjunction with executive management, is one of the key responsibilities of a bank's Board. An effective strategic planning process provides for regular reviews to determine whether assumptions and strategies remain valid or should be revised. The Board and management should update the strategic plan to reflect current conditions and should adopt a process to periodically review the plan going forward.

Chairman of the Board White stated that the strategic plan would be reviewed and updated before the end of 20x6 and annually thereafter.

Audit and Internal Control

The audit and internal control functions lack independence. While the scope and frequency of the internal audit program are adequate, Internal Auditor Mary Jackson reports directly to President Lincoln. Since President Lincoln is ultimately responsible for most of the day-to-day operations reviewed by the internal auditor, this situation compromises the independence of the internal audit program. The internal auditor should report directly to the Board of Directors or the Audit Committee of the Board to ensure the independence and effectiveness of the audit function. President Lincoln is also a member of the Audit Committee, which oversees the external audit function. Her presence on the committee further limits audit independence. Lack of independence in the internal control structure exposes the institution to operational and financial risks and could impact management and the Board's ability to appropriately control risks. Several outside directors are qualified to serve on the Audit Committee, and it is recommended that the Board strengthen the audit function by limiting committee membership to outside directors.

Several internal control deficiencies are detailed under Item 5 of the Risk Management Assessment section of this Report. While these deficiencies are relatively minor, management incorrectly reported that two of these items were corrected in the response to the last internal audit. Failure to accurately monitor and track corrective actions of audit findings decreases the Board's ability to fulfill their oversight responsibilities.

Chairman of the Board White stated that the Board would consider these recommendations at its next meeting. He also stated the internal control deficiencies would be addressed by the end of 20x6.

Reports of Condition and Income (Call Report)

Material errors were noted in the last three quarterly Reports of Condition and Income. In numerous cases, examiners were unable to reconcile bank records with the quarterly filings. The most significant errors relate to inaccurately reported interest and fee income on loans, the inappropriate inclusion of gains on the sale of repossessed assets in interest and fee income, and the shortfall in the ALLL. These errors misrepresent financial performance and negatively affect management's ability to make informed decisions. Management should investigate these errors and amend prior Reports of Condition and Income as appropriate.

Executive Vice President/Cashier John M. Gutierrez stated he will file amended June 30, 20x6, Reports of Condition and Income, prior to September 30, 20x6, to address these issues.

Bank Secrecy Act (BSA)

The BSA program is generally satisfactory; however, examiners cited apparent violations of Title 31 C.F.R. Chapter X Section 1010.306(a)(1) of the Treasury Department's BSA regulations. The apparent violations relate to CTRs that were not filed within prescribed periods; refer to the Violations of Laws and Regulations page for additional details. Management should establish procedures to ensure CTRs are filed within prescribed timeframes.

President Lincoln indicated procedures would be implemented within 90 days to ensure CTRs are submitted in a timely manner.

Office of Foreign Assets Control (OFAC)

Effective policies, procedures, and controls are in place to ensure satisfactory compliance with OFAC regulations.

CAPITAL - 3

Capital is less than satisfactory in relation to the bank's risk profile. The ACI Coverage Ratio remains high at approximately 84 percent. In addition, after adjustments for provisions to fund the ALLL appropriately, the bank has had net operating losses over the past two and a half years. The existing concentration in fishing industry loans, considering the industry's current depressed condition and anticipated continuing decline, adds to capital concerns. The Leverage Capital ratio of 7.44 percent, detailed on the Examination Data and Ratios page, reflects current examination adjustments for assets classified Loss and the provision expense needed to fund the ALLL appropriately.

President Lincoln stated that dividends have not been paid for five years. She further stated that no dividends would be paid until the Tier 1 Leverage Capital ratio exceeds eight percent and earnings become positive and stable.

LIQUIDITY - 2

The bank's liquidity position is satisfactory. Asset growth has been minimal since the prior examination and the loan portfolio is shrinking. Management has increased the volume of investments in mortgage-backed securities, with the portfolio maintaining slight appreciation. Non-core funding has increased slightly but management is using these funds appropriately. Management could further strengthen funds management practices by developing a written funds management policy and a contingency funding plan (CFP) commensurate with the bank's risk profile. Clearly articulated policies reflective of the bank's characteristics help ensure that the institution is operating within Board-approved risk tolerances, which can mitigate the negative impact of overreliance on volatile funding sources in an adverse economic environment. Off-balance sheet commitments are minimal.

President Lincoln stated a written funds management policy and a CFP would be developed by year-end 20x6.

SENSITIVITY TO MARKET RISK - 2

Sensitivity to market risk is moderate and risk management practices are satisfactory. Funding sources reasonably match the bank's asset repricing structure, and the loan portfolio includes a high volume of adjustable-rate commercial loans. Over the past two years, depositors have moved funds out of maturing time deposits and into money market demand accounts. Management actively manages rates on these deposits, as the local market is very competitive. The bank does not engage in off-balance sheet derivative activity.

Management regularly monitors the bank's rate sensitivity position using income simulations and an economic value of equity model, and presents detailed quarterly reports to the Board. However, the Board and management should establish interest rate risk (IRR) policy limits. If not properly controlled, IRR can impact an institution's earnings, capital, and its underlying economic value. Setting policy limits helps control this risk by establishing a baseline for the institution's tolerance for interest risk. Monitoring compliance with these limits ensures that the level of IRR is maintained at prudent levels and in accordance with the Board's expectations. Refer to the Risk Management Assessment page for additional details.

For additional information on prudent IRR management principles, refer to the Joint Agency Policy Statement on Interest Rate Risk.

Chairman of the Board White stated that management and the Board would establish IRR policy limits by year-end 20x6.

TRUST - 2

The Board and management's performance and risk management practices are satisfactory relative to the size of the department and the complexity of trust activities. Account administration is generally in compliance with governing documents. Oversight of the asset management function is satisfactory. Operations, internal controls, and audit are generally satisfactory in relation to the trust business model. The earnings component was not rated due to the department's size. Only moderate weaknesses are present and within management's ability to correct. Recommendations and management responses are noted below and further detailed on the Fiduciary Activities Assessment pages.

Account administration is generally in compliance with originating documents. However, potential conflicts of interest exist from the trust department using own-bank deposits, as well as from holding stock of the parent holding company and an affiliate in one trust account. Trust Officer Hannah Hancock surveys local deposit rates to ensure competitive rates are being paid on deposits, but does not maintain documentation of her surveys. Appropriate policies, procedures, and practices should be developed and implemented to effectively control conflicts of interest and manage own-bank deposits and stock holdings. Without proper policies, procedures, and practices, the bank is exposed to potential litigation risk, which could negatively affect earnings and capital.

Trust Officer Hancock stated she would maintain documentation of comparable rates in the future.

Asset management practices are generally satisfactory. All account transactions, including discretionary disbursements, are included in monthly Board reports, and the Board reviews all accounts annually. However, management should annually document its needs assessment for each applicable account and/or beneficiary, and indicate whether the account's investment mix is meeting those needs. Failure to adequately document needs assessments, evaluate the mix, and document the review exposes the bank to litigation risks.

Trust Officer Hancock committed to documenting annual needs assessments for each trust account.

INFORMATION TECHNOLOGY - 2

Overall, IT operations, risk management practices, and cybersecurity are satisfactory. The IT audit program is generally adequate. Management and Board oversight of IT programs are generally satisfactory as demonstrated by adequate policies and risk management practices. The bank is in general conformance with Appendix B to Part 364 - Interagency Guidelines Establishing Information Security Standards. Management adequately assesses its cybersecurity risk exposure including its inherent risks, and cyber maturity levels.

While the overall IT department is satisfactory, exceptions were noted related to:
- Audit reporting lines and scoping,
- Patch Management,
- Financial and audit review of critical vendors,
- Control assessments on third party providers,
- Detail in project documentation, and
- Business Continuity Plan parameters.

Management attention to the aforementioned areas will strengthen the institution's IT security, operating and control environment, and better prepare the institution to respond to business disruptions. These areas are further discussed on the Information Technology and Operations Risk Assessment pages.

Findings of the IT examination were discussed in detail on August 27, 20x6, with Information Technology Manager William Robbins and President Lincoln, during which they indicated agreement with all findings. Refer to the Information Technology and Operations Risk Assessment pages for details on the exceptions and management commitment and timeframes for corrective action.

MEETING WITH THE DIRECTORATE

A Board of Directors meeting was held on September 18, 20x6. All directors were present with the exception of Director Henry P. Black. William E. Smith, partner in the bank's auditing firm, was also present. Deputy Commissioner of Banking Cynthia B. Jones represented the State Department of Banking. Field Supervisor James D. Gilmore, Examiner-in-Charge Sandra E. Smart, and Financial Institution Examiner Monica D. Powers represented the FDIC. All matters listed above were discussed with the Board. Most of the discussion concerned the increase in severity of adverse classifications, the need to improve the ALLL methodology, and management's efforts to improve loan administration procedures. The Directorate and management's commitments for corrective action are noted within this report. Chairman of the Board White asserted that due to the improvement in the bank's overall condition, the MOU should be removed.

DIRECTORATE RESPONSIBILITY

Each member of the Board of Directors is responsible for reviewing this Report of Examination. Each Director must sign the Signatures of Directors page, which affirms that he or she reviewed the Report in its entirety.

Examiner (Signature)	Reviewing Official (Signature) and Title
Sandra E. Smart	Dale K. Watson, Assistant Regional Director

A Memorandum of Understanding (MOU) between the FDIC and the bank became effective on January 21, 20x5. Provisions of the MOU that require further efforts or are of a continuing nature are detailed below.

2(b). The bank shall maintain an Allowance for Loan and Lease Losses at an appropriate level.

Based on this examination's findings, the ALLL is at an insufficient level requiring an estimated allocation of at least $325M.

3(a). The bank shall maintain a Leverage Capital ratio equal to or greater than 7 percent.

As of June 30, 20x5, the Leverage Capital ratio, adjusted for the additional $325M provision for loan and lease loss expense, approximates 7.44 percent.

3(d). The bank shall maintain a Total Capital ratio equal to or greater than 10 percent.

As of June 30, 20x6, the Total Capital ratio, adjusted for the additional $325M provision for loan and lease loss expense is 11.75 percent.

4. The bank shall file accurate Call Reports.

Examiners noted significant errors in the December 31, 20x5, March 31, and June 30, 20x6, Call Reports which require amendments.

5. The bank shall not extend or renew, directly or indirectly, credit to, or for the benefit of, any borrower who has a loan or other extension of credit with the bank that has been charged off or classified, in whole or in part, Loss, Doubtful, or Substandard, unless rationale for the extension is noted in the official Board minutes and the appropriate credit file.

On January 30, 20x6, the bank extended a $50M loan to U. R. Worth. The borrower was adversely classified Loss at the previous examination. The Board did not specifically document the reason(s) for the extension in the official Board minutes or in the appropriate credit file.

6. The bank shall not declare or pay any dividends without the written consent of the FDIC.

No dividends have been declared or paid since the previous examination.

1. **Are risk management processes adequate in relation to economic conditions and asset concentration levels?**

   No. As discussed on the Examination Conclusions and Comments (ECC) pages, the Board's strategic plan is outdated and does not reflect the institution's current condition or operating environment. In addition, management does not adequately identify, evaluate and monitor asset concentrations as exemplified by the deficiencies noted in managing the correspondent bank, fishing industry, and individual borrower concentrations identified in this report. Establishment of appropriate concentration risk policies and procedures would enhance management's ability to identify and control risks and avoid potential violations of law. Refer to the Concentrations pages for additional details.

   President Lincoln stated that management will develop procedures to identify, evaluate, and monitor concentrations.

2. **Are risk management policies and practices for the credit function adequate**?

   No. Internal credit review and grading procedures are weak, and credit administration practices are deficient. Recommendations for improvement are included under Asset Quality on the ECC page.

   Due to the deficiencies noted in the institution's internal credit grading system and the use of inaccurate loan loss rates, the ALLL is at an insufficient level. In addition, management utilized an inappropriate loan loss experience to establish a reserve rate for its non-watch list loans, which contributed to the insufficient ALLL level. Management should ensure controls are in place to consistently determine the ALLL is maintained in accordance with GAAP and should maintain supporting documentation for the techniques used to develop the historical loss rate for each group of loans and the resulting estimated credit losses. For additional information, refer to the Interagency Policy Statement on the Allowance for Loan and Lease Losses.

   President Lincoln committed to filing Call Report amendments prior to the September 30, 20x6 submission and to reviewing the loan grading system.

   Additionally, although the bank's loan policy is generally adequate, it does not address the following matters:

   <u>Participation Loans</u> - The bank regularly purchases loans or portions of loans from other institutions. These specialized lending activities are not covered in the loan policy.

   <u>Construction Loans</u> - The bank finances the construction of 1- to 4-family residences and mixed use commercial property. While practices are generally adequate, a large construction loan listed for Special Mention reflects several weaknesses in construction lending. The policy lacks specific guidelines pertaining to construction lending.

   Development of comprehensive loan policy guidance provides management and staff with clear expectations for administering the lending function and facilitates sound risk management practices.

   President Lincoln stated that management would develop guidelines for purchased loans and construction lending and revise the loan policy by December 31, 20x6.

3. **Are risk management policies and practices for asset/liability management and the investment function adequate?**

Generally, yes. Management's liquidity management practices are generally adequate; but could be improved by implementing a formal funds management policy or a contingency funding plan. Overall practices for Sensitivity to Market Risk are generally adequate; however, policy parameters should be established that reflect the Board's tolerance for interest rate risk (IRR). The Board should establish and guide the bank's tolerance for IRR, including approving relevant risk limits and other key policies, identifying lines of authority and responsibility for managing risk, and ensuring adequate resources are devoted to IRR management. Implementing appropriate limits strengthens management's ability to manage IRR and monitor actual risk taking activity.

President Lincoln stated that IRR policy limits would be established by year-end 20x6.

Investment policy guidelines are adequate; however, management's adherence to its written investment policy is inconsistent. On at least three occasions since the previous examination, President Lincoln exceeded her purchasing authority when she purchased securities over $250M without prior Board approval. Failure to adhere to Board approved purchasing authority could increase the risk profile of the institution above Board approved risk tolerances.

The Board should ensure management purchases investments in conformance with existing policy standards or determine if it would be prudent to revise the standards to meet purchasing needs.

President Lincoln stated that she was presented with the opportunity to purchase these securities at a good price and could not wait for Board approval. She further stated she would comply with the policy in the future or discuss modifying the policy with the Board at the next Board meeting.

4. **Are risk management processes adequate in relation to, and consistent with, the institution's business plan, competitive conditions, and proposed new activities or products?**

No. As discussed on the ECC pages, risk management practices regarding the credit portfolio are insufficient for the institution's business model and risk profile.

5. **Are internal controls, audit procedures, and compliance with laws and regulations adequate (includes compliance with the Bank Secrecy Act [BSA] and related regulations)?**

No. As indicated on the ECC page, apparent violations of BSA regulations, Regulation O, and the state legal lending limit were cited during this examination. Additionally, the bank is not in conformance with the Interagency Guidelines Establishing Safety and Soundness Standards. Full details of these citations can be found on the Violations of Laws and Regulations pages. In addition, the audit and internal control functions lack independence.

<u>Internal Controls</u>

Examiners noted the weaknesses below in the bank's system of internal controls. Maintaining strong internal controls helps ensure the integrity of operations and discourages potential insider abuse.

- *Vacation Policy* – The bank's vacation policy requires employees to be absent from their normal duties for an uninterrupted period of two weeks each calendar year. Executive Vice President Leslie S. Cook did not remain absent during her two-week vacation in 20x5 as she returned daily to reconcile the Federal funds sold account. Management should enforce the policy, particularly for employees who are responsible for sensitive transactions.

- *Reconcilement of Correspondent Bank Accounts* - Management has not reconciled the correspondent bank accounts for the past three months. While personnel reconciled these accounts during the examination, they should be reconciled at least monthly

President Lincoln stated she would take action to address these deficiencies before year-end 20x6.

6. Is Board supervision adequate, and are controls over insider transactions, conflicts of interest, and parent/affiliate relationships acceptable?

No. Board supervision is less than satisfactory. Numerous underwriting weaknesses and credit administration deficiencies remain uncorrected from prior examinations, and the Board has not established an effective independent internal audit function. Refer to comments under Management on the ECC page for more details. Additionally, examiners cited two loans as apparent violations of the Federal Reserve Board's Regulation O because management did not obtain the prior approval of the Board on loans to the related interests of President Lincoln and Director Larry G. Green. Refer to the Violations of Laws and Regulations page of this Report for details.

APPARENT VIOLATIONS OF LAWS AND REGULATIONS

BANK SECRECY ACT

Title 31 C.F.R. Chapter X Section 1010.306(a)(1) of the Treasury Department's Bank Secrecy Act regulations requires a covered financial institution to file a CTR (FinCEN Form 104) within the prescribed period.

Examiners identified numerous instances where CTRs were not filed within the required 15-day period. This infraction was also cited at the previous FDIC examination. Between October 20x5 and July 20x6, 289 of 944 CTRs (31 percent) were filed late. In many cases, CTRs were signed by the approving official more than 15 days after the transaction date. The time between the transaction date and receipt by the Treasury Department on these late filings was generally around 20 to 25 days, with a few exceeding 70 days.

BSA Officer Donna Ludlow stated that some of the late CTRs were filed after an internal audit noted that the forms had not been submitted; however, she could offer no explanation as to why the remaining CTRs were filed late. President Lincoln stated that new procedures would be implemented within 90 days to ensure all CTRs are submitted in a timely manner in the future.

REGULATION O

The Federal Reserve Board's Regulation O, which implements Section 22(h) of the Federal Reserve Act and is made applicable to insured nonmember institutions by Section 18(j)(2) of the Federal Deposit Insurance Act, covers transactions with bank insiders. Section 215.4(b)(1) of Regulation O requires extensions of credit by an institution to a director or related interest exceeding the greater of $25M or five percent of unimpaired capital and surplus to have prior approval by a majority of the institution's board of directors.

The bank is in apparent violation of this section for extending the following loans with the prior approval of the Executive Loan Committee, which is composed of only three Board members, rather than prior approval by a majority of the Board.

Borrower	Date of Note	Original Amount
Lincoln, Allie C.	12/11/20x5	$500M
Any Body, Inc.	12/28/20x5	$250M
(A related interest of President Lincoln and Director Green.)		

President Lincoln stated that these exceptions were the result of oversight. She further indicated that bank policy requires that all insider loans receive the prior approval of the full Board. Examiners noted that all other insider loans received prior Board approval. President Lincoln and the Board of Directors promised future compliance.

LEGAL LENDING LIMIT

Section 1127 of the State Banking Code provides that the total direct or indirect loans and extension of credit or lease by a bank to one obligor or guarantor at no time shall exceed 15 percent of "statutory capital" (equivalent to total capital) of the bank, except upon approval by two-third vote of its board of directors, the limit may be increased up to 25 percent of the statutory capital of the bank. On January 2, 20x6, the bank extended an additional $650M to J&M Realty Trust, guaranteed by John and Mary Smith, which increased total outstanding debt to the Smiths and their companies to $1,950M, or 31 percent of statutory capital. The extension of additional credit was made without approval by the board of directors, and represents an apparent violation of Section 1127.

President Lincoln stated that the extension of credit over the lending limit was the result of oversight.

NONCONFORMANCE WITH GUIDELINES INCORPORATED INTO REGULATIONS

INTERAGENCY GUIDELINES ESTABLISHING STANDARDS FOR SAFETY AND SOUNDNESS APPENDIX A TO PART 364 OF THE FDIC's RULES AND REGULATIONS (APPENDIX A)

Appendix A sets out the safety and soundness standards that the FDIC uses to identify and address problems at insured depository institutions before capital becomes impaired. The institution is in nonconformance with the following sections of the Operational and Managerial Standards of Appendix A to Part 364.

A. Internal controls and information systems. An institution should have internal controls and information systems that, in part, are appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for timely and accurate financial, operational, and regulatory reports and compliance with applicable laws and regulations.

Material errors were noted in the institution's quarterly Call Report filings over the last three quarters, which necessitates restatement of the institution's most recent Call Report. Additionally, three apparent violations of laws and regulations were noted, including a repeat violation regarding untimely CTR filings.

B. Internal audit system. An institution should have an internal audit system that is appropriate to the size of the institution and the nature and scope of its activities and that provides for, in part: independence and objectivity; adequate testing and review of information systems; and adequate documentation of tests and findings and any corrective actions.

The audit and internal control functions lack independence, which jeopardizes the effectiveness of the internal audit program. Further, the lack of independence coupled with inadequate monitoring of audit findings status reports resulted in previously identified deficiencies being inaccurately reported as corrected.

C. Loan documentation. An institution should establish and maintain loan documentation practices that, in part: enable the institution to make an informed lending decision and to assess risk, as necessary, on an ongoing basis; identify the purpose of a loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner; ensure that any claim against a borrower is legally enforceable; and demonstrate appropriate administration and monitoring of loans.

Credit administration, although improving, remains deficient. Noted weaknesses include lapses in UCC-1 filings, absence of inspections or mechanic's lien waivers prior to construction advances, and absence of rent roll information. As noted on the Assets with Credit Data or Collateral Documentation Exceptions page, one-third of the dollar volume of loans reviewed had documentation exceptions that impaired management's ability to make an informed lending decision and to assess risk, as necessary on an ongoing basis.

D. Credit underwriting. An institution should establish and maintain prudent credit underwriting practices that: are commensurate with the types of loans the institution will make and, in part, provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed; establish a system of independent, ongoing credit review and appropriate communication to management and to the board of directors; and take adequate account of concentration of credit risk.

Management does not conduct pre-purchase credit analysis for participations purchased, which precludes its ability to evaluate the underlying creditworthiness of these credits and the borrower's ability to repay. Additionally, inadequate staffing of the credit review function contributed to inaccurate loan grading for several large credits. Moreover, management does not have adequate procedures in place to identify and monitor concentrations.

E. Asset quality. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should, in part, estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses.

As detailed on the ECC page, inaccurate internal loan grading resulted in an insufficient ALLL level.

President Lincoln stated that all noted deficiencies will be added to the Audit Findings Tracking Report and that applicable executive officers would begin action to address deficiencies immediately.

Uniform Rating System for Information Technology

	Current Exam	Prior Exam	Prior Exam
Examination Start Date	08/01/20x6	11/13/20x5 / S	10/21/20x4
Composite Rating	**2**	**1**	**2**
Component Ratings:			
Audit	**2**		
Management	**2**		
Development & Acquisition	**2**		
Support & Delivery	**2**		

Overall, IT, operations, risk management, and security are generally satisfactory. Management's attention is directed to the items below.

Audit - 2

The IT audit program is generally adequate, and internal auditors promptly identify and report deficiencies and risks. Identified issues are formally tracked and resolved in a timely fashion, and the IT audit plan is based on a thorough risk assessment of IT assets and internal and external threats.

The majority of critical IT areas were reviewed in recent IT audits; however, examiners identified a concern with the current audit scope. Specifically, patch management and cybersecurity are not included in the bank's IT audits. Management should ensure all critical IT areas are included in the scope of IT audits, with the frequency being based on the audit risk assessment. Including all critical IT areas in the internal audits may have reduced the number of items noted in the recent external vulnerability assessment and will help ensure operations continue functioning as needed going forward.

Examiners also noted a concern with the audit reporting structure. At present, internal auditors report to President Lincoln rather than the Board's Audit Committee. In order to increase the auditors' independence and help ensure the Board is able to fulfill its oversight responsibilities, the internal auditors should report directly to the Board's Audit Committee.

President Lincoln stated that the omission of patch management and cybersecurity from the recent IT General Controls audit was an oversight and agreed to include the areas in future audits. President Lincoln also stated that she would recommend to the Board that they modify the IT audit reporting structure so auditors report directly to the Board's Audit Committee.

Management - 2

Overall IT management provides adequate guidance and direction. The oversight and supervision of the information security program and related practices are supported by adequate Board approved policies and risk management practices. Managers are well qualified and tenured for their respective positions.

<u>Vendor Management</u>

Overall, management monitors service providers to confirm they satisfied their contractual obligations; however, management did not review the financial statements or the Statement on Standards for Attestation Engagements (SSAE 16) reports of two critical service providers. To help ensure all service providers are appropriately monitored and to improve the effectiveness of management's monitoring activities, management should formally document all required reviews.

President Lincoln indicated the missing reviews were an oversight and stated that a tickler system would be developed to remind the vendor -review officer of upcoming vendor reviews.

<u>Conformance with Information Security Standards</u>

Management is in general conformance with Appendix B to Part 364 - Interagency Guidelines Establishing Information Security Standards of the FDIC Rules and Regulations. Management identified the location of all non-public personal information, both electronic and hard copy. Threats to each type of information were identified, adequate controls are in place, and an annual report of the program is presented to the Board. While the overall program is adequate, management did not conduct control assessments on all third-party providers that obtain, use, or process non-public personal information. Management should expand the scope of the control assessments to include all applicable third-party providers. Including all applicable third parties in the assessments will help ensure the providers are appropriately identified and risk rated, and will help confirm third parties have adequate internal controls to protect non-public information.

President Lincoln stated that the vendor management program would be updated to identify all vendors with access to non-public personal information and that control assessments would be conducted on all identified vendors before March 31, 20x7.

<u>Cybersecurity Preparedness</u>

Management's assessment of the bank's cybersecurity risk exposure appropriately identifies inherent risks; however, cybersecurity preparedness could be strengthened by determining whether cyber-related controls are sufficient. By identifying cyber-related controls and determining whether they mitigate the identified inherent risks to an acceptable level, management will be better able to identify cybersecurity weaknesses and implement appropriate controls.

President Lincoln indicated that the assessment process would be expanded to include targeted maturity levels by June 30, 20x7.

Development and Acquisition - 2

Development and acquisition practices, which include hardware and software implementation and change-management practices, are appropriate for the institution's size and complexity. Overall, project management processes are adequate and provide sufficient guidance to manage projects. Currently, any project exceeding $20M is rated as a major project and requires specific project documentation. However, not all project documentation complies with the internal bank guidelines. For example, the documentation of three recent projects did not include reviews of alternative project solutions or explanations of why the solutions recommended in the project proposals were the most appropriate solutions. Management should comply with internal bank guidelines to ensure project requirements are met and consistent project documentation is in place.

President Lincoln indicated the project management program was relatively new and that project requirements were being introduced in a phased approach to not overwhelm employees. However, she agreed to follow internal project guidelines on future projects.

Support and Delivery - 2

Overall computer operations and information security practices are adequate, and management has improved its business continuity and disaster recovery plans. Management established an information security group to set standards, monitor trends, and review system logs and alerts. Although overall operations are adequate, examiners identified areas that require management's attention such as system-log monitoring, vulnerability assessments, patch management, and business continuity planning.

Logging and Monitoring

Management uses different logging platforms for firewalls, internal servers, and routers, and data are not shared or correlated among the logging systems. While servers and base operating systems are logged, logging is not enabled for virtual operating system environments. Management should review its current logging program to ensure all critical systems are included and that there is sufficient data correlation between the systems. Improving the logging program will help ensure all necessary information is obtained and provide the information security group with data in a more effective, centralized format.

Vulnerability Assessments

Management contracts an outside third party to conduct annual, internal vulnerability assessments as part of an overall security review. The scope of the vulnerability assessment is adequate; however, having only one assessment per year could result in vulnerabilities not being promptly identified. Management should review the frequency of its vulnerability assessment to ensure the frequency of the assessments is based on appropriate risk analysis.

President Lincoln committed to revisiting the logging and monitoring program to ensure that all needed information is logged and, to the extent possible, centralized. Additionally, she stated that management would review the frequency of the vulnerability assessments and conduct more frequent assessments based on appropriate risk analysis. President Lincoln stated the reviews would be completed by the end of 20x6, and appropriate corrective actions would be implemented by March 31, 20x7.

Business Continuity Planning (BCP)

Management changed the structure of its BCP this year. Most elements of the new program are adequate, but some should be improved. The areas of business impact analysis (BIA) and disaster recovery (DR) testing require further refinement.

The BIA and risk assessments are out-of-date, but are being updated to include new recovery time objectives (RTO) and to identify reasonably foreseeable threats, including cybersecurity threats. Currently, the shortest RTO is 24 hours. The 24-hour RTO may be too extended for the application, and there are several systems that may benefit from RTOs of four hours or less. The current extended RTOs may significantly affect multiple business lines and the institution's ability to restore critical systems after a disaster. Management should ensure RTOs are appropriate so that critical operations can be restored promptly after a disaster or business interruption. While some disaster recovery (DR) testing has occurred, management has not sufficiently tested a few critical systems. Management should review its testing universe and implement a risk-based testing approach to ensure all necessary testing is completed in a timely manner. Failure to conduct appropriate tests could result in material delays in restoring critical systems if a disaster occurs.

President Lincoln agreed to conduct the BIA and risk assessments, review RTOs, and implement risk-based DR testing by March 31, 20x7.

Uniform Interagency Trust Rating System

	Current Exam	Prior Exam	Prior Exam
Examination Start Date	**08/01/20x6**	**11/13/20x5 / S**	**10/21/20x4**
Composite Rating:	2	2	2
Management	2	2	2
Operations, Internal Controls and Auditing	2	2	2
Earnings Compliance	0	0	0
Asset Management	2	2	2
Management	2	2	2

A Trust Department Rating of "2" is assigned. Overall risk management practices are satisfactory relative to the institution's size and complexity. There are no material supervisory concerns. Fiduciary activities are conducted in substantial compliance with laws and regulations. Examination recommendations and management's responses are detailed below.

Compliance – 2

Account administration is generally in compliance with originating documents. Potential conflicts of interest exist from the trust department using own-bank deposits, as well as from holding stock of the parent holding company and an affiliate in one trust account. Trust Officer Hancock surveys local deposit rates to ensure competitive rates are being paid on deposits, but does not maintain documentation of her surveys. Appropriate policies, procedures, and practices should be in place to effectively control conflicts of interest and manage own-bank deposits and stock holdings. Without proper policies, procedures, and practices, the bank is exposed to potential litigation risk, which could negatively affect earnings and capital.

Trust Officer Hancock stated she would maintain documentation of comparable rates beginning immediately.

Regarding the trust account with holding company and affiliate stock, the party in interest of that account is informed of the trust officer's proxy vote and attends annual stockholder meetings; however, these facts are not documented in the trust files. Failure to adequately document voting rights could be viewed as a breach of trust and expose the bank to a potential conflict of interest.

Trust Officer Hancock indicated that since the party in interest to that account is a member of the Lincoln family, and stockholder meeting minutes of the holding company and the affiliate could be produced should the need arise, the risk is minimal.

Asset Management – 2

Asset management practices are generally satisfactory. All account transactions, including discretionary disbursements, are included in monthly Board reports, and the Board reviews all accounts annually. However, management should document in the annual account reviews an assessment of the needs of each applicable account and/or beneficiary, and whether the account's investment mix is meeting those needs. In addition, three trust accounts use fixed income and/or equity mutual funds. Qualified staff should annually review each mutual fund's investment mix, performance relative to competing mutual funds, and any other related criteria. These mutual fund reviews should also consider the ongoing needs and objectives of the respective trust accounts. Failure to adequately document needs assessments, evaluate the mix, and document the review exposes the bank to litigation risks.

Trust Officer Hancock committed to documenting annual needs assessments for each trust account, as well as annual mutual fund reviews going forward.

Management – 2

The Board's and management's performance and risk management practices are satisfactory relative to the size of the department and the complexity of trust activities. Only moderate weaknesses are present and are within management's capabilities and willingness to correct. The full Board acts as the Trust Committee and reviews department activity reports monthly. Trust Officer Hancock is the primary administrator and record keeper for personal trust accounts, while President Lincoln administers the farm management agency account.

The Board has adopted a general Trust Policy. The Directorate should consider adding policy criteria regarding environmental reviews of real estate that may be held in current or future trust accounts. Such policy guidance would help ensure that department management can identify and take mitigating action on potential environmental concerns on real estate held in managed accounts.

Trust Officer Hancock agreed to develop such guidance for the Board's consideration at its next meeting.

Operations, Internal Controls and Auditing – 2

Operations, internal controls, and audit are satisfactory in relation to the volume and character of trust business. Moderate weaknesses exist, but in general are effectively identified and monitored. The bank's audit program includes an annual review of trust department activity, including the verification of trust assets.

Trust department records are maintained manually, which limits internal control capability. Trust Officer Hancock is implementing a computerized trust record keeping system as time permits. The computerized system has the capacity to allow for the separation of record keeping and data entry functions from the account administration function. Limited staff restricts full segregation of duties. Despite this, check writing and account reconciliation procedures should be separated to reduce the risk of error or inappropriate activity going undetected.

Trust Officer Hancock stated she would enhance the deposit account reconcilement procedures by the end of the third quarter.

Earnings – 0

This small department is operating primarily as a service to current customers rather than as a profit center. Due to this aspect of the trust department's operations, and the limited volume of $3.3 million assets under management, the earnings component is not rated.

Meeting With Management

A meeting was held on September 8, 20x6, with President Lincoln and Trust Officer Hancock to discuss examination findings in detail. An overview of these findings was also presented to the bank's Board of Directors at its meeting on September 18, 20x6.

ASSET QUALITY		ADVERSELY CLASSIFIED			
		Substandard	Doubtful	Loss	Total
Loans and Leases		4,290	140	890	5,320
Securities		45			45
Other Real Estate Owned		1,125		100	1,225
Other Assets				25	25
Other Transfer Risk					
Subtotal		5,460	140	1,015	6,615
Contingent Liabilities		230			230
Totals at Exam Date	06/30/20x6	5,690	140	1,015	6,845
Totals at Prior Exam	09/30/20x5	7,345	220	194	7,759
Totals at Prior Exam	09/30/20x4	6,655	177	67	6,899

	Exam Date 06/30/20x6	Prior Exam 09/30/20x5 (S)	Prior Exam 09/30/20x4
Total Special Mention	854	515	
Adversely Classified Items Coverage Ratio	84.41	102.71	94.92
Total Adversely Classified Assets/Total Assets	8.21	9.93	8.20
Past Due and Nonaccrual Loans and Leases/Gross Loans and Leases	6.74	8.42	9.12
Adversely Classified Loans and Leases/Total Loans	9.86	12.68	11.30
ALLL/Total Loans and Leases	3.67	3.15	2.50

CAPITAL	Exam Date 06/30/20x6	Prior Exam 09/30/20x5 (S)	Prior Exam 09/30/20x4
Tier 1 Capital/Average Total Assets	7.44	7.55	7.67
Common Equity Tier 1 Capital/Risk-Weighted Assets[(1)]	10.48		
Tier 1 Capital/Risk-Weighted Assets[(1)]	10.48	9.88	9.90
Total Capital/Risk-Weighted Assets[(1)]	11.75	8.42	11.40
Prompt Corrective Action Capital Category	W	W	W

PCA Categories: W – Well-capitalized, A – Adequately capitalized, U – Undercapitalized, S – Significantly undercapitalized, C – Critically undercapitalized

	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Retained Earnings[(1)]/Average Total Equity	3.37	9.32	(2.05)	(3.86)
Asset Growth Rate	2.66	6.78	0.42	0.20
Cash Dividends/Net Income		32.65		

EARNINGS	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Income (After Tax)/Average Assets [(*)]	0.27	1.03	(0.15)	(0.30)
Net Interest Income (TE)/Average Earning Assets	4.74	4.64	4.37	4.64
Total Noninterest Expense/Average Assets	3.82	2.90	3.62	3.54

LIQUIDITY	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Non-Core Funding Dependence	14.71	1.02	8.69	6.66
Net Loans and Leases/Assets	64.45	66.20	68.79	69.24

[(1)] Institutions under the CBLR framework do not calculate Risk-Weighted Assets or Tier 2 Capital. For such institutions, Tier 1 Capital equals Total Capital under Part 324.
[(*)] After management's planned $325M adjustment to the ALLL, the 6/30/20x6 Ratio will drop to (0.58)%.

ASSETS	6/30/20x6	12/31/20x5
Total Loans and Leases	53,931	55,545
Less: Allowance for Loan & Lease Losses	1,979	1,748
Loans and Leases (net)	51,952	53,797
Interest-Bearing Balances	20	
Federal Funds Sold and Securities Purchased Under Agreements to Resell	4,000	9,100
Trading Account Assets		
Securities: Held-to-Maturity (at Amortized Cost)	2,787	5,993
Available-for-Sale (at Fair Value)	9,969	
Equity Securities with readily determinable fair values not held for trading	919	
Total Earning Assets	**69,647**	**68,890**
Cash and Noninterest-Bearing Balances	5,895	4,754
Premises and Fixed Assets	2,530	2,709
Other Real Estate Owned	1,225	690
Intangible Assets		
Other Assets	1,307	1,175
TOTAL ASSETS	**80,604**	**78,207**

LIABILITIES		
Deposits	67,815	66,221
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	441	516
Other Borrowed Money	5,857	5,136
Other Liabilities	301	307
Subordinated Notes and Debentures		
Total Liabilities	**74,414**	**72,180**
EQUITY CAPITAL		
Perpetual Preferred Stock		
Common Equity Capital	6,190	6,027
Includes net unrealized holding gains (losses) on available-for-sale securities.		
Other Equity Capital		
Total Bank Equity Capital	**6,190**	**6,027**
Minority Interest in Consolidated Subsidiaries		
Total Equity Capital	**6,190**	**6,027**
TOTAL LIABILITIES AND EQUITY CAPITAL	**80,604**	**78,207**

DERIVATIVES AND OFF-BALANCE SHEET ITEMS		
Unused Commitments	4,333	5,893
Letters of Credit	209	824
Other Off-Balance Sheet Items		
Notional Amount of Derivative Contracts		
Appreciation (Depreciation) in Held-to-Maturity Securities	56	

Footnotes:

Loans and Lease Financing Receivables | 99999

Date: 06/30/20x6

Category:	Amount	Percent
Real Estate Loans	21,938	40.53
Installment Loans	7,058	13.04
Credit Card and Related Plans	90	0.17
Commercial Loans	22,292	41.18
All Other Loans and Leases	2,753	5.09
Gross Loans and Leases	54,121	100.00

PAST DUE AND NONACCRUAL LOANS AND LEASES

Date: 06/30/20x6

Category	Past Due 30 through 89 Days and Accruing	Past Due 90 Days or More and Accruing	Total Past Due and Accruing	Percent of Category	Nonaccrual	Nonaccrual Percent of Category
Real Estate Loans	800	44	844	3.85	1,402	6.39
Installment Loans	125		125	1.77	107	1.52
Credit Card and Related Plans	3		3	3.33		
Commercial and All Other Loans and Leases	626		626	2.50	554	2.21
Totals	1,554	44	1,598	2.95	2,063	3.81
Memorandum Restructured Loans and Leases Included in the Above Totals						

Footnotes:

Description	HELD-TO-MATURITY		AVAILABLE-FOR-SALE	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. Treasury securities	1,537	1,593		
U.S. Government agency obligations			2,550	2,554
Securities issued by U.S. states & political subdivisions	250	250		
Mortgage-backed securities (MBS)				
Residential pass-through securities:				
Issued or guaranteed by FNMA, FHLMC, or GNMA			7,322	7,415
Other residential MBS (inc. CMOs, REMICs, & stripped MBS):				
Issued or guaranteed by U.S. Government agencies or sponsored agencies				
Collateralized by MBS issued or guaranteed by U.S. Government agencies or sponsored agencies				
All other residential MBS				
Commercial MBS				
Commercial mortgage pass-through securities:				
Issued or guaranteed by FNMA, FHLMC, or GNMA				
Other pass-through securities				
Other Commercial MBS:				
Issued or guaranteed by U.S. Government agencies or sponsored agencies				
All other commercial MBS				
Asset-backed Securities (ABS) and structured financial products				
Asset-backed securities				
Structured financial products:				
Other Debt Securities				
Other Domestic Debt Securities				
Foreign Debt Securities	1,000	1,000		
Totals:	2,787	2,843	9,872	9,969

SECURITIES APPRECIATION (DEPRECIATION)

Description	Held-to-Maturity	Available-for-Sale	Total
Securities Appreciation (Depreciation)	56	97	153
As a Percent of Amortized Cost	2.01	0.90	1.13

MEMORANDUM: EQUITY SECURITIES WITH READILY DETERMINABLE FAIR VALUES NOT HELD FOR TRADING

Description	Fair Value
Investments in mutual funds & other equity securities with readily determinable fair values not held for trading	919

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

		CATEGORY	
AMOUNT, DESCRIPTION AND COMMENTS	Substandard	Doubtful	Loss

These sample write-ups do not reflect required or preferred formats, but simply illustrate various ways to present the required analytical elements.

LOANS

500	(1)	Nonaccrual	96 Days Past Due			
250	(2)	Nonaccrual	96 Days Past Due			
750				750		

AMHILL TOOL & DIE, INC.
By: Robert E. Hill, President
Gty: Roger S. Barrett

Amhill Tool & Die, Inc. manufactures custom plastic-forming dies and provides injection-molding services.

(1) Note originated 1/7/20x2 at $500M to refinance a $450M mortgage on the obligor's manufacturing plant and provide $50M working capital. The note matures 1/7/20x9 and requires interest-only payments, with principal due on demand. (2) Term note originated 6/10/20x3 at $280M, matures 6/11/20x0, and was extended to refinance a working capital note at another financial institution. The primary source of repayment for both notes is operating CF.

The loans are cross-collateralized by a first mortgage on the manufacturing plant, located in Anytown, Anystate, and a first security interest in all business assets. A 12/7/20x1 appraisal reflects a property value of $625M; however, the valuation appears stale given downward trends in local RE values. As of 12/31/20x5, management estimated the value of account receivables and inventory at $100M and assigned an estimated liquidation value of $125M to machinery and equipment. Reliance on the machinery and equipment as a secondary repayment source is restricted by their highly specialized nature and limited marketability.

Amhill Tool & Die, Inc. has been negatively impacted by cancelled contracts and high employee turnover. Weak CFs have caused on-going delinquency problems and management placed the notes on nonaccrual on 3/31/20x6. The obligor's 12/31/20x5 income statement reported gross income of $800M and a NOI of $100M. Gross sale revenues declined steadily since year-end 2012 and operating losses of $123M and $234M were reported as of 12/31/20x3 and 12/31/20x4, respectively. NW declined to $125M at year-end 20x5, and DSC was calculated at 0.91 as of 12/31/20x5. The guarantor's 12/31/20x4 personal FS reflects liquid assets of $30M, a NW of $375M, and TA of $890M centered in his ownership interest in Amhill Tool & Die, Inc.

EVP/SLO Leslie S. Cook indicated managerial conflicts contributed to the loss of several lucrative contracts and numerous highly trained employees; however, he stated production output is increasing due to the addition of two knowledgeable managers and improved employee training. He also stated management intends to obtain a new

AMOUNT, DESCRIPTION AND COMMENTS	Substandard	CATEGORY Doubtful	Loss

property appraisal, restructure the notes to better match the corporation's cash flows, and to require principal and interest payments on the modified mortgage note.

Debts classified Substandard based on inadequate cash flows, continuing delinquencies, and marginal collateral protection.

Internal Rating: 6 (Watch)
Originating/Servicing Officer: Cook
Examiner: T. Hinojosa

AMOUNT, DESCRIPTION AND COMMENTS	Substandard	Doubtful	Loss
340 BROOKS, JAMES	200	140	
1,250 IRMA DEAT, LTD.	750		500
290 KING, CHRISTOPHER Gty: Sam King, Inc.	290		
865 LAST CHANCE MOTEL, INC.	500		365
275 RAMIREZ, PETER	250		25
1,550 EIGHT LOANS LESS THAN $250,000 List left with management.	1,550		
TOTAL ADVERSELY CLASSIFIED LOANS	4,290	140	890

SECURITIES

AMOUNT, DESCRIPTION AND COMMENTS	Substandard	Doubtful	Loss
45 ANYCOUNTY MUNICIPAL GENERAL OBLIGATION	45		
TOTAL ADVERSELY CLASSIFIED SECURITIES	45		

AMOUNT, DESCRIPTION AND COMMENTS	CATEGORY		
	Substandard	Doubtful	Loss
OTHER REAL ESTATE OWNED			
550 ONE WAY HOME, INC. PROPERTY	550		
675 ROLLY PROPERTY	575		100
TOTAL ADVERSELY CLASSIFIED ORE	1,125		100
OTHER ASSETS			
25 SUN, RAYMOND Repossessed Heavy Equipment			25
TOTAL ADVERSELY CLASSIFIED OTHER ASSETS			25
CONTINGENT LIABILITIES			
230 KING, CHRISTOPHER Amount represents unfunded portion of loan commitment for construction of a single-family residence.	230		
TOTAL ADVERSELY CLASSIFIED CONTINGENT LIABILITIES	230		
TOTAL ADVERSELY CLASSIFIED ITEMS	5,690	140	1,015

Items Listed for Special Mention	99999

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

DESCRIPTION	AMOUNT

LOANS

854 RAIN, ROBERT, L.L.C. GTY: Robert Rain	854

Debt represents the balance outstanding on a $1,600M construction/permanent facility, dated 3/7/20x6, to refinance an existing $1,200M loan at subject bank granted 1/5/20x5. The original loan was granted to develop a 3-story mixed-use commercial and apartment building in Neighboring Town. The new loan provided the borrower with an additional $400M in funds to accommodate a revised construction budget stemming from plan modifications. Loan terms require interest-only payments at 4.375% for a 10-month period. Principal and interest payments of $8,231 based on a 25-year amortization are to commence on 1/7/20x7, with the loan to mature in 20x1. Collateral consists of a first mortgage on the property under construction appraised at $1,000M "as is" and $2,000M "as complete."

The following credit concerns are associated with the indebtedness:

- The project encountered numerous delays due to difficulty in obtaining permits resulting from the changes in construction plans and due to the need for additional financing.
- Guarantor analysis is inadequate, as liquid assets were not verified and a global CF analysis was not prepared.
- Monitoring of the project has been weak. As a result, the loan has been 53 percent funded, but the project is only 40 percent completed, with the difference representing construction funds used for soft costs.
- No feasibility analysis was performed to support the 20x5 origination.
- The guarantor's experience as a construction manager is questionable considering the delays, revisions, and cost overruns.
- The appraised value may need to be updated, as it is based on the project being completed within the revised budget and assumes that projected operating results will materialize.

Given the concerns noted above and weaknesses associated with this indebtedness, a Special Mention designation is warranted. To strengthen the credit, close management oversight and monitoring is required, along with the following actions:

- Monitor construction progress and compare to budget to ensure percentage completion is brought in line with funding.
- Verify the guarantor's liquid assets and obtain financial information to perform a global CF analysis.
- Obtain an updated appraisal if actual rental rates significantly diverge from the appraisal's projections, if project costs outstrip the revised budget, or if further delays ensue.

Internal Rating: 3
Originating/Servicing Officer: Cook
Examiner: V. Stewart

TOTAL LOANS LISTED FOR SPECIAL MENTION	854

Analysis of Loans Subject to Adverse Classification	**99999**

DESCRIPTION	SUBSTANDARD	DOUBTFUL	LOSS	TOTAL
Book Value at Last Examination: 09/30/20x5	6,641	220	176	7,037
Reductions:				
Payments	1,030	58		1,088
Not Now Adversely Classified	955	162		1,117
Now Classified Substandard				
Now Classified Doubtful	140			140
Now Classified Loss	890			890
To Other Real Estate or Other Assets				
Charged-Off	209		176	385
TOTAL REDUCTIONS	3,224	220	176	3,620
Additions:				
Not Adversely Classified Previously	873			873
Further Advances – Loans				
Not Adversely Classified Previously				
Further Advances – Loans				
Adversely Classified Previously				
Credits Newly Extended				
Previously Classified Substandard		140	890	1,030
Previously Classified Doubtful				
Previously Classified Loss				
TOTAL ADDITIONS	873	140	890	1,903
Book Value at This Examination: 06/30/20x6	4,290	140	890	5,320

DESCRIPTION	SUBSTANDARD	DOUBTFUL	LOSS	TOTAL
Book Value at Last Examination: 09/30/20x5	672		18	690
Reductions:				
Not Now Adversely Classified				
Sales With Outside Financing				
Sales With Financing				
Provided By Subject Institution				
Now Classified Substandard				
Now Classified Doubtful				
Now Classified Loss	100			100
Charged-Off			18	18
TOTAL REDUCTIONS	100		18	118
Additions:				
Not Adversely Classified Previously	550			550
Further Advances - ORE or Loans Not Adversely Classified Previously				
Transferred from Previously Adversely Classified Loans				
Further Advances - ORE or Loans Adversely Classified Previously	3			3
ORE From Credits Newly Extended				
Previously Classified Substandard ORE			100	100
Previously Classified Doubtful ORE				
Previously Classified Loss ORE				
TOTAL ADDITIONS	553		100	653
Book Value at This Examination: 06/30/20x6	1,125		100	1,225

Assets with Credit Data or Collateral Documentation Exceptions | 99999

This Page includes assets with technical defects not corrected during the examination. The appropriate number or description is noted in the "Deficiency Description" column.

1 - Appraisal
2 - Title Search or Legal Opinion
3 - Borrowing Authorization
4 - Recordation
5 - Insurance
6 - Collateral Assignment
7 - Financial Statement
8 - Inadequate Income/Cash Flow Information
9 - Livestock Inspection
10 - Crop Inspection

Name or Description	Amount	Date of Most Recent Financial Statement	Deficiency Description
LOANS			
AMHERST, MARY	400	None	7
BODY, CHARLES	1,932	12/31/2014	7
C&C MARINA	1,973	6/30/2014	7
GOETZ, MICHAEL	1,538	None	1
IRMA DEAT, LTD.	750		4, 6
JENNINGS, JENNIFER	1,906		5, 6
KING, CHRISTOPHER	290		4, 5, 6
Gty: Sam King		None	7
LAST CHANCE MOTEL, INC.	500		3, 4, 6
TOTAL	9,289		

Total represents 33 percent of the dollar volume of loans reviewed.

Name or Description	Amount	Date of Most Recent Financial Statement	Deficiency Description
OTHER REAL ESTATE OWNED			
ONE WAY HOME, INC. PROPERTY	550		5
TOTAL	550		

Total represents 45 percent of the dollar volume of ORE reviewed.

DESCRIPTION	DETAIL	AMOUNT EXTENDED

CORRESPONDENT BANK CONCENTRATIONS

FIRST NATIONAL BANK
Anothercity, Anotherstate

Due From Account	4,025	
Federal Funds Sold	5,000	
		9,025

- Concentration to First National Bank (FNB) represents 111 percent of Tier 1 Capital plus the allowance for loan and lease losses.
- Aggregate monthly balances have averaged over $9 million for the past six quarters.
- Management does not formally measure or track the level of this concentration.
- Management does not perform formal financial analysis of FNB.
- Management stays abreast of the FNB's financial condition through routine business contacts and review of publicly available financial data.
- The overall health of regional banks is satisfactory.
- Credit risk is relatively low due to FNB's current financial strength.
- Concentration risk is moderate due to a lack of formal monitoring procedures.
- Deterioration in FNB's financial position could negatively affect daily operations as the Bank of Anytown uses the Due From FNB account to clear transactions and the federal funds sold account is a primary liquidity source.
- Policies and procedures for ensuring compliance with the Federal Reserve's Regulation F are satisfactory; however, management has not established formal guidelines for identifying or limiting overall correspondent concentrations.

Summary

This correspondent bank concentration presents moderate risk to the institution and is generally adequately managed, though President Lincoln indicated that more formal correspondent bank risk management guidelines would be developed. See Question 1 on the Risk Management Assessment Page.

INDIVIDUAL BORROWER CONCENTRATION

John and Mary Smith Relationship

John and Mary Smith		
RE mortgage	500	
JMS Corporation		
JM: John and Mary Smith		
Secured commercial loans (3)	785	
Commercial letters of credit (2)	315	
J&M Realty Trust		
Gty: John and Mary Smith		
Commercial RE mortgage	750	
		2,350

The Smiths own JMS Corporation (JMS), which repairs and resells used wood pallets, and J&M Realty Trust, which holds their commercial property. This credit concentration represents 29 percent of Tier 1 Capital plus the allowance for loan and lease losses.

The wood pallet industry is facing increased competition from the plastic pallet industry. However, JMS's recycling of scrap wood has allowed it to maintain solid sales and profitability levels to offset the effect of the increased competition. The borrowers have had a very positive, long-term credit relationship with the bank, the notes are well collateralized by diverse and marketable collateral, and the concentration poses limited risk to the bank.

The Loan Policy includes appropriate credit limits to one borrower, and management reports large credit relationships to the Board each month. However, the Smith's residential mortgage was not identified in the bank's relationship analysis and the Smith relationship has not been reported to the Board as a concentration. The most recent annual loan review for this credit relationship included adequate analysis of the economic and competitive factors that may affect this concentration's risk profile, and the internal risk rating is appropriate. However, the origination of the J&M Realty Trust mortgage on 1/2/20x6, caused the outstanding balances for this relationship to exceed the Anystate legal lending limit statute, as discussed previously on the Violations of Laws and Regulations page for further discussion.

Summary

The concentration poses limited risk to the institution. However, concentration identification and reporting practices need improvement. See Question 1 on the Risk Management Assessment Page.

INDUSTRY CONCENTRATION

Shellfish Fishing Industry (NAICS Code 114112) 8,694

Identification - This credit concentration consists of loans to borrowers who specialize in shell fishing or the sale of customized fishing vessels and equipment. Although loans to the shell fishing industry represent 107 percent of Tier 1 Capital plus the allowance for loan and lease losses, management does not measure or track the credits as a concentration of risk.

Economic and Competitive Factors - Management stays abreast of general factors and economic trends relating to the industry through local news reports and discussions with borrowers. However, management does not maintain a formal process for obtaining and disseminating economic, competitive, or regulatory information to the Board or loan staff. Given the informality of the process, management was unaware of some key factors adversely affecting the industry, such as federal efforts to reduce overfishing through lower fuel subsidies and State proposals to reduce daily catch limits and shorten permissible fishing hours.

Risk Stratification and Vulnerability Assessment - Most of the borrowers are fishermen that share the same fishing grounds, as there are no alternative grounds readily available. The collateral consists of specialized fishing vessels and equipment that are not easily converted to other purposes, thereby limiting their marketability.

Borrower CF is heavily influenced by catch volumes, market price, and operating costs. Although sustained demand has contributed to higher per-pound prices, lower catch volumes and higher fuel costs have reduced profitability levels and increased repayment risk associated with this industry.

Underwriting standards are heavily reliant on collateral values, with limited analysis of projected CFs. Delinquencies remain relatively low, but have been increasing. Internal risk ratings, which appear to accurately reflect the characteristics of individual loans, have not been aggregated for analysis of the fishing portfolio. Additionally, as management does not formally monitor industry risks, there has been no analysis of the potential impact to the institution's asset quality, earnings, or capital if adverse trends continue.

Risk Management and Control Processes - Management relies on general loan delinquency reports and periodic discussions with borrowers to monitor loans to the fishing industry. Although the strategic plan identifies fishing as an important factor in the local economy, it does not address any of the unique risks or mitigating risk management practices associated with lending to this industry. Also, as noted above, management has not established formal procedures to identify, aggregate, or track loans to the fishing industry, and the loan policy does not address portfolio concentration limits.

Summary

Monitoring of this concentration has been relatively informal, given management’s long term experience in lending to this industry, but given the size of the concentration and vulnerabilities in the industry, risk management should be more robust. President Lincoln stated that plans are to continue to lend in this industry at the current levels; however, she stated that oversight and administration of the concentration would be strengthened. See Question 1 on the Risk Management Assessment Page.

COMMON EQUITY TIER 1 CAPITAL (CET1)		
Common Stock and Surplus net of Treasury Stock and unearned ESOP shares	6,027	
Retained Earnings	103	
Accumulated Other Comprehensive Income	60	
Common Equity Tier 1 Minority Interest includable in Common Equity Tier 1		
Subtotal: Common Equity Tier 1 Capital Before Adjustments and Deductions		6190
Adjustments and Deductions to CET1		
Less: Goodwill net of Associated Deferred Tax Liabilities		
- Intangible Assets (other than Goodwill and Mortgage Servicing Assets), net of associated deferred tax liabilities		
- Deferred Tax Assets that arise from net operating loss and tax credit carryforwards, net of any related valuation allowances and net of deferred tax liabilities		
- AOCI-related Adjustments[1]	60	
- Unrealized net gain (loss) related to changes in the fair value of liabilities that are due to changes in own credit risk		
- All other deductions from (additions to) CET1 capital before threshold-based deductions		
- Investments in the capital of unconsolidated financial institutions in the form of common stock that exceeds the 25 percent CET1 Capital deduction threshold		
- MSAs, net of associated DTLs that exceed the 25 percent CET1 capital deduction threshold		
- DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTLs that exceed the 25 percent CET1 deduction threshold[3]		
- Deductions for insufficient amounts of Additional Tier 1 and Tier 2 capital to cover deductions		
Subtotal: Adjustments and Deductions to CET1		60
Less: Assets Other than Held-for-Investment Loans and Leases Classified Loss	125	
- Additional Provision (to be Transferred to Tier 2 Capital, if applicable)[2]	325	
- Other Adjustments to and Deductions from Common Equity Tier 1 Capital[3]		
Subtotal: Other Adjustments and Deductions to CET1		450
Common Equity Tier 1 Capital		5,680
ADDITIONAL TIER 1 CAPITAL		
Noncumulative Perpetual Preferred Stock and related Surplus		
Non-qualifying capital instruments subject to phase-out from Additional Tier 1 capital		
Tier 1 Minority Interest not included in CET1 Capital		
Subtotal: Additional Tier 1 Capital before Deductions		
Less: Additional Tier 1 Capital Deductions		
Additional Tier 1 Capital		
Tier 1 Capital		5,680

TIER 2 CAPITAL [(2)]

Tier 2 Capital instruments and related surplus		
Non-qualifying capital instruments subject to phase-out from Tier 2 Capital		
Total capital minority interest that is not included in Tier 1 capital		
Allowance for Loan and Lease Losses	1,979	
Less: Held-for-Investment Loans and Leases Classified Loss	890	
Add: Additional Provision Transferred from Common Equity Tier 1 Capital	325	
Examination Adjusted Allowance for Loan and Lease Losses	1,414	
Less: Excess Allowance for Loan and Lease Losses (If Applicable)	728	
Allowance for Loan and Lease Losses Includable in Tier 2 Capital	686	
Subtotal: Tier 2 Capital Before Deductions	686	
Less: Tier 2 Capital Deductions		
Tier 2 Capital		686
TOTAL CAPITAL[(2)]		6,366

RISK-WEIGHTED ASSETS AND AVERAGE TOTAL ASSETS CALCULATIONS[(2)]

Risk-Weighted Assets Before Deductions for Excess Allowance for Loan and Lease Losses and Allocated Transfer Risk Reserve	55,920	
Less: Excess Allowance for Loan and Lease Losses	728	
Less: Allocated Transfer Risk Reserve		
Less: Risk-Weighted Asset Amounts Deducted from Capital	1,015	
Total Risk-Weighted Assets		54,177
Average Total Assets	76,803	
Less: Deductions from Common Equity Tier 1 Capital and Additional Tier 1 Capital[(3)]	450	
Average Total Assets for the Leverage Ratio		76,353

MEMORANDA

Capital Conservation Buffer[(2)]		N/A
Securities Appreciation (Depreciation)		1,126
Contingent Liabilities/Potential Loss	130,787 / 0	

Footnotes:

(1) Includes AOCI adjustments by banks making the AOCI opt-out election and the adjustment for certain accumulated gains (losses) on cash flow hedges by banks not making the AOCI opt-out election as outlined in Part 324.

(2) Institutions under the CBLR framework do not calculate Tier 2 Capital. For such institutions, Tier 1 Capital equals Total Capital under Part 324. In addition, these institutions do not calculate Risk-Weighted Assets or the Capital Conservation Buffer.

(3) Includes adjustment for financial subsidiaries as defined by the Gramm-Leach-Bliley Act of 1999, if applicable.

Comparative Statement of Income

	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Interest Income	2,519	5,582	7,329
Interest Expense	894	2,452	3,850
Net Interest Income	1,625	3,130	3,479
Noninterest Income	304	589	643
Noninterest Expense	1,467	2,902	2,904
Provision for Loan and Lease Losses	300	1,025	1,580
Securities Gains (Losses)	15	48	
Net Operating Income (Pre-Tax)	177	(160)	(362)
Applicable Income Taxes	74	(36)	(117)
Net Operating Income (After-Tax)	103	(124)	(245)
Discontinued Operations Net of Applicable Income Taxes			
Net Income (Loss) Attributable to Noncontrolling (Minority) Interests			
Net Income	103	(124)	(245)
Other Increases/Decreases	60		
Includes changes in the net unrealized holding gains (losses) on Available-For-Sale Securities			
Cash Dividends			
Net Change in Equity Accounts	163	(124)	(245)

Reconcilement of Allowance for Loan and Lease Losses

	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Beginning Balance	1,748	1,407	950
Gross Loan and Lease Losses	181	884	1274
Recoveries	112	200	151
Provision for Loan and Lease Losses	300	1025	1580
Other Increases (Decreases)			
Ending Balance	1,979	1,748	1,407

Other Component Ratios and Trends

Ratio	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Interest Income (TE)/Average Earning Assets	4.74	4.37	4.64
Total Noninterest Expense/Average Assets	3.82	3.62	3.54
Net Income/Average Total Equity	3.39	-2.05	-3.87
Net Losses/Average Total Loans and Leases	0.025	1.24	1.88
Earnings Coverage of Net Losses (X)	6.7	-1.19	-1.08
ALLL/Total Loans and Leases	3.67	3.15	2.5
Noncurrent Loans and Leases/ALLL	106.47	143.88	100.64

Footnotes:

ITEMS	06/30/20x6	12/31/20x5	12/31/20x4
INTEREST INCOME:			
Interest and fee income on loans	2,185	4,826	6,305
Income from lease financing			
Interest on balances with depository institutions			
Income on Federal funds sold and repos	66	350	512
Interest from assets held in trading accounts			
Interest and dividends on securities	268	406	512
Other Interest Income			
TOTAL INTEREST INCOME	2519	5582	7,329
INTEREST EXPENSE:			
Interest on deposits	858	2,434	3,832
Expense on Federal funds purchased and repos	5	18	18
Other interest expense	31		
TOTAL INTEREST EXPENSE	894	2,452	3,850
NET INTEREST INCOME	1,625	3,130	3,479
NONINTEREST INCOME:			
Services charges on deposit accounts	234	461	415
All other noninterest income	70	128	228
TOTAL NONINTEREST INCOME	304	589	643
NONINTEREST EXPENSE:			
Salaries and employee benefits	750	1,422	1,342
Premises and fixed assets expense (net of rental income)	271	549	584
Amortization expense of intangible assets (including goodwill)			
Other noninterest expense	446	931	978
TOTAL NONINTEREST EXPENSE	1,467	2,902	2,904
Provision for loan and lease losses	300	1,025	1,580
Securities gains (losses)	15	48	
NET OPERATING INCOME (PRETAX)	177	(160)	(362)
Applicable income taxes	74	(36)	(117)
NET OPERATING INCOME (AFTERTAX)	103	(124)	(245)
Discontinued operations net of applicable income taxes			
Net income (loss) attributable to noncontrolling (minority) interests			
NET INCOME	103	(124)	(245)
Other increases in equity capital accounts	60		
Other decreases in equity capital accounts			
Cash dividends declared on common stock			
Net change in equity capital accounts for the period	163	(124)	(245)
Equity capital accounts at beginning of the period	6,027	6,151	6,396
Equity capital accounts at end of the period	6,190	6,027	6,151

Footnotes:

HOLDING COMPANY RATIOS AND TRENDS

	HOLDING COMPANY		
CONSOLIDATED HOLDING COMPANY	(Date)	(Date)	(Date)
Net Operating Income to Average Assets Total Risk-Based Capital Ratio Leverage Capital Ratio This Institution's Assets to Consolidated Holding Company Assets			
PARENT ONLY			
Pre-Tax Operating Income and Interest Expense to Interest Expense (X) (Fixed Charge Coverage) Operating Income - Tax + Non-Cash Items to Total Operating Expense and Dividends Paid (Cash Flow Match) Total Liabilities to Equity Equity Investments in Subsidiaries to Equity (Double Leverage) Equity Investment in Subsidiaries - Equity Capital/Net Income - Dividends (Double Leverage Payback in Years)			

EXTENSIONS OF CREDIT TO AFFILIATED ORGANIZATIONS

DESCRIPTION	DIRECT	INDIRECT	TOTAL
A. Affiliated organizations including securities issued by affiliated organizations.	250		250
B. Indebtedness of others, or portions of such indebtedness, collateralized by securities issued by affiliated organizations.			0
Total	250	0	250
Less duplications within and between groups			0
Net Total	250	0	250

Comments:

HOLDING COMPANY

Any Company, Inc.
Anytown, Anystate

SUBSIDIARY

Any Time, Inc.
Anytown, Anystate

OTHER AFFILIATES

Any Body, Inc.
Anytown, Anystate

Extensions of Credit to Directors/Trustees, Officers, Principal Shareholders, and Their Related Interests	**99999**

Description	**Total**
A. Executive Officers and their related interests	1,200
B. Directors/Trustees and Principal Shareholders and their related interests	250
TOTAL	1,450
Less duplications within and between groups	250
NET TOTAL	1,200
Capital and unimpaired surplus as of last Call Report date (Per Regulation "O")	7,094
Net total insider borrowing as a percentage of unimpaired capital and surplus	16.92%

NAME AND COMMENTS (Designate all duplications with a "D")	Detail	% of Unimpaired Capital & Surplus
Group A		
LINCOLN, ALLIE C. Director and President	500	7.05%
GUTIERREZ, JOHN M. Executive Vice President and Cashier	450	6.34%
ANY BODY, INC. Duplication debt guaranteed by President Lincoln and Director Green.	250 D	3.52%
TOTAL	1,200	
Group B		
ANY BODY, INC. A related interest of President Lincoln and Director Green. Both individuals guarantee the debt.	250 D	3.52%

Safety and Soundness

Composite 3. Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Information Technology

Composite 2. Financial institutions and service providers rated composite "2" exhibit safe and sound performance but may demonstrate modest weaknesses in operating performance, monitoring, management processes, or system development. Generally, senior management corrects weaknesses in the normal course of business. Risk management processes adequately identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are defined but may require clarification, better coordination, or improved communication throughout the organization. As a result, management anticipates, but responds less quickly to changes in market, business, and technological needs of the entity. Management normally identifies weaknesses and takes appropriate corrective action. However, greater reliance is placed on audit and regulatory intervention to identify and resolve concerns. The financial condition of the service provider is acceptable and while internal control weaknesses may exist, there are no significant supervisory concerns. As a result, supervisory action is informal and limited.

Trust

Composite 2. Administration of fiduciary activities is fundamentally sound. Generally, no component rating should be more severe than 3. Only moderate weaknesses are present and are well within management's capabilities and willingness to correct. Fiduciary activities are conducted in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Compliance

Composite 2. An institution in this category is in a generally strong compliance position. Management is capable of administering an effective compliance program. Although a system of internal operating procedures and controls has been established to ensure compliance, violations have nonetheless occurred. These violations, however, involve technical aspects of the law or result from oversight on the part of operating personnel. Modification in the bank's compliance program and/or the establishment of additional review/audit procedures may eliminate many of the violations. Compliance training is satisfactory. There is no evidence of discriminatory acts or practices, reimbursable violations, or practices resulting in repeat violations.

Community Reinvestment Act (CRA)

A CRA rating of "Satisfactory" is assigned. An institution in this group has a satisfactory record of helping to meet the credit needs of its assessment area, including low- and moderate income neighborhoods, in a manner consistent with its resources and capabilities.

Refer to http://www.fdic.gov/regulations/examinations/ratings/index.html for definitions of all composite ratings.

We the undersigned directors/trustees of Bank of Anytown, Anytown, Anystate, have personally reviewed the contents of the Report of Examination dated June 30, 20x6

Signatures of Directors/Trustees	Date
Henry P. Black	
Michael D. Brown	
Larry G. Green	
Kerry A. Jones	
Allie C. Lincoln	
Jaime S. Martin	
John D. Scott	
Roger White	

NOTE: This form should remain attached to the Report of Examination and be retained in the institution's file for review during subsequent examinations. The signatures of committee members will suffice only if the committee includes outside directors and a resolution has been passed by the full board delegating the review to such committee.

CONTROL AND RELATIONSHIPS

Any Company, Inc., a one-bank holding company, continues to own 100 percent of the bank's common stock. Bank directors own or control a combined 908,584 shares or 56 percent of holding company stock. President Lincoln is the largest individual stockholder, controlling 500,326 shares or 31 percent of the outstanding stock. Any Time, Inc. is a subsidiary of the bank and holds title to ORE. Any Body, Inc., is an on-premise insurance agency owned by President Lincoln and Director Green that sells credit life, auto, fire, and disability insurance but does not utilize bank employees or equipment. President Lincoln stated that no ownership or management changes are planned. President Lincoln notified the bonding company of the nonbank activity being conducted on the premises and received an acknowledgement letter from the bonding company dated November 9, 20x5. On January 20, 20x6, the board of directors of Any Company reviewed the operations of Any Body, Inc., and approved its continued operations and lease of bank space for another year.

DIRECTOR INVOLVEMENT

One of the bank's directors contacted the EIC during the examination to discuss his concerns with the current committee structure of the bank. Director John Scott indicated that he felt the Loan Committee membership should be expanded and that the committees were dominated by Chairman White and President Lincoln.

DOMINANT MANAGEMENT

Chairman of the Board Roger White and President Allie Lincoln exhibit a dominant influence over the bank's affairs. Their dominance over policy discussion and decisions has negatively impacted the condition of the institution as noted throughout the report of examination. Both Chairman White and President Lincoln were responsive to regulatory concerns and promised prompt corrective actions to implement the current exam recommendations and outstanding MOU.

EXAMINATION SCOPE

Examination Number 12345

The examination scope was expanded from the pre-exam planning (EP) memo in the following areas:

- Construction Lending – Expanded due to administrative problems identified in the original loan sample. Ten additional construction loans serviced by the two construction lenders and originated in 20x6 were reviewed.
- BSA Review – Expanded to include a review of all Currency Transaction Reports filed in 20x6 due to indications that they were being filed late.
- Call Report Review – Expanded to include year-end 20x5 in response to the volume of errors noted with the original review.

As a result, examination hours, totaling 760, are 150 over budget (25 percent). Other examination procedures were not modified from those identified in the EP memo and no significant variances between projected and actual examination hours, scope, or procedures were noted in the BSA/AML (Exam #12346), Trust (Exam #12347), or IT (Exam #12348) reviews.

SUGGESTIONS FOR FUTURE EXAMINATIONS

There is sufficient working space for seven examiners.
Management accommodated working hours of 7:30am to 5:30pm.
The examination crew should contain at least one examiner with experience in construction loan analysis.

List alphabetically all directors/trustees, senior officers, and principal stockholders. Also indicate their titles. Number of shares owned is not rounded. (J – indicates stock jointly owned; P – indicates preferred stock owned; H – indicates holding company stock owned; C – indicates stock controlled but not owned)

Names and Comments	Net Worth		Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
	Amount	Date of Statement					

Biographical and background information on directors, officers, and other key management officials listed on this page should be prepared in accordance with the Report of Examination Instructions.

DIRECTORS/TRUSTEES

Names and Comments	Amount	Date of Statement	Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
BLACK, HENRY P. Attorney *Address*	501	3/1/20x5	1980	1961	12	50,992 (H)	
BROWN, MICHAEL D. Commercial RE Consultant (1) *Address*	7,890	6/1/20x5	1983	1959	5	5,005 (H)	
GREEN, LARRY G. Automobile Dealership Owner (1) *Address* *Estimated by President Lincoln.	10,000	8/1/20x6*	1981	1955	12	200,150 (H)	
JONES, KERRY A. Retired Doctor *Address*	2,500	6/1/20x5	1979	1933	12	1,010 (H)	
LINCOLN, ALLIE C. President (1)(2) *Address*	1,357	2/1/20x5	1982	1951	12	500,326 (H)	100 25(B)
MARTIN, JAIME S. Economist *Address*	3,565	3/1/20x5	1981	1950	11	150,500 (H)	
SCOTT, JOHN D. Certified Public Accountant (2) *Address*	7,234	8/7/20x5	1982	1954	11	101 (H)	
WHITE, ROGER Chairman of the Board (1)(2) *Address* *Estimated by Money Magazine.	5,000	6/24/20x6*	1980	1960	12	500 (H)	24(B)

OFFICERS, NOT DIRECTORS/TRUSTEES

Names and Comments	Amount	Date of Statement	Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
COOK, LESLIE S. Executive Vice President - Commercial Lending (1)			1983	1960			85

Names and Comments	Net Worth		Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
	Amount	Date of Statement					
GUTIERREZ, JOHN M. Executive Vice President / Cashier (2)			1983	1958			70
PRINCIPAL SHAREHOLDERS, NOT DIRECTORS/TRUSTEES OR OFFICERS							
ANY COMPANY, INC. Anytown, Anystate						162,247	

(1) Loan Committee
(2) Investment Committee

Total Holding Company shares owned by the Directorate: 908,584
Percentage Holding Company ownership by the Directorate: 56 percent

There have been 12 regular Board meetings since the last regulatory examination.
Director fees are $250 per Board meeting attended.
Committee fees are $100 per committee attended.

DISCLAIMER This section of the Bank of Anytown provides sample comments for International pages in the Report of Examination. The information on the pages is not intended to tie directly with information in other sections of the Bank of Anytown Report of Examination.

BANK OF ANYTOWN

ANYTOWN	**ANY COUNTY**	**ANYSTATE**

Region:	Any Region	Certificate Number:	99999
Examiner-In-Charge:	Sandra E. Smart		
Examination Start Date:	August 1, 2015		
Examination As Of Date:	June 30, 2015		

INTERNATIONAL REPORT PAGES

Description	Detail	Not Rated	Substandard	Value Impaired	Loss
Anycountry					
November 13, 2015					
Performing Short-Term Trade Credits		15			
Performing Short-Term Bank Credits		10			
All Other Exposures	250				
Less: Loss Classification on Credit Risk	-150				
Net Exposure			100		

In December 2014, the Anycountry government defaulted on $50 billion of bonds held by foreign creditors and subsequently imposed strict capital controls that severely limited the ability of private borrowers to service their external liabilities. Private borrowers from Anycountry have accumulated significant interest and principal arrears to external creditors. Prior to the present interruption of external debt service, the country had been current on payments since completing a restructuring of bank debt in the early 1990s.

U.S. banks cut their exposures to Anycountry sharply in 2014, reflecting material reductions in business activities/lending and significant write-offs. In June 2015, U.S. banks' cross-border exposure totaled $6.2 billion, down roughly 44 percent from a year earlier. Locally funded business fell by over two-thirds, to $3.3 billion.

Amount scheduled as Substandard represents exposure to the Anycountry Distillery Corporation. Another facility to the Anycountry Oil Corporation is not adversely classified for transfer risk as it is subject to a credit risk classification of Loss.

Insert the actual transfer risk write-up provided by the Interagency Country Exposure Review Committee. Adjust the comments if more severe adverse classifications (based on credit risk) are scheduled in the ROE.

Note: Countries and amounts provided are for illustrative purposes and do not reflect actual classifications.

Management of the country risk process is satisfactory. Senior management and the Asset/Liability Management Committee continue to closely monitor the economic and political stability of countries where the bank maintains international transaction activity. Due to deteriorated economic and political situations in certain countries where the bank conducts business, there has been a reorientation of business strategy. The Board has strategically decided to focus future business development on its domestic banking market and to reduce its overall risk emanating from transfer risk exposure. As a result, the bank has substantially reduced the level of approved country limits, and it has frozen most assigned limits, and the resulting level of net transfer risk exposure.

Refer to additional guidance for completing this page contained in the ROE Instructions and the Interagency Statement on Sound Country Risk Management Practices.

Note: Countries and amounts provided are for illustrative purposes and do not reflect actual classifications. Amounts shown do not correspond with other information in the Bank of Anytown ROE.

Description	Detail	Amount Extended
Argentina		
Value Impaired	980	
Less: ATRR	-784	
Net Amount	196	

The concentration represents 1.00 percent of Tier 1 capital. All credits are rated Value Impaired and subject to an ATRR of 80 percent.

Description	Detail	Amount Extended
Ecuador		
Transfer Risk Claims	580	
Less: Performing Short-Term Trade and Bank Credit	-80	
All Other Credit - Substandard		500

The concentration represents 2.55 percent of Tier 1 capital. Performing short-term trade and bank credit is not rated.

Description	Detail	Amount Extended
United Kingdom		
Transfer Risk Claims		6,325

The concentration represents 32.27 percent of Tier 1 capital. The amount is listed for informational purposes.

Refer to specific guidance for completing this page contained in the Report of Examination Instructions section of the Manual.

Note: Countries and amounts provided are for illustrative purposes and do not correspond with other information in the Bank of Anytown ROE.

DISCLAIMER: This information is provided to illustrate a relatively complex PBO. It does not correspond to other ownership/control information provided in the Bank of Anytown.

List the following information for the bank(s) and/or bank holding company(s) in the PBO.

U.S. Name: Demo International Bank[1]
City, Country: Miami, FL
Number of Outstanding Shares: 1,000,000

Foreign Name: Demo International, C.A.
City, Country: Caracas, Venezuela
Number of Outstanding Shares: 50,000

Foreign Name: Demo Bank Venezuela[2]
City, Country: Caracas, Venezuela

Foreign Name: Demo Bank do Brazil[3]
City, Country: Brasillia, Brazil

Foreign Name: Demo Bank Mexico
City, Country: Mexico City, Mexico
Number of Outstanding Shares: 100,000

[1] Of the ten entities that compose the PBO, only the three foreign banks and the foreign bank holding company that actively engage in transactions with Demo International Bank, Miami, Florida are detailed above. The remaining five entities within the PBO structure include Demo Holdings, Caracas, Venezuela, which wholly owns Demo Bank International, Panama City, Panama; Demo Finance Company, Caracas, Venezuela, which wholly owns Demo Bank International, Guayaquil, Ecuador and Demo Bank Interandino, Lima, Peru.

[2] Wholly owned subsidiary of Demo International, C.A., Caracus, Venezuela.

[3] Wholly owned subsidiary of Demo Bank Venezuela, Caracas, Venezuela.

Detail the stock owned by the beneficial owner(s) whose direct/indirect control forms the nexus of the PBO.

U.S. Name: Demo International Bank	**Number of Shares**	**Percent Owned**	**Type of Control**
Beneficial Owner: Demo Family Trust (Jose Demo controls 100%)	750,000	75.00%	Direct
Beneficial Owner: Example Family Trust (Juan Example controls 100%)	250,000	25.00%	Direct

Foreign Name: Demo International, C.A.	**Number of Shares**	**Percent Owned**	**Type of Control[1]**
Beneficial Owner: Jose M. Demo[4]	5,000	10.00%	Direct
Beneficial Owner: Carlita S. Demo[4]	12,500	25.00%	Direct
Beneficial Owner: Paco M. Demo	7,500	15.00%	Direct
Beneficial Owner: Juan H. Example	12,500	25.00%	Direct
Beneficial Owner: Demo Family Members	12,500	25.00%	Direct

[4] Mr. Jose M. Demo has indirect control of the shares owned by his wife, Ms. Carlita S. Demo.

Foreign Name: Demo Bank (Mexico)	**Number of Shares**	**Percent Owned**	**Type of Control[1]**
Beneficial Owner: Jose M. Demo[5]	50,000	50.00%	Direct
Beneficial Owner: Carlita S. Demo[5]	25,000	25.00%	Direct

[5] Mr. Jose M. Demo has indirect control of the shares owned by his wife, Ms. Carlita S. Demo.

Discuss the factor(s) or combination of attributes (besides or in addition to common stock ownership) that was considered in determining whether a PBO relationship exists. Consider whether an individual or a group of individuals (e.g., family members, business partners, or any other group) acting together (directly or indirectly):

1) Constitute a quorum or a significant presence on the board of directors of both the U.S. depository institution and the foreign bank or the foreign bank holding company.

The members of the Demo family listed above serve as the chairman, vice chairman, or director for seven of the banking entities. However, none of the individuals are on the board of directors of Demo Bank International, Panama. Their membership does not constitute a quorum on any of the three foreign or U.S. bank boards, but does constitute a quorum on the board of the foreign bank holding company, Demo International, C.A.

2) Controls, in any manner, the election of a majority of the directors of the U.S. depository institution and the foreign bank or the foreign bank holding company.

The shareholder-meeting minutes for electing the directorate for Demo Bank Venezuela were not available for review. However, Mr. Jose Demo and his family members control the election through their ability to vote a majority of the holding company's stock. Mr. Jose Demo's ability to vote the majority of Demo International Bank's stock indicates that he controls the election of its directorate.

3) Constitutes a quorum or a significant portion of the executive management of both the U.S. depository institution and the foreign bank or the foreign bank holding company.

The members of the Demo family listed above serve as the president, vice president or cashier of Demo International Bank, Demo International, C.A. and at the seven foreign banks, except Demo Bank International, Panama. Their positions constitute a quorum of the executive management at Demo International, C.A., (Venezuela) but not the other banks, but they do occupy critical positions on those teams.

4) Exercises a controlling influence over the management and/or policies of both organizations.

Mr. Jose Demo is chairman of Demo International Bank and president of Demo Bank Venezuela, which enables him to exert a controlling influence over the management and policies of both organizations.

5) Engages in an unusually high level of reciprocal correspondent banking and/or other transactions or facilities between the U.S. depository institution and the foreign bank.

The banks primarily engage in correspondent bank services, dollar clearings, letters of credit, and trade related transactions. Fee income from transactions with the three foreign banks equaled over 40 percent of the total fee income generated by Demo International Bank in 2011. The U.S. bank also extended a $5 million line of credit secured by a $5 million certificate of deposit to Demo Bank Venezuela, Caracus, Venezuela.

6) Obtains financing to purchase the stock of either the U.S. depository institution or the foreign bank or the foreign bank holding company from, or arranged by, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan.

None noted.

7) Requires the U.S. depository institution to adopt particular/unique policies or strategies similar to those of the foreign bank, such as common or joint marketing strategies, cross-selling of products, sharing of customer information, or linked web sites.

The Demo International Bank's website is linked to Demo Bank Venezuela's website. Both offer similar loan and deposit products and banking services.

8) Names the U.S. depository institution in a similar fashion to that of the foreign bank.

The titles of the banking organizations use similar naming conventions.

9) Presents any other factor(s) or attribute(s) that affected the conclusion.

None known.

Summarize the Examination Findings

The review determined that a PBO relationship exists between Demo International Bank and three foreign banks and a foreign bank holding company through the common control of the Demo family, primarily through Mr. Jose Demo's ownership/control of the Demo International Bank in Miami, Florida; Demo International, C.A. in Caracas, Venezuela (foreign bank holding company); and Demo Bank Mexico in Mexico City, Mexico. Each of the affiliated foreign banks has audited annual reports for the most recent fiscal year.

Demo Bank do Brazil reported a negative 0.3 percent return on average assets for the most recent fiscal year because of elevated credit losses. Its book capital (minus goodwill) declined to 5 percent of total assets as of December 31, 2015. Other foreign financial affiliates had positive net income and at minimum, a book capital to assets ratio of 10 percent as of December 31, 2015.

Bank management acknowledges that the institutions are under common control and actively monitors all transactions with affiliated entities. No adverse trends were noted relating to transactions with foreign banking affiliates. Refer to the Related Organizations page and the Risk Management Assessment page for additional information.

Return to top.

INTERNATIONAL WORKPAPERS

An international loan, acceptance, or letter of credit is defined as any such instrument between this bank and a resident or entity domiciled outside the United States, District of Columbia, Puerto Rico or other United States Territory or Possession.

DISTRIBUTION

Description	Amount
Mortgage loans (Including Ship loans of $2,327)	8,732
Loans insured or guaranteed by the U.S. government or its agencies	14,065
Loans to foreign governments, agencies thereof and central banks	15.971
Loans to financial institutions other than central banks	500
Loans to commercial, industrial and agricultural interests	41,689
Other Loans (Describe) Loans to religious institutions	8,572
All other loans	1,171
Total International Loans*	90,700
*Does NOT include loans to U.S. subsidiaries of foreign corporations	12,444

Description	Amount
Participation loans and paper purchased	41,505
Placed paper, direct loans and participation loans sold	5,365
Syndication and consortium financing	5,000
International acceptances outstanding	1,489
International letters of credit outstanding	7,836
Other (Describe)	

1. Are duties and responsibilities for the conduct of international operations clearly defined? Comment briefly.

Yes. The bank's Board of Directors has approved a satisfactory, written policy statement setting forth the various duties and responsibilities of the operating entities within the international division.

2. Does the bank have a definite international lending policy? If "yes", summarize such, state whether it has been approved by the board of directors/trustees, and indicate extent of compliance.

Yes. The bank's Board of Directors, in line with the directives of the parent bank, has delineated specific guidelines on clientele to be served, limits on country exposure both in the aggregate and by maturity within those limits and risks to be undertaken. Officers submit recommendations to the international loan committee, which has authority to approve loans up to $5 million. Larger loans require senior loan committee approval. In all cases, these policies are adequate for the bank's needs and have been appropriately followed.

3. (a) Comment upon policy guidelines in effect regarding country risk assets and volume limitations imposed thereon. (b) How often are guidelines reviewed? (c) Does the bank have any country risk concentrations of credit? If "yes", list the country and percentage of such extensions of credit to the bank's total capital and reserves.

(a) The policy requires all extensions of credit (including bank placements, formal loan commitments, and foreign exchange lines) to be included within country limits. Claims are reallocated to the country of guarantor or the country where collateral is realizable. Sub-limits are provided by maturity of the obligation. Separate limits are provided for each of the 15 countries where lending is permitted.
(b) Reviewed quarterly.
(c) Yes, Japan 84%, France 40%, Federal Republic of Germany 59%, United Kingdom 39%.

4. Are guarantees of other banking institutions and/or parent or affiliated organizations of borrowers required on certain loan obligations? If "yes", under what circumstances and in what form are such guarantees extended?

Yes. Letters of Guarantee from two European banks have been furnished as support to financially weak borrowers. The parent bank has extended guarantees in the form of letters of credit essentially to provide additional protection to the subject bank's position. The parent's guarantee was not relied upon as a primary source for repayment of the loan.

5. (a) Describe the general nature and character of collateral pledged, and (b) comment upon the adequacy of supporting documentation.

(a) Collateral includes first preferred ship mortgages, notes and bond obligations of various foreign governments, time deposits, commodities, stocks, and UCC filings.
(b) Supporting documentation appeared in order.

6. Is credit information timely in content and available in sufficient readable detail?

Credit information on loans originated at the Nassau Branch continues to be inadequate. Deficiencies include a lack of current and complete financial information on the obligor and guarantor, an absence of thorough credit analysis, and a lack of complete information on country conditions. Management initiated a project (and hired two new credit analysts at the Nassau Branch) during the examination to enhance the availability and sufficiency of credit information on loans originated at the Nassau Branch.

7. (a) Describe the general nature and types of acceptance financing extended, and (b) the general lines of business involved.

(a) The bank is primarily involved in acceptance financing in connection with international trade activity.

(b) The acceptance financing involves manufactured goods, commodities, and exchange activities of central banks.

8. (a) Describe the general nature and types of letter of credit accommodations offered, and (b) the general lines of business involved.

(a) The bank issues documentary letters of credit to importers, confirms other banks' letters of credit for export customers and, to a limited extent, engages in deferred payment letter of credit financing. Standby letters of credit are undertaken only for prime customers.

(b) The letters of credit involve manufacturers, machinery exporters and importers, commodity importers, and foreign governments and agencies.

9. Describe the provision for repayment of (a) acceptances, and (b) drafts drawn under letters of credit. Include comment regarding extent of refinancing.

(a) and (b) Provisions for repayment are arranged prior to issuance and vary as individual conditions warrant. Repayment is generally accomplished by charge to customer's account or by loan accommodation under approved credit lines in the case of acceptances and by charge to the customer's account or acceptance with respect to letters of credit. In certain situations, refinancing is permitted, generally for short periods.

1. Comment on the general nature and volume of present Eurocurrency operations.

Eurocurrency operations are conducted through the Nassau Branch. Investments are primarily loans to South American corporations and central governments, securities of foreign governments and bank placements. Sources of funding are individual, partnership, corporation, bank, and affiliate time deposits. As of the examination date, Eurocurrency loans, securities, and bank placements totaled $325 million with approximately 98 percent of the placements funded by Eurocurrency time deposits.

2. Describe the procedures followed and guidelines utilized in establishing lines of credit and making and approving due to (takings) and due from (placements). Comment on the adequacy of procedures enabling senior management to ascertain compliance with guidelines and directives.

The parent bank has issued adequate guidelines to be considered before establishing lines of credit and bank relationships. With respect to banks, these criteria center on the obligor’s capital resources, country risk, and type of institution. Bank and nonbank clientele analysis includes consideration of volume and maturity factors, as well as a review of financial responsibility and reputation. Senior management receives weekly reports.

3. (a) Comment on the maturity composition of present Eurocurrency takings and placements and the effect of such on the bank's liquidity position. (b) Are asset and liability maturities reasonably matched?

(a) On the examination date, Eurocurrency takings totaled $285 million, while placements aggregate $195 million. All placements and 74% of takings ($210 million) mature within 90 days with no adverse effects on the bank’s liquidity position.

(b) Both near-term and longer-term maturities are reasonably matched.

4. Are all interbank placements confirmed at inception and, thereafter, subject to periodic direct verification audits?

Yes.

NOTE: A negative answer below (questions 2 through 8(e)) may be indicative of a condition in need of correction. Such answers may call for comment, or expanded treatment, below or elsewhere in the examination report.

DESCRIPTION	YES	NO
1. Is the bank engaged, in any manner, in foreign exchange activities? If "Yes", answer the following questions:	X	
2. Is the net open position of each foreign currency reasonable in relation to the bank's total capital and reserves?	X	
3. Is the aggregate net open position of all foreign currencies reasonable in relation to the bank's total capital and reserves?	X	
4. Are the future maturities of foreign currency assets, liabilities, and contracts reasonably matched with respect to long and short positions in all time periods?	X	
5. Does a current revaluation of the bank's foreign currencies reflect an insignificant profit or loss?	X	
6. Has the directorate and/or head office imposed reasonable guidelines and limits with respect to foreign exchange operations?	X	
7. Are guidelines and limits being adhered to by active management?	X	
8. With respect to foreign exchange operations, are the following adequate:		
(a) recording procedures?	X	
(b) bookkeeping procedures other than 8(a)?		X
(c) contract confirmation procedures?	X	
(d) internal routines and controls other than 8(c)?	X	
(e) audit procedures?	X	

8(b) Refer to comments under Audit and Internal Controls.

Country United Kingdom	Monetary Unit Pound Sterling			
Description	**Assets and Purchases (Long Position)**		**Liabilities and Sales (Short Position)**	
	Foreign Currency	U.S. Dollar Book Value	Foreign Currency	U.S. Dollar Book Value
Cash	1,000	2,600		
Demand Balances Due (Nostro)	50,000	19,800		
Loans	1,000,000	2,500,000		
Securities	100,000	275,800		
Deposits of Banks (Vostro)			100,000	242,000
Other Deposits			400,000	1,040,000
Spot Contracts	1,300,000	3,120,000	1,400,000	3,346,000
Forward Contracts				
Holdovers				
Other: (Specify) Accrued Interest Receivable	10,500	25,200		
Accrued Interest Payable			3,000	7,200
Gross Position	2,461,500	5,943,400	1,903,000	4,635,200
Less: Long/Short	1,903,000	4,635,200		
Net Position	558,500	1,308,200		
Net position as a % of the bank's total capital and reserves:	2.90%			

OTHER CURRENCIES								
		Long		**Short**		**Net Position**		**(%)***
Country	**Monetary Unit**	Foreign Currency	U.S. Dollar Book Value	Foreign Currency	U.S. Dollar Book Value	Foreign Currency	U.S. Dollar Book Value	**Net Position**
Australia	Dollar	24,600	27,900			24,600	27,900	0.06%
Canada	Dollar	66,000			90,000	66,000	(90,000)	0.20%
France	Franc	1,000,000	210,000			1,000,000	210,000	0.47%
Germany	Mark	693,000	215,000	203,000	61,000	490,000	154,000	0.34%
Italy	Lire	27,873,600	30,500	54,344,500	59,500	(26,470,900)	(29,000)	0.06%
Switzerland	France					0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
Subtotal (U.S.)						0	536,200	0.00%
Plus: Major Currency (U.S.)							1,308,200	
Aggregate Position (U.S.)						0	0	
* as a percentage of the bank's Total							1,844,400	3.88%
Capital and Reserves.								

DESCRIPTION	YES	NO
1a. Is the net open position of each foreign currency reasonable in relation to the bank's total capital and reserves?	X	
1b. Is the aggregate net open position of all foreign currencies reasonable in relation to the bank's total capital and reserves?	X	

MATURITY DISTRIBUTION SCHEDULE

Monetary Unit	Maturity Dates	Assets and Purchases Long	Liabilities and Sales Short	Net Gap for Period Long/Short	Spot Rate P = Prem. D = Disc.	Profit	Loss
		F.C.	F.C.	F.C.		U.S.	U.S.
Pound (UK)	5/15	51,000	100,000	(49,000)			
	5/16	25,000		25,000			
	5/17	25,000		25,000			
	5/18	35,000		35,000			
	5/19	50,000	40,000	10,000			
	5/22		50,000	(50,000)			
	5/23	50,000	75,000	(25,000)			
	5/24	100,000	50,000	50,000			
	5/25	50,000		50,000			
	5/30	50,000	75,000	(25,000)			
	5/31		100,000	(100,000)			
	June	110,500	100,000	10,500			
	July	125,000	203,000	(78,000)			
	August	175,000	110,000	65,000			
	September		75,000	(75,000)			
	October	245,000	225,000	20,000			
	November	175,000	100,000	75,000			
	December	325,000	200,000	125,000			
	20X6	370,000	300,000	70,000			
	20X7	150,000	50,000	100,000			
	20X8	250,000	50,000	200,000			
	After	100,000		100,000			
	TOTALS	2,461,500	1,903,000	558,500		0	0
				Less:	Profit/Loss		
				Future	**Adjustment**	0	0
						YES	**NO**
2. Are future maturities of foreign assets, liabilities, and contracts reasonably matched with respect to long and short positions in all time periods?						X	

Monetary Unit	Book Value of F.C.	Net Position U.S.	Exam Date Spot Rate	Current U.S. Market Value (F.C. x Spot)	U.S. Spot Rate Profit (Loss)	U.S. Future Profit (Loss) Adjustment	U.S. Net Profit or (Loss)
Australia $	24,600	27,900	1.149500	28,300	400		400
				0	0		0
Canada $	66,000	(90,000)	0.868300	57,300	147,300	(500)	146,800
				0	0		0
France Franc	1,000,000	210,000	0.219100	219,100	9,100		9,100
				0	0		0
German Mark	490,000	154,000	0.493800	242,000	87,700		87,700
				0	0		0
Italian Lira	(26,470,900)	(29,000)	0.001176	(31,100)	(2,100)		(2,100)
				0	0		0
Swiss Franc	(60,700)	(25,300)	0.532800	(32,300)	(7,000)		(7,000)
				0	0		0
UK Pound	558,500	1,308,200	2.222000	1,241,000	(67,200)	1,000	(66,200)
				0	0		0
				0	0		0
				0	0		0
				Total	168,200	500	168,700

Does not include $ profit (loss) attributable to outstanding SWAP transactions

$ has already been taken into income/expense through accrual accounting

	YES	NO
3. Does a current revaluation of the bank's foreign currencies reflect an insignificant profit or loss?	X	

Previous Calendar Year	Amount or Percent
Quarterly Average of Gross Assets	562,500,000
Total Foreign Exchange Income	1,000,000
Net Foreign Exchange Income (Loss)	550,000
% of Total Foreign Exchange Income to Average Gross Assets	0.18%
% of Net Foreign Exchange Income (Loss) to Average Gross Assets	0.10%
Year to Date	**Amount or Percent**
Total Operating Income (Bank)	25,156,300
Net Operating Income (Loss)	4,192,700
Total Foreign Exchange Income	735,200
Net Foreign Exchange Income (Loss)	404,400

1. **(a) Describe the net and aggregate position limits, maturity exposure limits, and any other limits placed on foreign exchange operations by the board of directors/trustees. (b) Do such limits appear reasonable?**

   (a) The bank's Board of Directors has authorized trading only in currencies listed in the position schedules. Overnight limits for each currency with the exception of the pound sterling are fixed at $250M; pound sterling limit is $1,500M. The aggregate position limit for all currencies is $2,000M. Maturity gaps are authorized only on major active currencies up to $100M not to exceed 3 months. Major active currencies have been described as having an active forward market.

   (b) Limits appear to be reasonable.

2. **Describe the limits and guidelines established by the board of directors/trustees for dealing in foreign exchange with other banks and customers.**

   Individual customer limits are approved by the bank's International Committee based on the customer's creditworthiness and the volume of its foreign currency needs. The bank's written internal credit policy pertaining to bank and nonbank customer foreign exchange lines is:

   (a) 100% of the foreign exchange line may mature within 180 days,
   (b) 50% of the foreign exchange line may mature within 360 days,
   (c) 20% of the foreign exchange line is available for contracts with maturities up to 18 months, and
   (d) no maturities may exceed 18 months.

   Excesses must be approved in writing by the account officer who approved the customer line. Maximum daily delivery risk limits per customer are set at 20% of the aggregate limits approved.

3. **Fully describe any recent significant deviations by the bank from established limits and guidelines. Include in this description any significant deviations noted after completion of the Position Analysis, and the Maturity Distribution (GAP) Analysis.**

   No deviations from bank policy were noted in preparing the position analysis. Two exceptions to bank policy on GAP exposure were in evidence due to an inability to obtain forward cover. These exceptions were approved by the International Committee. No other recent deviations were identified.

4. **(a) Describe the reports (i.e., position maturity, gap, revaluation, etc.) required by the directorate and senior management to ascertain compliance with bank policy. (b) Determine whether the directorate or senior management are notified when actions are taken which constitute deviation from policy? Describe and assess the approval procedures for such deviations from policy.**

   (a) Net position reports enumerating all foreign currency balance sheet items, future contracts, and after-hour and holdover transactions are transmitted to the designee of the International Committee on a daily basis. Reports are prepared by the foreign exchange bookkeeping department and reconciled to the trader's blotter. Maturity gap reports are produced daily with the next month's transaction reflected on a daily basis and subsequent transactions grouped in two-week intervals. Revaluation reports detailing ledger accounts, spot contracts, and forward contracts are developed on a weekly basis.

(b) Bank's written policy provides for the immediate generation of exception reports where applicable limits are exceeded. Prior written approval of the account officer is required for deviation from customer limits. Deviation from other limits is not permitted under any circumstances without prior approval of International Committee.

5. If the bank is a subsidiary of a foreign bank, describe the controls and guidelines the parent has imposed on the bank's foreign exchange activities, and describe the foreign exchange reports prepared by the bank for the parent.

The aforementioned guidelines and limits have been implemented at the direction of the parent bank. All reports of the bank's audit department and the reporting mechanisms described in 4(a) are furnished to the parent bank for review prior to implementation.

6. Briefly describe the procedures used in the revaluation, including the frequency and responsible party. If forward contracts are not revalued at future rates, so indicate.

Revaluation is performed on a bi-weekly basis by the International Operations section. Actual realized profit or loss is calculated by applying current spot rates to balance sheet accounts, as well as contracts of very near maturities. Unrealized profit or loss on future transactions is determined by applying the appropriate forward rates to the net position for each future period in the bank's gap report.

7. Describe the general ledger accounts affected by the periodic revaluation and the journal entries used to effect changes in these accounts. If any accounts are being used to capitalize losses or defer immediate recognition of profit, so indicate.

Actual realized profit or loss is charged to the profit and loss account with offsetting entries to the applicable local currency ledger accounts. With respect to future transactions, the bank charges the "estimated profit(loss) on foreign exchange futures" account for the amount of the adjustment with an offset to the profit and loss account. Profits and losses are recognized at the date of revaluation.

8. (a) Approximate the volume of foreign exchange transactions the bank has with related companies or banks? (b) Determine whether the terms and conditions of such dealings vary from similar transactions with non-related companies and banks?

(a) During 2015, the bank entered into approximately $40,000M of forward contracts to purchase and sell foreign exchange with a related bank, First European Bank, London, England.

(b) Terms and conditions of contracts are substantially the same as transactions with non-related parties.

9. Regarding holdover and/or after hour transactions, describe and assess the bank's system for controlling and recording such transactions. Indicate how management is informed of such transactions before recordation, and determine whether the system is correctly designed and adequately controlled?

The foreign exchange control group prepares a list of holdover items. Holdover items are incorporated into the daily position sheet, which together with the holdover list, is furnished to management on a daily basis. Holdover items are posted as of the dates contracted. The system is considered adequately controlled.

NOTE: A negative response below may indicate a condition that requires correction and comment(s) below and/or in the report of examination.

AUDIT

			YES	NO
1		Have the directors/trustees made provision for an audit of the foreign exchange area?	X	
		If "Yes," indicate method utilized:		
	X	Employment of full time auditor.		
	X	Periodic employment of independent auditor.		
	______	Designation of an audit supervisor and an established program of internal audit by bank personnel.		
		Name of Audit Supervisor:		
2		If the answer to question 1 is "yes", does the audit program include the following:		
	(a)	Periodic proof of forward and spot contracts?	X	
	(b)	Periodic proof and/or reconcilement of foreign exchange general ledger accounts?	X	
	(c)	Periodic direct verification of forward and spot contracts? Frequency: Annually Amount: $25,200,000	X	
	(d)	Review of management reports and adherence to guidelines?	X	
	(e)	Comparison of rate quotations in management reports and revaluations with outside sources?	X	
	(f)	Perusal of authorized signatures?	X	
	(g)	Briefly describe any other audit procedures conducted:		
3		If applicable, has the bank corrected major criticisms noted in the last independent audit report? Date of audit: 12/31/2014		X
		Briefly describe major criticisms and/or recommendations in such report: The bank was criticized for not maintaining a complete and current set of instructional memoranda describing the information generated from the accounting system and the general and subsidiary ledger accounts affected by trading activity. This defect has been corrected. Deficiencies still exist with respect to confirmation procedures.		
4		Is the foreign exchange audit program adequate as to scope and frequency?	X	
5		Does the foreign exchange auditor or audit supervisor report regularly and directly to the bank's board of directors/trustees or a committee thereof?		
6		Is a written audit report of the foreign exchange area maintained by the bank?	X	

2(c) All outstanding spot and forward contracts as of the audit date are directly verified.

NOTE: A negative response below may indicate a condition that requires correction and comment(s) below and/or in the report of examination.

INTERNAL CONTROLS

		YES	NO
1	Are all contracts recorded on the date contracted?	X	
2	Is it a firm rule that all forward and spot contracts be confirmed at inception?	X	
3	Has the bank instituted an effective and current (within seven days) follow-up system regarding unconfirmed and/or incorrectly confirmed forward and spot contracts?		X
4	Are foreign exchange contracts and dealing slips prenumbered and used in such order?	X	
5	Does the bank have an effective system of controls over the trader and the trading environment?	X	
	A “Yes” answer to this question requires a “Yes” answer to each of the following: Is it a firm rule that:		
	(a) The trader not be allowed to receive confirmations on forward and spot contracts?	X	
	(b) The trader not be allowed to sign contracts?	X	
	(c) The trader be prohibited from initiating and receiving interbank funds transfers, opening current accounts, or receiving credits to current accounts?	X	
	(d) The trader not be involved in the revaluation procedure?	X	
	(e) Trading activities be segregated from other bank activities, in particular the accounting, confirmation, and report functions?	X	

2-3 Although the bank established guidelines regarding the confirmation of spot and future contracts, examiners observed that outgoing confirmations are frequently incomplete, with trade and value dates frequently omitted. Further, many entries in the confirmation exception logs are incomplete, and the log is not reviewed by an operations officer. These deficiencies were noted by both the bank’s internal and external auditors; however, management has not yet corrected the deficiencies .

INTERNATIONAL PRE-EXAMINATION QUESTIONNAIRE

Examiners can use this optional questionnaire, in whole or part, during the pre-examination process as part of the preliminary risk assessment. This workpaper includes a list of questions that examiners can ask management to help identify international activities, develop document request lists, and scope examination activities.

Briefly summarize significant discussion topics in the pre-examination planning memorandum. Summarize items such as material changes since the prior examination, economic conditions in the institution's area of operation, new products or services, and areas of perceived risk. Include any other information useful for allocating examination resources. Document the officer's name and title, and note the discussion date.

INTERNATIONAL ACTIVITIES

1) Does the bank offer any international products or services? For example:
   - Cross-border loans or investments,
   - Loans to domestic borrowers that are part of an international supply chain or that are guaranteed by a foreign parent, or other foreign legal entity,
   - Trade financing,
   - Foreign wire transfers,
   - Foreign deposits or borrowings,
   - Loans to non-resident aliens (NRAs),
   - Private banking or wealth management for foreign nationals,
   - Foreign correspondent banking, or
   - Foreign exchange trading.

   If yes:
   - Provide a summary description of each activity,
   - Indicate where the activities are conducted within the organization, and
   - Provide the name and title of the person(s) responsible for each area.

2) Does the bank have an International Banking Facility (IBF)?

   (Note: An IBF is a set of asset and liability accounts segregated on the books and records of a depository institution, United States branch or agency of a foreign bank, or an Edge or Agreement corporation that includes only IBF time deposits and IBF extensions of credit.)

3) Does the bank have any representative office(s)?

   If yes:
   - Indicate where the office(s) are located,
   - Provide the name and title of the person(s) responsible for each office, and
   - Provide a summary of the activities conducted by the office(s).

4) Does the bank maintain any foreign branches or subsidiaries, control a foreign organization, or have 20 percent or more of the organization's voting equity interests in a foreign organization?

   If yes:
   - What records and record keeping policies does the bank maintain to ensure compliance with the provisions of Section 347.116 of the FDIC Rules and Regulations?

FOREIGN BANKING ORGANIZATION (FBO)

5) Is the bank part of a FBO?

(Note: An FBO is a U.S. banking operation owned by a foreign banking organization. An FBO's operations may encompass a variety of banking and nonbanking activities conducted through subsidiaries, branches, agencies, or representative offices.)

If yes:

- Describe the organizational and ownership structure of the FBO.
- Summarize transactions or agreements of the FBO with its parent/controlling institution, and
  - Include a list of transactions conducted with the parent institution (participations purchased, participations sold, fund transfers, etc.), including the volume and approximate number of transactions, dollar amount, and percentage of income derived from such transactions.
  - Include a list of services provided to or received from the FBO (rental space, correspondent services, auditing, IT-related services, etc.).
  - Indicate fees paid or received for services rendered.

PARALLEL BANKING ORGANIZATION (PBO)

6) Is the bank owned or controlled, directly or indirectly, by an individual, family or group of individuals that are closely associated in their business, or otherwise acting in concert, that also own/control at least one foreign banking institution?

If yes:

- Provide a list of all relationships and international affiliations within the PBO, and
- Summarize transactions or agreements with the international relationships or affiliates listed, including the volume and approximate number of transactions, dollar amount, and percentage of income derived from such transactions.

7) Do any bank insiders, as defined by Regulation O, have cross-border related interests?

If yes:

- Describe the type of transactions between the bank and the related interests.

CORRESPONDENT BANKING

8) Does the bank have any foreign correspondent bank relationships?

If yes:

- Summarize the nature of the relationships and services offered (clearings, deposits, loans, trade financing, etc.), and
- Describe the due diligence conducted on each foreign correspondent.

COUNTRY EXPOSURE

9) Does the bank's present or future business strategy include cross-border lending or investment activities, in particular with emerging markets and other notable countries and regions?

If yes:

- Describe the bank's systems and controls over their country exposure, and
- Describe the process management uses to monitor economic and political situations in countries where the bank has exposure (either directly or through NRA relationships).

10) Does the bank file FFIEC Form 009 and/or Treasury International Capital (TIC) forms?

FOREIGN DEPOSITS

11) Does the bank accept foreign deposits?

If yes:

- Describe the bank's foreign deposit gathering activities or programs.

12) Are deposits referred to the bank by affiliates or other related foreign organizations?

If yes:

- Describe the process of how deposit accounts are referred by affiliates or related foreign organizations.

13) Does the bank use independent agents to acquire foreign deposits?

If yes:

- Describe how foreign deposit accounts are acquired through independent agents, and indicate if a fee is paid for deposit referral services.

GENERAL INSTRUCTIONS

These instructions provide general guidance for conducting field investigations and preparing the Report of Investigation (ROI). Since each application has unique characteristics and often involves special circumstances, examiners should consult the references below and discuss issues or questions with the appropriate Case Manager. The examiner should look beyond the surface of the proposal and address the likelihood of success or failure. The final report should be comprehensive, well supported, and address any atypical attributes.

REFERENCES

Use the following reference material in preparing the ROI:

- The instructions contained herein
- Statement of Policy on Applications for Deposit Insurance (SOP)
- FDIC Rules and Regulations Part 303, Subpart B, Deposit Insurance, and Federal Deposit Insurance Act sections 5 and 6
- Section 19 of the FDI Act and the Statement of Policy for Section 19 of the FDI Act
- Statement of Policy Regarding use of Offering Circulars in Connection with Public Distribution of Bank Securities
- Statement of Policy on the National Historic Preservation Act of 1966
- Applicable State Statutes and Regulations
- Case Managers Procedures Manual
- DSC Manual of Examination Policies
- Examination Documentation (ED) Modules
- Electronic Data Processing Examination Handbook
- Outstanding Applications memoranda and directives
- Questions and Answers on Stock Benefit Plans
- Division of Insurance and Research (DIR) – Statistics on Depository Institutions
- Uniform Bank Performance Report (UBPR)
- DSC and Risk Management & Applications Section Websites

APPLICATION PROCESSING

The FDIC is responsible for approving or denying all applications for deposit insurance, regardless of the type of institution or fund affiliation. In addition to proposed state nonmember banks, mutual savings banks, and industrial banks, the FDIC acts on any application for deposit insurance from a proposed national bank, member bank, district bank, trust company, Federal or State savings association, or savings and loan. Applications for de novo institutions are filed with the chartering authority and the FDIC using the *Interagency Charter and Federal Deposit Insurance Application*. To ensure interagency applications go smoothly, examiners should contact the chartering agency as soon as possible to coordinate a joint field investigation and reduce regulatory burden.

Generally, examiners should attend any pre-filing or other meetings held by the chartering agency with the applicant. Application processing timelines vary among the banking agencies, therefore close coordination with the chartering agency is necessary. Duplication of work should be avoided such as conducting background checks on proposed officers and directors. Normally, in an application for a thrift or national bank charter, the OTS or OCC conduct the background checks.

REPORT OF INVESTIGATION PROCEDURES

Reports of Investigation often vary in content and structure and emphasis should be placed on producing a well-conceived final product rather than following any strict format. The Statement of Policy on Applications for Deposit Insurance (SOP) is the primary source document for the factors that should be considered during the investigation. These guidelines are designed to assure uniform and fair treatment to all applicants.

Examiners should review the entire application and business plan to identify potential problems, incomplete or inconsistent information, areas of non-compliance with the SOP and/or Federal and State banking statutes, and any other factors which will require additional attention. It is important to identify, early on in the process, any concerns that will require significant attention to ensure that they do not delay the timely processing of the report. Subject Matter Experts in areas such as Consumer Compliance, Information Systems, Trust, Capital Markets, and Specialized Lending should be involved in the investigation when deemed necessary to adequately assess a proposal.

Examiners should be aware that proposals not conforming to the SOP are not delegated to the Regional Office and will be forward to the Washington Office for final action. Further, applications involving foreign ownership of 25% or more (foreign ownership includes ownership by a foreign non-banking entity, a foreign bank, or person who is not a citizen of the United States) are also forward to the Washington Office for final action.

After a thorough review and Regional Office concurrence, examiners should contact the organizers to discuss the specific issues and request any additional information. The examiner should hold a board meeting with proposed directors and senior officers. At a minimum, the meeting should include a discussion of the FDIC’s expectations regarding director supervision, conduct and ethics. A sample agenda with suggested topics is found in Appendix A. The organizers and proposed directors should be individually interviewed to determine the extent of their understanding of the responsibilities they are taking on as directors, their abilities to execute the business plan and their commitment to the proposed bank. A sample Management/Director Interview form is found in Appendix A.

Examiners should not discuss the probable outcome of the investigation with the applicants.

STATUTORY FACTORS

Sections 5 and 6 of the FDI Act specifically deal with the granting of deposit insurance. Section 6 identifies seven statutory factors that must be considered by the FDIC in determining the merits of an application. Those factors include:

1. Financial history and condition;
2. Adequacy of capital;
3. Future earnings prospects;
4. General character of management;
5. Risk presented to the insurance fund;
6. Convenience and needs of the community;
7. Consistency of corporate powers.

The Report of Investigation should detail the relevant facts pertinent to each of the statutory factors and state the examiner's opinion as to whether the criteria under each area has been met. Findings of Favorable Subject to the Imposition of Conditions are permissible if the reasons for such a finding are clearly supported. Narrative comments should fully support any negative finding and when possible, identify any corrective action that, if taken, would favorably resolve the concerns. Examples could be issues such as finalizing blanket bond coverage, obtaining an appraisal on the premises, finalizing stock sale, etc.

While all factors are important and must receive a favorable finding, the FDIC considers Management and Capital as being the two most important factors. The Investigation Report Conclusions and Recommendations page should include a description of the proposal, a summary of each factor, and an overall recommendation relative to the granting of insurance.

MISCELLANEOUS REPORT ISSUES

Generally, the public may inspect the non-confidential portions of an application. While the burden is on the applicant to request confidential treatment of certain application material, the following areas are generally considered confidential:

1. Personal information, the release of which would constitute a clearly unwarranted invasion of privacy;
2. Commercial or financial information, the disclosure of which would result in substantial competitive harm to the submitter; and
3. Information the disclosure of which could seriously affect the financial condition of any depository institution.

The public may obtain photocopies of non-confidential material through a Freedom of Information Act request and by an oral or written request to the Regional Office.

Financial numbers are rounded to the nearest thousand.

COVER – REPORT OF INVESTIGATION

Insert complete name of proposed bank, city, county, and state.

Insert Region, EIC, and type of charter.

- Date investigation commenced would be the date review began in the field office.
- Investigation closed date is date the report was mailed to Regional Office.
- Date of application is obtained from the application.
- Date application accepted is found on ViSION's Application Tracking (AT).

TABLE OF CONTENTS

The table of contents identifies the three major report sections: Conclusions and Recommendations; Assessment; and Other Information. Completion of all pages is mandatory. Examiners may create and add pages under each factor if it supports their conclusions and recommendations.

INVESTIGATION REPORT CONCLUSIONS AND RECOMMENDATIONS

This page should summarize the proposal with enough details to give the reader a complete understanding of the transaction. The investigating examiner should provide a brief summary of the proposed business plan under the "Description of the Transaction" heading. Each statutory factor and finding of Favorable, Unfavorable, or Favorable Subject to Conditions should also be summarized. The investigating examiner should conclude with an overall recommendation.

FINANCIAL HISTORY AND CONDITION

Generally, proposed financial institutions have no financial history to serve as a basis for determining qualification for deposit insurance. Therefore, the primary areas of consideration under this factor are the reasonableness of asset and liability projections and composition in relation to the proposed market, the level of investment in fixed assets, the ability of insiders to provide financial support to the institution, terms upon which transactions with insiders are granted, and whether adequate disclosure of insider transactions has been made.

- Assess the applicant's projected asset and deposit mix for reasonableness and as compared to the proposed business plan and an appropriate peer group.

- Using the financial statements contained in the business plan, construct the projected balance sheet for the first three years of operation. Discuss with the applicant, significant differences between the proposal's projections and yours. If necessary, the applicant should revise the projections. Projections that are not reasonable or unsupportable should lead to an unfavorable finding.

- Total direct and indirect fixed asset investment (including leases) should be reasonable in relation to projected earnings capacity and capital levels. A brief review should determine if the figures provided by the proponents are reasonable with regard to anticipated need and cost. Fixed asset schedules from other newly formed institutions can be used as a point of reference. Compliance with State law should be considered since most states impose a statutory limit on fixed asset investment relative to either capital or total assets.

- When real estate is to be purchased and a building constructed, the investigating examiner should review the cost of the land, estimated construction costs, the identity of the seller and general contractor, completeness of the title policy, and terms of any financing obtained. Part 323 of the FDIC Rules and Regulations is applicable to the purchase of real property, including leaseholds, and a qualifying appraisal is usually required. For leased premises, the terms and reasonableness of the lease should be discussed. Applicants are generally cautioned against purchasing any fixed assets or entering into any non-cancelable construction contracts, lease or other binding arrangements related to the proposal unless and until the FDIC approves the application.

- Any time assets are purchased or leased from insiders or when insiders are involved in providing contracted services, the transactions should be supported by an independent appraisal or competitive bid process. The organizers must substantiate that any transaction with an insider is made on substantially the same terms as those prevailing for comparable transactions with non-insiders and do not involve more than a normal degree of risk. Such transactions must be intended for the benefit of the institution and not entered into as an accommodation to the insider. All such transactions must also be approved in advance by a majority of the incorporators and fully disclosed to all proposed directors and shareholders.

- Organizers, including an affiliated holding company, must demonstrate the ability to provide on-going financial support. Analyzing the ability of the proponents to raise additional capital is important since new banks (operating at a loss) will often experience difficulty in attracting capital from outside sources. Analysis of this will be primarily dependent upon the financial statements submitted by the proponents or Uniform Bank Holding Company Reports when a holding company is involved. If reasonable, consideration should be given to the ability of the proponents to raise additional funds through the capital markets or the local community.

- Assess compliance with the security requirements of Part 326 of the FDIC Rules and Regulations.

- Assess compliance with the National Environmental Policy Act of 1969. The FDIC is responsible for making a determination whether certain decisions made by it constitute "major Federal actions significantly affecting the quality of the human environment" under this Act. Granting of approval for deposit insurance seldom constitutes a significant action requiring an environmental impact statement, but a threshold determination as to the probable effect upon the human environment must be made under the statute. The environmental factors to be considered include: (a) compliance with local zoning laws; (b) location; (c) traffic patterns including the adequacy of roads, parking places and traffic congestion; and (d) any favorable impact such as possible decrease in pollution or fuel consumption.

Compliance with zoning laws is generally the key determining factor for the FDIC since courts have ruled that compliance is an assurance that such environmental effects will be no greater than demanded by the residents acting through their elected representatives.

- Section 106 of the National Historic Preservation Act (NHPA) requires that a Federal agency having authority to license any undertaking shall, prior to issuing any license, take into account the effect of the undertaking on any district, site, building, structure, or object that is included in, or eligible for inclusion in, the National Register of Historic Places (National Register).

  At the time of filing an application for Federal deposit insurance, the proponents should have already been in contact with the appropriate State Historic Preservation Officer (SHPO) regarding whether the proposed main office (as well as any branch office) site is an historic property - that is, listed in, or eligible for listing in, the National Register. The FDIC generally relies on the SHPO's opinion regarding whether the proposed office site is historic and, if it is, what effect the Federal deposit insurance proposal will have on the property. If it is determined that the proposal will have an adverse effect on an historic property, then the FDIC (usually the RO staff) must work with the proponents, the SHPO, other consulting parties, and, in some cases, the Advisory Council, to develop and evaluate alternatives or modifications to the undertaking that could avoid, minimize, or mitigate the adverse effect.

  It is very important that the examiner advise the proponents that absolutely no site preparation work should be initiated until SHPO has been consulted and a determination has been made regarding whether the proposed office site is historic and, if it is, what effect the proposal will have on the historic property.

  For Federal deposit insurance applications that involve establishment of a new national bank or thrift, for which a charter application has been filed with the OCC or OTS, the FDIC may not have to determine whether the proposed office site is historic and how the proposal will affect an historic property, if the primary Federal regulator has assumed this responsibility. The examiner or the Case Manager should contact their counterparts at the Federal chartering authority in order to ascertain which agency will be responsible for complying with the requirements of the NHPA.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

ADEQUACY OF THE CAPITAL STRUCTURE

Normally, initial capital of a proposed institution should be sufficient to provide a Tier 1 capital to assets leverage ratio of at least 8% throughout the first three years of operation. In addition, the institution must maintain an adequate allowance for loan and lease losses. This means that the proposed institution **can not** inject the capital as it grows. Opening day capital must be sufficient to maintain at least an 8% Tier 1 Leverage ratio based on the three-year projections. Exceptions apply to new institutions formed by an eligible holding company (See section 303.22).

The adequacy of capital is closely related to the new bank's risk appetite, its deposit volume, fixed assets, and anticipated growth. Deposit projections made by the applicant must be fully supported and documented. Projections should be based on identifiable patterns in the target market. Special purpose institutions (such as credit card banks) should provide initial capital commensurate with the type of business to be conducted and the potential for growth of that business. Additional discussion of unique capital proposals such as contribution of in-kind capital as part of initial capitalization, and capital adequacy of new institutions organized to facilitate and carry on an existing business line is presented below. Examiners are reminded that these types of proposals and others presenting a higher risk profile may warrant a leverage capital ratio greater than 8%.

- Using capital data contained in the application, construct the Proposed Capital Structure table.

    - “Minimum Statutory Requirements” line should include any minimum capital required by the chartering agency.
    - “Amount indicated on Application” should reflect capital allocations shown in the application excluding any adjustments made by the examiner. All components of this line should be based on applicant’s projections.
    - “Revised Proposal” line is used only when the organizers present a revised capital proposal.
    - “Recommendation of Examiner” line may or may not be the same as applicant’s proposal; however, it must agree with final projections used throughout the report.
    - “Retained Earnings” column is the cumulative 3-year net income.
    - “Third Year Average Assets” column comes from the business plan projections and examiner’s estimates.

- The examiner should assess the deposit forecasts and make any necessary adjustments. The proponents should have a good feel for the deposit potential of their market. However, if growth projections are inconsistent with the size of the market, with current economic conditions, or with the overall business plan, adjustments should be made along with the examiner’s rationale. Examiners could consult any number of sources including the Uniform Bank Performance Report and DIR’s Statistics on Depository Institutions, for supporting data.

- If available, review the stock offering circular, stock solicitation material and related documents. The Washington Office’s Registration, Disclosure and Securities Operations Unit normally reviews both private and public offering materials and is available for assistance. All stock of the same class should be offered at the same price, and have the same voting rights. Arrangements that give insiders greater rights or more favorable pricing are not acceptable. A price disparity may allow organizers to gain control disproportionate to their investment and may promote excessive risk taking. In addition, such arrangements are analogous to compensating or paying a fee to organizers solely for their efforts in establishing the institution. Stock price disparities may also be used to hide excessive reimbursement to organizers. Another example of price disparity is offering stock warrants to investors who purchase a large volume of shares in the stock offering. Closely assess the appropriateness of stock offerings that award incorporators warrants to acquire additional shares. Stock warrants to insiders or investors that are beyond the guidance contained under the management factor of the SOP are not acceptable.

- If the institution is being established as a wholly owned subsidiary of an eligible holding company (as defined in part 303, subpart B) consider the financial resources of the parent organization in assessing the adequacy of the initial capital. In some cases, DSC may find favorably with respect to the capital factor when initial capital is sufficient to provide a Tier 1 leverage capital ratio of at least 8% at the end of the first year of operation, based on a realistic business plan, or initial capital meets the $2 million minimum standard set in the SOP, or any minimum standards established by the chartering authority, whichever is greater. The holding company must also provide a written commitment to maintain the Tier 1 leverage ratio at no less than 8% throughout the first three years of operation.

- Stock financing arrangements by proposed officers, directors, and 10% shareholders should be carefully reviewed. Financing arrangements are only acceptable if the investor can clearly demonstrate the ability to service the debt without undue reliance on dividends or other forms of compensation from the new institution. Normally the direct or indirect financing of 75% or more of the purchase price by an individual or the financing of 50% of the purchase price by all insiders in the aggregate will require supporting justification. Ensure that the applicant bank did not agree to maintain compensating balances with the lender in order to procure financing. Also, the proponents should be made aware that such loans can not be refinanced by the applicant bank.

- Watch for voting trust arrangements. Generally, these agreements are discouraged in new banks because of control issues (insiders gaining control disproportionate to their investment), but are not prohibited per se. Review the agreements for any unfavorable features, such as control issues, or hampering sale of additional stock. Examiners should consult with the case manager and/or a regional attorney to obtain additional guidance.

- The stock subscription list should be reviewed to ensure that control issues have been identified and resolved, and to determine the likelihood of a successful offering.

- Cash dividends during the first three years of operation should only be paid from cumulative net operating income and only after an appropriate allowance for loan and lease loss has been established and overall capital is adequate.

Unique capital proposals and capital for institutions organized to facilitate and carry on existing business lines.

The SOP is silent on the issue of organizing an institution with in-kind capital. Likewise, it does not address how the FDIC will assess proposals that entail a new institution organized to facilitate and carry on an existing business line. Nonetheless, the FDIC has been presented with applications containing both proposals. In-kind capital contributions have been in several forms including, but not limited to, real estate, fixed assets, loans, leases, and mortgage banking operations. Existing business lines proposed in prior applications included equipment lease financing, credit card operations, and mortgage banking operations. These proposals present unique risks deserving close scrutiny. Examiners should also evaluate possible 23A and 23B implications and limitation from Part 325 capital calculation. The following points address prior instances where in-kind capital and existing business lines were part of applications.

- In applications where the FDIC will not be the primary regulator, the examiner should participate in the primary regulator's investigation.

- When loans or leases are proposed to be contributed as initial capital, the examiner should conduct a review of the loans and leases comparable to that completed during a traditional safety and soundness examination in order to assess asset quality. The sample should be large enough to assess loan or lease mix, underwriting standards, valuation and residual values, and proper documentation. Valuations should be supported by proper market value analysis such as discounted cash flow analysis. The examiner should strive to obtain an independent physical inspection of the assets in the sample. In lieu of a physical inspection, the examiner may rely on an independent audit confirmation of the assets in question.

- Tangible assets such as real estate and fixed assets contributed as part of initial capital present two main questions: valuation and insider involvement.

    - In the case of real estate, organizers must have an independent appraisal performed by certified or licensed appraisers (see Part 323 of the FDIC Rules and Regulations). The appraisal should conform to generally accepted appraisal standards and arrive at a fair market value. Fixed asset values should be supported by independent market valuations performed by experienced appraisers. Review the appropriateness of scheduled depreciation. A longer than normal depreciation period could overstate book value and earnings. Total fixed asset investment must also conform to State limitations.

    - Transactions involving organizers, directors, officers, or principal shareholders (insiders) should be closely reviewed to determine fairness and proper disclosure. For example, a contribution of bank premises under construction by an insider or related interest should not contain unfavorable features. Proper disclosure to other shareholders, written construction contracts based on a competitive bid process, and independent appraisals should be required.

    - In-kind capital contributions may be proposed in the form of the market value of an existing business such as a mortgage company. Proposals such as this should be fully supported by at least two appraisals of the company's fair market value. Examiners should ensure that the appraisals are independent, current (within 6 months) and based on recognized valuation methods.

Proposals for new institutions organized to facilitate and carry on an existing business line also provide special capital considerations. Contribution of the business as initial capital may or may not be a part of the proposal; however, recent cases have contained both. These include:

- An institution organized with a leasing company to provide equipment lease financing.
- An institution partly capitalized with seasoned auto loans, specializing in direct purchase of dealer-originated auto loans and from an affiliate credit finance company.
- An institution formed by an energy company, capitalized with in-kind contribution of consumer loans and will specialize in providing loans for energy-related home improvements.
- An institution formed by a farm equipment retailer to acquire its credit card receivables and continue origination and servicing company branded credit cards.
- An institution formed by a company that provides capital lease financing for small to medium sized businesses over the Internet. New bank to provide retail funding and lease financing.

Examiners should look to the prior performance of the business and the character of the management continuing on with the institution. The management group should be sufficient to satisfy the management factor. The business line should be financial in nature, and not expose the institution to undue risk. The business plan should be reasonable and the projections should be well supported by historical performance and sound analysis. Examiners should use all available information such as Dun & Bradstreet reports, SEC filings, independent audit reports, public recordings, and credit rating agency reports to verify data. If deemed necessary, an on-site visit to review the existing business' operations should be conducted.

When assets are proposed to be contributed as capital or purchased from organizing group or affiliate, values should be supported by independent appraisals. Asset quality should be assessed the same way credit reviews are conducted, i.e. sample by risk, volume, delinquency, underwriting, etc (refer to ED risk focus modules). If the business has not had a recent audit, or credit or collateral documentation is not complete, an independent verification or inspection of assets should be obtained.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

EARNINGS PROSPECTS

Construct the "Estimated Income and Expense", and the "Estimated Average Deposits and Average Earning Assets" schedules using the financial statements contained in the Business Plan.

The examiner should determine whether the proposed bank is likely to be profitable within a reasonable period of time, usually three years. The main concern is whether the applicant's projections are realistic and supportable. The earnings should be sufficient to provide an adequate profit. When projections are not reasonable or deficiencies are material, revisions should be requested from the proponents. Examiner-derived estimates can be incorporated into the report; however, comments should clearly address the differences between the examiner's estimates and those of the organizers. Common shortcomings in projections include, but are not limited to:

- Unreasonable earning asset yields
- Unreasonable interest expense factors
- Overstated earnings factors (NIM, ROAA)
- Underestimating data processing costs
- Understated overhead costs
- Inadequate loan loss provisions
- Failure to write-off organizational expenses during the first year of operations

Items to be considered include projected loan growth relative to other new banks and that of competing institutions, likely structure of the deposit base, investment objectives, estimated asset and liability mix, reasonable noninterest income, and probable provision expense. Consideration should also be given to ensure consistency with other projections such as deposit growth and personnel expense. Projections and assumptions should be consistent with the overall business plan.

The UBPR generally provides sufficient data to assess the line items contained in the projections. Financial data from recently formed institutions should prove to be the most beneficial. Peer data is also available for all new banks established within three years and under $50 million in assets. Peer data for established community banks also warrants review especially when serving the same general area or market niche. Examiners should be aware that using peer ratios of established banks might result in some differences since new banks generally have a larger percentage of assets funded by capital. This results in higher margins during the early years. Examiner's selection and use of Peer data should be fully discussed and supported.

Loan loss provisions should be closely reviewed. Niche or special purpose banks that engage in higher risk lending, such as subprime loans and high loan to value lending, should fully support their loan loss reserve methodology, estimated losses and provisions. The methodology should account for replenishing the reserve to an adequate level after charge-offs.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

GENERAL CHARACTER OF MANAGEMENT

Management is often the most important factor. Although the SOP indicates that evidence should support a management rating tantamount to a "2" rating or better under the Uniform Bank Rating System, this is somewhat difficult to determine without an operating record as a management team. As a result, the assessment of management should center on an evaluation of the individual's background in relation to their proposed duties and responsibilities. Consideration should be given to the following:

- Financial institution experience
- Other business experience
- Personal and professional financial responsibility
- Reputation for honesty and integrity; and
- Familiarity with the economy, banking needs, and general character of the community in which the bank will operate.

Examiners should provide an overall assessment of the management team and board of directors on the General Character of Management page. Address each proposed officers and directors' qualification on the biographical section of the report. Comments should also include any prior experience that may reflect positively or negatively on the individual, any serious business failures or compromising of debts and length of residence in the community or trade area. All entities in which the proposed officer or director has a financial or other significant interest should also be identified.

The examiner should normally conduct personal interviews with all of the organizers, senior management, and directors. Any pertinent information derived should be included with the individual's biographical information. Current and former employers may also be contacted unless a prospective officer raises a valid objection (current employers may not know officer is seeking other employment and contacting them may cause the officer harm). Prior employer's concerns over privacy laws, however, may prevent them from divulging much information. At a minimum, a former employer should be able to tell you the individual's title, and whether the individual is eligible for rehire.

The biographical and financial information (FDIC 3064-0006, Interagency Biographical Financial Report) submitted as part of the application serves as the primary tool in assessing financial standing and responsibility. All questions should be answered and fully supported. These forms should disclose any prior bankruptcies or the compromise of any debt. The forms should also include information on contingent liabilities, civil litigation, prior criminal convictions, administrative proceedings, and other matters involving a breach of trust.

A section 19 application will be necessary if an employee, officer, director, controlling shareholder or Institution Affiliated Party has been convicted of a criminal offense involving dishonesty or breach of trust, money laundering or has entered into a pretrial diversion in connection with a prosecution of such an offense. The Applicant must obtain the FDIC's written consent under section 19 of the FDI Act before any such person may serve in one or more of those capacities.

Significant assets in the form of closely held corporations, partnerships, or sole proprietorships should be supported by detailed financial statements on these entities. Net equity positions should be reviewed to determine the reasonableness of the carrying value and the potential impact of related debt. In addition, if an individual's financial standing is largely dependent upon appreciated value of real estate or closely held companies, the basis for valuation of the assets should be sought.

For state nonmember charters, background checks are normally requested by the Regional Office and if necessary and available, forwarded to field personnel for review during preparation of the investigation report. Such information provides an independent, third party check that can be used to verify the applicant's stated financial position, credit history, and confirm the absence of public filings and judgements. Liens, lawsuits, wage assignments, defaults, and public filings such as bankruptcies and judgements will be shown. The major credit reporting agencies also provide an additional service that automatically alerts the requester to possible false social security numbers and high risk addresses such as post office boxes, and multiple business addresses.

If necessary, additional information can be requested through the Regional Office, including Nexis/Lexis. These systems feature searches that can be conducted by key words or names. Nexis provides access to numerous news service publications and Lexis allows for a search of legal databases containing final case law from Federal and State courts. Finalized civil and criminal proceedings as well as bankruptcy cases are listed. Also, a background check can include a search of State Corporation Commission records, Dun & Bradstreet, and county and other State records. The Federal Reserve also maintains information on international and foreign companies.

Be cautious of bank ownership that is restricted to a single individual or entity, or a small group of individuals who lack broad-based financial strength. Also identify any proposed directors that have little or no prior financial institution experience, minimal financial interest in the proposal, or are poorly equipped to contribute to policy formation or adequate supervision. Determine whether senior officers lack necessary experience, or have not served in senior management positions, which provide adequate insight into proposed roles. The SOP requires at least a five-member board of directors. At a minimum, an even mix of directors with and without banking experience is preferred. The proposed board should provide for officer/director continuing education, and a management succession plan.

The SOP requires that the proposed full-time chief executive officer be made known to the FDIC. If the proposed CEO has not served in a similar capacity, it is important to determine whether the individual has the technical competence to fulfill the responsibilities of the position. Further, the proposed CEO's expertise and experience should correlate with the proposed business plan. Knowledge of such areas as lending and investments, interest rate risk management, internal controls, and bank regulations should be considered.

The proposed operating policies and strategic plan should be reviewed in assessing management. Inadequate policies may be an indication of a weak management team. Written investment, loan, funds management, and liquidity policies should be reviewed and comments should be made regarding their soundness and acceptability. The CEO is also expected to be a qualified and experienced lending officer. If not, an explanation should be provided and the name of the proposed chief lending officer should be furnished.

While conditional approval can be granted prior to the selection of a chief executive officer or primary lender, this is allowable in only very limited circumstances. An example is where the new bank will be owned by an "eligible holding company" as defined in section 303.22 of the FDIC's regulations. Ultimately, prior to opening, these individuals should be identified and their abilities assessed. Any changes in the directorate, active management, or 10% shareholders prior to the bank's opening must also be disclosed to the FDIC in writing.

When it appears that an unfavorable ruling will be made regarding an individual's qualifications or fitness to serve, the examiner should consult with the responsible Case Manager. The examiner should thoroughly support any negative assessment by:

- Conducting an adequate investigation into the individual's qualifications;
- With the concurrence of the Case Manager, give the individual the chance in an interview or letter to respond to any objections raised;
- Checking any files to which the FDIC has access before making an adverse determination regarding the individual;
- To the extent possible, attempting to locate documentary evidence rather than relying on oral opinions.

All information relied upon should be maintained. When information is obtained from an outside source, every effort should be made to obtain such information in writing and verify through a secondary source.

Organizational expenses should be reviewed for reasonableness. Prudent management would not commit a bank to excessive expenses, the existence of which may be indicative of a management deficiency, even if the fees or costs were approved by formal action of the incorporating shareholders. This applies to all costs, organizational expenses, and legal fees. Identify and assess the source of funding; start-up cash, personal or bank loans.

Review expenses for professional or other services rendered by insiders for any indication of self-dealing to the detriment of the institution or its shareholders. The FDIC expects full disclosure to all directors and shareholders of any arrangement with an insider.

Employment agreements should be reviewed to ensure that the contracts limit severance pay to a duration of one year. Under Part 359 - Golden Parachutes, severance payments are limited to one year in the case of troubled institutions. While not applicable to non-troubled institutions, the one-year guideline should be used as a benchmark. Section 359.1(f)(2)(v) states payments pursuant to a nondiscriminatory severance plan should not exceed the base compensation during the twelve months immediately preceding termination. Employment contracts that contain severance payments exceeding one year of compensation should be assessed for appropriateness and supported by extraordinary factors.

Stock Options and Warrants

Organizers/incorporators (incorporators) may propose establishing stock benefit plans, including stock options, stock warrants, and similar stock based compensation plans. Participants may include officers as well as directors, although the FDIC anticipates that such plans will focus primarily on active officers. Stock benefit plans may also be established to compensate incorporators who place funds at risk to finance the organization or who provide professional or other services during the organizational phase. Stock option/warrant plans are also found in both private and public stock offering material.

Management stability is generally an essential element for the ultimate success of a de novo institution. Therefore, the structure of the stock benefit plans, whether available to active management or incorporators, should encourage the continued involvement of the participants and serve as an incentive for the successful operation of the institution. Satisfactory management should not commit the bank, directly or indirectly, to plans that result in excessive compensation to insiders, place undue incentives on short-term performance (at the potential expense of long-term safety and soundness), or present other unfavorable features.

The SOP describes features that are required in order for stock benefit plans to be deemed acceptable, and sets forth certain unacceptable features. In considering whether stock benefit plans are acceptable, each case should be reviewed independently. Stock benefit plans involving only a nominal percentage of ownership in the proposed institution need not be subjected to in-depth scrutiny.

Guidance provided in the SOP distinguishes between two types of award plans:

1. Options/warrants granted to directors and active management to reward future performance. (Type 1)
2. Options/warrants granted to incorporators as compensation for financial risk borne during the organizational phases or as compensation for professional or other services rendered in conjunction with the organization. (Type 2)

Type 1 plans for active directors and officers must include the following provisions and should be reviewed as part of the total compensation package:

- disclosure,
- duration limits (maximum 10 years),
- vesting requirements (generally, a minimum of three years, in equal amounts),
- transferability restrictions (not transferable),
- exercise price requirements (not less than fair market value at time of grant),
- rights upon termination (expire within a reasonable time), and
- an "exercise or forfeiture" clause (in the event capital falls below regulatory minimums).

Examiners should refer to FASB Statement No. 123, “Accounting for Stock-based Compensation”, which provides guidance on calculating fair market value of stock options.

Type 2 plans do not require vesting, transferability restrictions, or continued association with the institution, but would require equal restrictions regarding disclosure, duration limits, strike price requirements, and an "exercise or forfeiture" clause.

Type 2 plans for incorporators not continuing as directors or officers should serve as compensation for services rendered or "seed" money placed at risk. Typically, it is the latter since professional services (accounting, legal, etc.) are normally paid for in cash. Incorporators often receive a proportional amount of stock after the bank is established as "repayment" of their initial financial contribution. In addition to stock acquired in this manner, incorporators may also receive some proportional volume of stock options/warrants as compensation for financial risk borne during the organizational phase of the bank.

The following summarizes the plan types:

Type 1 Plans

- **Directors and officers who are not incorporators** may participate in prospective management incentive plans. Such plans should be reviewed as part of the total compensation package offered to the individuals involved.

- **Incorporators who are also directors and officers** are allowed to receive a maximum of one option/warrant for each share of stock for which they subscribed in the initial offering. An incorporator who will also be a senior executive officer may receive additional options as part of a prospective management incentive plan. The volume of additional options/warrants proposed beyond that based on stock subscribed should be reviewed for reasonableness on a case-by-case basis, giving consideration to the individual's financial commitment, time, expertise, and continuing involvement in the management of the proposed institution.

Type 2 Plans

- **Incorporators who are not continuing as directors or officers** are allowed to receive a maximum of one option/warrant per share received for "repayment" of seed money and do not qualify for options/warrants based on additional stock subscribed beyond that which is a return of seed money.

- **Incorporators who are not continuing as directors or officers** who agree to accept shares of bank stock as payment for professional services (which otherwise would have been purchased from non-insiders) are also allowed to receive a maximum of one option/warrant for each share received as payment for professional services. The value of such professional services should be supported by proper documentation.

RED FLAGS. Stock appreciation rights, phantom stock, and other similar plans that include a cash payment to the recipient based directly on the market value of the depository institution's stock are unacceptable. These plans have the potential of removing an undetermined amount of cash from the bank's capital accounts, in contrast to option plans that provide an infusion. Under a cash-less exercise of options plan, a broker lends funds to exercise the options and immediately sells the shares to repay the loan. This discourages insiders from retaining the stock and having an on-going stake in the bank. Further, the bank should not be assuming responsibility for paying any of the taxes associated with exercise of the options. These types of options are objectionable in the formative years of a new bank when there is often a need to preserve capital during a period of rapid growth and operating losses.

If the proposal involves the formation of a de novo holding company and a stock benefit plan is being proposed at the holding company level, that plan will be reviewed by the FDIC in the same manner as a plan involving stock issued by the proposed institution. Many de novo banks are organized as subsidiaries of a bank holding company whose only substantive function is to own the stock of the proposed bank. If the FDIC did not assert its right to set standards on stock benefit plans sponsored by de novo shell holding companies organized to sponsor new banks, the FDIC would in essence be giving up its ability to review stock benefit plans in new banks since the agency's requirements could easily be avoided by organizing a bank holding company.

The FDIC does not assert the right to regulate stock benefit plans for *operating* holding companies or holding companies with other material businesses. Additionally, the above criteria relating to stock benefit plans should not be applied to operating institutions but rather only to de novo institutions.

Finally, the following documents provide good guidance and resource on the subject of stock options; the Foundation for Enterprise Development http://www.fed.org and the National Center for Employee Ownership http://www.nceo.org .

Fidelity bond coverage and excess employee dishonesty bond coverage should equal or exceed $1 million if the primary blanket bond is less. It is helpful if a binder or commitment letter is obtained; however, approval may be conditioned upon acquisition of adequate coverage prior to opening.

Applicants are expected to commit to obtain an opinion audit by an independent public accountant annually for at least the first three years. The requirement for an external audit is a standard condition of the FDI Order granting deposit insurance. When the applicant is owned by a holding company, a consolidated audit of the holding company will generally suffice.

The proposed management structure should be reviewed to ensure that no management interlocks exist as defined in Part 348 of the FDIC Rules and Regulations.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

RISK TO THE FUNDS

Assess the proposed institution’s business plan, particularly addressing any unsound activities, practices or other issues. Any high-risk activity to establish market share, attain growth, or provide for profitable operations should be discussed. Business plans that are not commensurate with management's capabilities, should be addressed here as well. Operating plans that rely on high risk lending, niche marketing or significant funding from sources other than core deposits or that diverge from conventional banking will require substantial documentation as to the suitability of the proposed activities. Extensive documentation will also be necessary when economic conditions are marginal. The business plan should demonstrate a reasonable ability to achieve sustainable market share, generate earnings, and attract and maintain adequate capital.

Industrial Loan Companies (ILC) and Special Purpose Banks (SPB)

Industrial loan companies and special purpose banks are unique in that neither are considered “banks” under the Bank Holding Company Act. As such, parent and affiliated entities are not regulated by Federal or State supervisory agencies.

Currently, states offering the ILC charter include California, Colorado, and Utah. The charters typically allow institutions to be organized and owned by commercial enterprises, including retailers and manufacturers. Special purpose banks can include credit card issuers organized under the Competitive Equality in Banking Act (CEBA) and trust companies. Because these charters allow institutions to export rates and terms, the formats can provide for a single platform from which to operate in all 50 states. The charters also provide access to the payment system and additional sources of funding.

However, the ILC charter also presents a potentially significant limiting factor that emanates from the stated intention of serving the working class within an institution’s defined market area. To encourage ILC’s to maintain this focus, institutions are prohibited from accepting demand deposits if total assets exceed $100 million, generally. Although not restricted by regulation, in practice, special purpose institutions might limit their deposit activities.

In general, ILC’s and special purpose banks limit their deposit activities to money center operations or brokered deposits; retail accounts might be limited to time deposits and accounts securing outstanding credit lines. In certain operations, including credit card and trust operations, deposit activities might be limited to a single account from the parent organization – a $500,000 deposit that, under the FDIC’s General Counsel’s Opinion, qualifies as “being in the business of accepting deposits.”

Regardless of the form of charter, ILC’s and special purpose charters present unique characteristics that must be fully considered during the investigation. As noted, these include the absence of a regulatory regime outside the insured entity and unique limitations or practical restraints on deposit activities. When coupled with the broad powers conferred, examiners must be particularly cautious in reviewing management competencies, corporate structures and relationships, and the underlying business plans.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

CONVENIENCE AND NEEDS OF THE COMMUNITY TO BE SERVED

Discussion of this factor should begin with a description of the primary trade area, including its location and population. A drive through the neighborhood surrounding the proposed location may be beneficial in determining the visibility, proximity to potential customers, accessibility, and immediate competition. A general discussion of land development in the immediate trade area may also be pertinent. Any differences between the examiner's perception of the trade area and that of the proponents should be discussed.

Also provide a general discussion of the relevant economic conditions, primary industries, and employers. Economic data should be limited to relevant information and relate a general understanding of the vitality and composition of the local economy. Population figures are particularly relevant (especially growth rates) and data establishing trends and projections should be provided if available. Several sources of economic data that provide insight into the economic conditions of the State, county or MSA are available. These include the Federal Reserve Quarterly Economic Review, the FDIC's statistical publications and databases, and other economic periodicals published by creditable sources.

Detail competition, both bank and non-bank, if applicable. Usually this is provided by the organizers, but driving through the surrounding area or consulting data that provides a summary of branches can be beneficial.

Finally, consider the services to be offered by the applicant and how they differ from those presently available including physical convenience. Consult with the responsible Case Manager to determine CRA requirements.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

CONSISTENCY OF CORPORATE POWERS

This factor was originally intended to eliminate institutions with broad-based charters that permitted the applicant to engage in unusual or risky forms of business. However, most states have issued statutes that preclude granting any powers inconsistent with the FDI Act. If any doubts exist, the Legal Division should be contacted. Pursuant to Section 24 of the FDI Act, no insured bank may engage in any activity that is not permissible for a national bank unless the FDIC has determined that the activity would not pose a significant risk to the fund and the institution is in compliance with applicable capital regulations. Applicants are also prohibited from exercising trust powers without the written approval of the FDIC; most States also require written approval.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

OTHER MATTERS

Currently, it is the responsibility of the examiner to evaluate the applicant's Articles of Incorporation and Corporate Bylaws. Of particular importance is a review of the director indemnification, to ensure that the agreements are not overly liberal. Liberal clauses, which include protection against gross negligence and fraud, should be closely scrutinized. The FDIC has taken the position that such broad agreements are not acceptable. With case manager concurrence, consult with a Regional Office attorney.

Review the offering circular when securities are to be offered to the public. The goal is to ensure that de novo financial institutions comply with the anti-fraud provisions of the Federal securities laws that require full and adequate disclosure. Flawed disclosures may expose the institution to litigation and serious capital loss. Refer to the FDIC Statement of Policy Regarding Use of Offering Circulars in Connection with Public Distribution of Bank Securities. The Washington Office’s Registration, Disclosure and Securities Operations Unit normally reviews both private and public offering materials and is available for assistance.

The review should insure that the circular provides sufficient disclosure of all material facts. SEC Rule I Ob-5 makes it unlawful to employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact or to omit a material fact in connection with an offering of any security.

In most cases, when securities are offered to the public an attorney specializing in securities law is employed. This usually ensures that the basic disclosures are made.

Offering circulars may also disclose proposed stock option plans, employment agreements, and issuance of stock warrants that should be closely reviewed.

Officials of area depository institutions should be contacted during the investigation and given an opportunity to express their opinions regarding the application. Opinions of other business and community leaders may also prove beneficial. Any formal objections should be investigated and appropriate comments set forth in the report. Sole reliance upon the opinions of competitors should be avoided and impartial conclusions should be reached. A sample Community/Competition Interview form is found in Appendix A.

For applicant’s proposing to deliver services over electronic channels, such as the Internet or wireless devices, the examiner should assess the information systems infrastructure, policies and security. An information systems subject matter expert should be required to participate in the investigation, depending on the complexity of the proposed delivery channel.

INVESTIGATION REPORT SUMMARY

Detail the applicant's designated contact person, including title, mailing address, email address, fax and phone number.

APPENDIX A

PROPONENTS/ORGANIZERS MEETING AGENDA SAMPLE

AND

MANAGEMENT/DIRECTOR INTERVIEW FORM

AND

COMMUNITY/COMPETITION INTERVIEW FORM

ANYWHERE BANK (PROPOSED)
MEETING WITH PROPONENTS
MAY 15, 2002

AGENDA

I. Opening Remarks

A. Acquaint Directors With Their Responsibilities and Liabilities
B. Apprise Organizers of Regulatory Involvement and Concerns

II. Directors Responsibilities

A. Sound, Independent Business Judgment
    a. Candid, Open Discussion of Bank Business
    b. Documentation of Decisions and Expression of Dissent Within the Board Minutes
    c. Confidentiality and Integrity
B. Informed of All Facets of Bank, Operations, Regulatory Environment, Competitive Environment
    a. Management, Reports, UBPRs
    b. Report of Examination and Visitation
    c. Internal and External Audit Reports
    d. Trade Publications, Seminars, Meetings
C. Direct the Bank in a Prudent Manner
    a. Establish goals, policies and strategies
    b. Hire Suitable Management to Implement Goals
    c. Monitor Management's Compliance with Board Directives
    d. Discipline or Dismiss Management as Necessary
D. Build Business for the Bank
E. Ethical Conduct and Policy
    a. Regulation O
    b. Represent the Bank in Your Community

III. Director Liability

A. Can be Personally Liable for Losses Arising From
    a. Legal lending Limit Violations
    b. Insider Transactions
    c. Bank Failures
B. Civil Money Penalties

C. Civil Suites (Shareholders) for Breaches of

   a. Duty of Care
   b. Duty of Knowledge
      aa. Willful Ignorance is not a Defense Against Liability for Negligence
D. Board Minutes are Legal Record and Vehicle for Expressing Dissent

IV. Ongoing Regulatory Involvement

A. Pre-opening Visitation
B. New bank Visitation
C. Examinations
   a. Safety and Soundness
   b. IS/Other Specialty
   c. Compliance

V. Why Banks Fail

A. Bad Loans – Poor underwriting, selection of risk, etc..
B. Poor Funds Management
C. Pursuit of Earnings with High-Risk Lending and Investment
D. Bad Management; Lack of Board Supervision

MANAGEMENT/DIRECTOR INTERVIEW FORM

Proposed Bank: ______________________________

Location: ______________________________

Director/Officer's Name: ____________________ Born: ____________

Resident Of: ____________________ Years: ____________

Principal Business: ______________________________

# of Shares Subscribed: ____________________ % of Subscription financed: ____________

Stock Payment Method: ______________________________

Reasons for becoming a Director/Officer?: ______________________________

How associated with proposal?: ______________________________

Previous experience as financial institution Director/Officer (If yes, when and where): ______________________________

Why does community need this Bank?: ______________________________

What strengths/contributions will you bring to Board/Bank?: ______________________________

How long have you known other Director/Officers?: ______________________________

Management/Director Interview Form
Page 2

Impressions of other proponents as individuals and as a working team?: ______________________________
____
____
____
____

Is any one proponent Dominant? Passive? :____
____
____
____
____

How much loan/deposit business will you bring to the bank in the first year?:__________________________
____
____
____
____

Ever been denied credit for reasons of credit problems?:____
____
____
____
____

Ever been indicted/convicted of a felony?:____
____
____
____

Questions/Comments:____
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____

COMMUNITY/COMPETITION INTERVIEW QUESTIONNAIRE

Date:____________________

Interviewee Name:________________________

Location: ________________________________

Need for an additional bank?:____

Economy and outlook of the market/trade area?:__________________________________

Deposit growth in the market/trade area and at your institution?: ______________________

Impressions and reputation of organizers/CEO?:__________________________________

Percentage of the market the new bank can expect to achieve?: _______________________

Loan rates at your institution? (Ask for a loan rate schedule in order to compare):______________

Deposit rates? (Ask for a deposit rate schedule): ______________________________

Any official protest or objection to the proposal?:_______________________________

FDIC

Report of Investigation

THIS REPORT OF INVESTIGATION IS STRICTLY CONFIDENTIAL

BANK OF ANYTOWN

ANYTOWN **ANYCOUNTY** **ANYSTATE**

Regio
n: Any Region harter:

Investigation Commenced:	11/30/2001	Date of Application:	09/25/2001
Investigation Closed:	02/06/2002	Date Application Accepted:	10/22/2001

FEDERAL DEPOSIT INSURANCE CORPORATION

FDIC 6510/10 (02-2002)

TABLE OF CONTENTS

This Report of Investigation consists of three major sections: Conclusions and Recommendations; Assessment; and Other Information. Investigating examiners should refer to the FDIC Statement of Policy on Applications for Deposit Insurance and Part 303 Subpart B – Deposit Insurance, of the Rules and Regulations for guidance. In considering applications for deposit insurance for a proposed depository institution, the FDIC must evaluate each application in relation to the factors prescribed in section 6 of the FDI Act. In general, the application will receive deposit insurance if all the statutory factors plus the considerations required by the National Historic Preservation Act and the National Environmental Policy Act of 1969 are resolved favorably.

CONCLUSIONS AND RECOMMENDATIONS

ASSESSMENT

OTHER

INVESTIGATION REPORT CONCLUSIONS AND RECOMMENDATIONS

Description of the Transaction

Applicant is a Federally chartered National Association in organization and as such, has no financial history. Proponent *originally* applied to the Office of the Comptroller of the Currency (OCC), its primary regulator, for permission to organize as a National Association on August 23, 2000.

However, due to the volume of substantive deficiencies in the Application, the OCC and Federal Deposit Insurance Corporation, requested additional supporting information during the Fall of 2000. In summation, these deficiencies emanated from the lack of supporting documentation regarding critical business model assumptions including but not limited to, customer acquisition rates as well as, deposit/loan growth composition and volumes. Other material weaknesses included the absence of profitability within the formative stages and independent market research supporting the feasibility of the nontraditional delivery channels proposed {non-branch kiosk}. Weaknesses emanating from the original proposal were never satisfactorily resolved and the Applicant withdrew the proposal on April 16, 2001.

Applicant, after substantive modifications to the business model and management team, resubmitted the proposal on October 9, 2001. The proposal calls for the Applicant to be part of a two-tier holding company structure. The United States (US) based holding company and initial-tier will be Holding Company-2, Incorporated, Anytown, Anystate. It will be a wholly owned subsidiary of Holding Company-1 plc, London, England, the top-tier holding company. Both holding companies are active and fully operational as of the date of application. The Applicant intends to file an application with the Federal Reserve Bank for the formation of a bank holding company.

The Applicant's business model espouses the use of multiple delivery channels (integrated model) to service its customer base including: a traditional retail bank site and supermarket branch network, as well as, a fully transactional web site and customer call center.

Financial History and Condition

The Applicant has provided reasonable support for asset and liability projections. Moreover, the proposed investment in fixed assets is within regulatory guidelines. Organizational expenses, while seemingly excessive, are fully covered by the initial level of capital. While the finding on this statutory factor is ***favorabl****e*, one open supervisory item remains. This pertains to the submission of acceptable agreements covering the two proposed related party transactions. Said related party transactions should ensure that the resulting expenses to the insured institution are on terms prevailing in the market for similar services performed and/or due not result in any economic disadvantage or consequence. Related party transactions are summarized on page 8 of this Report.

Adequacy of the Capital Structure

The Applicant has provided for a strong initial capitalization base. Such capital is commensurate with the inherent risks of the business plan and sufficient for the projected growth of the institution. Year three proforma leverage ratio amounts to 8.82%. While the finding on this factor is ***favorable,*** it is contingent on the execution of the licensing (lease) agreements for the in store branches with Albertsons, Inc.

Future Earnings Prospects

The Applicant's business model suggests that it can attain adequate profitability. This profitability is based viable assumptions, which are comparable to various banking peer groups. The finding on this factor is ***favorable.***

INVESTIGATION REPORT CONCLUSIONS AND RECOMMENDATIONS (Continued)

General Character of Management

The general character of the proposed management team appears fundamentally sound and consistent with a rating of "2" under the Uniform Financial Institutions Rating System. Proposed management's aversion for risk is suggested by the concentration of less risky residential real estate during the formative years. While the finding on this factor is ***favorable***, one open supervisory item remains pending. To date, the Applicant has not submitted any stock benefit plans/agreements on its executive officers or directors. In light of exceptions taken during the prior proposal on the extent of option grants to certain executive officers, appropriate due diligence should be accorded prior to chartering.

Risk to the Fund

The proposal does not appear to present any undue risk to the insurance fund. This determination is based on the business model's strong initial capitalization base, seemingly conservative management team and investment philosophy, as well as, the viable and multi-faceted branch network strategy. The finding on this factor is ***favorable***.

Convenience and Needs of the Community

Given the extent of competition and available market share, the Applicant would not adversely impact competition or the delivery of financial services within the market area. The finding on this factor is ***favorable*.**

Consistency of Corporate Powers

The finding on this factor is ***favorable***.

Recommendation

The Examiner has concluded that all seven statutory factors have been favorably resolved. However, three open supervisory items remain and should be satisfactorily addressed prior to chartering.

Examiner

FINANCIAL HISTORY AND CONDITION

Assess the reasonableness of asset and liability projections, and composition in relation to the proposed market. Assess the financial condition of parent company and its significant subsidiaries, if applicable. Asses the investment in fix assets. The applicant's aggregate direct and indirect fixed asset investment, including lease obligations, must be reasonable in relation to its projected earning capacity, capital, and other pertinent matters of consideration. Proposed fixed asset investments should conform to applicable State law limitations. Assess compliance with security requirements of Part 326 and with the National Historic Preservation Act. Evaluate any financial arrangement or transaction involving the applicant and an insider(s). The transaction should demonstrate that: (1) the proposed transaction is made on substantially the same terms as those prevailing at the time for comparable transactions with non-insiders, and does not involve more than normal risk or present other unfavorable features; and (2) the proposed transaction must be approved in advance by a majority of the incorporators. In addition, full disclosure of any arrangements with an insider must be made to all proposed directors and prospective shareholders. An insider is a person who is proposed to be a director, officer, or incorporator, a shareholder who directly or indirectly controls 10 percent or more of a class of the applicant's outstanding voting stock; or the associates or interest of any such person.

Summary and Findings

Proposed Retail Bank Site and Supermarket Branch Network

Retail Bank Site

Holding Company-2 (USA), the initial-tier holding company, has leased approximately 6,100 square feet of ground floor space in a five story commercial office building located at 2001 Palm Blvd., Anytown, Anystate. This site serves as the headquarters to Holding Company-2 and retail banking location of the proposed institution. It formerly served as a site for another financial institution and thus contains a vault and drop box area. The current building contains a certain amount of unoccupied space to accommodate the Applicant's future growth needs. An option on this additional space has been structured and provided for within the lease. The site is located within Metropolitan, AnyCounty, and on a heavily traveled boulevard adjacent to a major intrastate highway (I-95). The service area within the immediate vicinity, contains numerous commercial office buildings, service establishments, a shopping mall, financial institutions, as well as, nearby residential developments and condominiums.

Lease Agreement - Retail Bank Site

An office building lease was executed between 2001 Partners, L.C. and Holding Company-1 plc, London, England, the top-tier holding company. It contains an initial three-year lease provision, as well as, certain options. The tenant may extend subject lease for two (2) five (5) year periods under the same terms and conditions. In addition, tenant may also exercise an option for an additional 4,800 square feet within the building under similar terms and conditions. Rent is payable monthly and subject to annual increases based on the lesser of 5% or the percentage rise in the Consumer Price Index. The current rent within the lease includes real property taxes based on 1999 estimates. Any subsequent increases in said taxes are based on the tenant's pro rata share. No bankruptcy or dissolution clause was noted. A security deposit of $19,000 was collected.

Supermarket Branch Network

The organizers intend to operate a total of twelve supermarket branches during the first year of operation with Albertsons, Inc. as its host retailer. Eleven of the twelve branches were fully operational units that were closed July 2001 by Wachovia, NA, following its acquisition of Republic Security Bank, Anytown, Anystate. Albertsons will open the last supermarket branch (twelve) in November 2002. The proposed supermarket branch network will have seven locations in two counties, and will be located within heavily populated cities and townships.

Lease Agreement – Supermarket Branches

Albertsons and the Applicant have yet to complete and execute a contract on the twelve store locations proposed. Currently, Albertsons has submitted a proposal to the Applicant for all twelve stores. While no contract exists yet, proposed CEO Hamm has made assurances that Albertsons management has reserved said branches for the Bank and removed them from their branch availability list. All eleven existing banking facilities (one in process of construction) have been vacant since July 2001. Albertsons' legal counsel is presently preparing a License Agreement for execution, which may reportedly include the following terms and conditions.

Each License (lease) term will be for a minimum of five years, and include two five-year options. Initial license fees will be $30,500 annually ($2,541/mo.+ ATM fees of $250/mo) with modest increases for each successive option term. While the branches are essentially complete, any additional remodeling and/or modification related expenses will be borne by Applicant. All personal and real property taxes are the responsibility of the host, Albertsons.

Branch Network Host – Albertson's Inc. (NYSE: ABS)

Albertson's Inc, a national supermarket operator, is one of the world's largest food and drug retailers, with annual revenue of approximately $37 billion. The company is based in Boise, Idaho and operates more than 2,500 retail stores in 36 states. The company has a market capitalization of nearly $13 billion and holds a credit rating[1] for its outstanding senior notes and debentures of BBB+ (investment grade rating).

Recently Albertsons issued a press release (November 29, 2001) reaffirming the company's intent of preserving Anystate as a strategic market. This release was in response to securities analyst reports that the company had weak market share in many Anystate, cities and was potentially planning an exit out of the entire state. Such a decision would have serious repercussions for the Applicant's deposit assumptions considering the supermarket channel's relative importance to customer and deposit acquisition. The press release stated that the company was attempting to increase operating efficiencies by closing under-performing stores but will invest $125 million throughout the state for new store construction and remodeling. The capital expenditure represents a 25% increase over the prior year. Proposed CEO Hamm stated that company officials have not identified any of the eleven supermarket branch locations in subject proposal for closure.

Asset and Deposit Funding Projections

Deposit Growth Considerations – Prevailing Market Share, Competitive Factors & Recent Denovo Activity

Statistics delineating all FDIC insured institutions with offices located in Anycounty-1 and Anycounty-2, Anystate, suggests that there is intense competition for existing market share. Competition comes from three distinct sources; (1) retail branches within the both county's market, (2) Internet divisions of retail banks, and (3) banks/thrifts operating exclusively on the Internet.

As of June 30, 2001, there were a total of 450 banking offices located within Anycounty-1 with aggregate deposits of $22.4 billion, representing a nearly 5% year over year (YOY) deposit increase. For the same period, Anycounty-2 reflected 405 banking offices with aggregate deposits of $23.9 billion, or a 5.5%YOY increase.

The bulk of the market share within both counties is held by the branch offices of larger out of state regional and super-regional holding companies. Despite the extent of competition, the organizers believe that they can differentiate their proposed institution by delivering high quality service via multiple delivery channels. The Applicant will employ marketing strategies professing same and will stimulate growth through the strategic pricing of deposits and efficiency of service.

Denovo Institutions – Traditional

A review of denovo institutions, which have opened in Southeastern Anystate suggests that nearly all have experienced a certain degree of success in attracting funding. This has occurred despite intense competition by local and out of area institutions within those respective markets. Contributing factors to their success include all and/or a combination of the following: (1) favorable state/local economy and area demographics (2) an existing and vast deposit base (3) overall negative consumer perceptions about larger institutions and their inability to provide adequate service and (4) ability of local directors and executive officers to leverage their existing community contacts in order to attract new business.

[1] Standard and Poors Corporation; Bond Guide, December 2001.

The following table depicts the recent experience of certain Denovo institutions within select Anystate markets.

Institution Total Assets – Latest Qtr. Available 9/01- $000	Insured Date Charter Type Business Model	Volume of Total Deposits After Year 1 - $000 **v**. Projections	Volume of Total Deposits After Year 2 - $000 **v**. Projections
Grand Bank Anytown, Anystate $95,313	Feb. 1999 State Traditional Retail	$51,422 *	$65,663
		$18,500	$32,752
Landmark Bank, NA Anytown, Anystate $145,450	Aug. 1998 National Traditional Retail	$20,701 *	$39,930
		$13,800	$26,900
Marine Bank & Trust Anytown, Anystate $65,011	Jul. 1997 State Traditional Retail	$24,149 *	$36,799
		$15,000	$28,000
Independent Community Bank Anytown, Anystate $33,815	Oct. 1998 State Traditional Retail	$13,625 *	$27,153
		$25,000	$35,000
First Peoples Bank Anytown, Anystate $35,352	Apr 1999 State Traditional Retail	$18,110 *	$24,115
		$20,000	$27,500
Gulfstream Business Bank Anytown, Anystate $99,701	May 1999 State Traditional Retail	$33,542 *	$43,747
		$20,152	30,736
Flagler Bank Anytown, Anystate $33,501	Apr. 2000 State Traditional Retail	$10,795 *	$28,503
		$10,330	$18,210
Transcapital Bank Anytown, Anystate $93,097	Jul 1999 State Traditional Retail	$41,228 *	$77,199
		$27,280	$48,430

Projections obtained from respective Reports of Investigation, Summary of Investigation Report, and/or supporting Regional office data when available. * Represents less than twelve months from insured date unless a later opening date is specified.

Deposit Projections & Assumptions

As depicted on page 12 of this Report, the Applicant projects total deposit volumes of $95.1 million, $164.5 million, and $202.8 million, within the first three years, respectively. Additional key assumptions include the following:

- Customer funding will come from the following sources: Branch network 81.5%, 13% Internet, Other (executive officer call program, customer call center, promotional/event kiosks, referrals) 5.5%.

- The distribution channels above project to achieve customer volumes of 9,124, 15,004, and 17,932 during the first three years, respectively. Within this assumption, Applicant further assumes that each customer will have two accounts. This translates to yearly total account volumes of 18,248; 30,004; and 35,864, respectively.

- In arriving at total deposit volumes, the Applicant estimated that each account would retain an average balance of between $5.2M to $5.6M. The table on the subsequent page summarizes these calculations.

	Year 1	Year 2	Year 3
Deposit Customer Volumes – Cumulative	9,124	15,004	17,932
Account Volumes – Cumulative	18,248	30,008	35,864
@ average Balance of $5,216 Y1, $5,481 Y2, and $5,657 Y3 = Year-end Deposit Volumes	$95.1 MM	$164.4MM	$202.8 MM

With regard to the *Retail Branch* delivery channel, the Applicant assumes that its twelve supermarket branch network and traditional retail office will generate a sustainable deposit base during the formative years. The Applicant argues that eleven of the twelve proposed supermarket branch locations were profitable and viable branches when they were closed just six months ago by Wachovia Bank, following its acquisition of Republic Bank. According to proposed CEO Hamm, Wachovia's decision to close the branches, was driven primarily by philosophical differences and Wachovia's general unfamiliarity over that particular retail distribution channel.

Mr. Hamm stated that the branches are supported by Albertsons' extensive market research. As a matter of necessity and prudent retail practices, Albertsons will assess and enter new store markets only when certain favorable economic and demographic factors prevail. These factors include densely populated areas, traffic patterns, competition, and household income profiles. The favorable outcome of these studies will determine ultimate capital investment and store locations. Mr. Hamm argues that this research is critical to the proposal and a reason why the former branches were successful when owned by Republic Bank. The table below depicts the branch network's one-year history in attracting core funding. Results for December 2000 reflect nearly a 50% rise in funding from the previous period. Applicant projects that it can regenerate at least 65% {$78MM} of the balances existing at year-end 2000 during its formative first year.

Anycounty-2 Stores (7)		Dec-99	Jun-00	Sep-00	Dec-00
Total $ Mil.		**54.5**	**58.4**	**62.1**	**67.1**
Average		7.8	8.3	8.9	9.6

Anycounty-1 Stores (4)		Dec-99	Jun-00	Sep-00	Dec-00
Total $ Mil.		**25.7**	**41.8**	**47**	**53.1**
Average		6.4	10.5	11.8	13.3

Totals All 11 Branches		80.2	100.2	109.1	120.2
Average/Branch		7.3	9.1	9.9	10.9

In addition to the actual experience of the former branches, in-store branch projections have also been based on studies from two credible market sources, specializing in supermarket branches and alternative delivery systems; National Commerce Bank Services (NCBS), Memphis, TN., and International Banking Technologies (IBT) Norcross, GA. A 2000 NCBS study of 61 financial institutions covering 148 in-store branches resulted in the following average branch (NCBS owned branches) statistics below.

- Total accounts: 1,523
- Total Deposits: $11,906M
- Checking: $1,896M {16% of total – Average Balance (AB) $2,243}
- Savings/MMDA $4,532M {38% of total – AB of $10,739}
- CDs: $5,478M {46% of total – AB $21,317}

IBT, one of the largest retail consulting companies in the industry, has market data on clients ranging in size from, $21 million to $600 billion. It categorizes the performance of supermarket branches into high, median, and low. The Proposal's assumptions on the next page are compared with IBT's *median* supermarket branch performance measures (per branch). Applicant projections are also included for its one main office and traditional retail branch.

Period	IBT Median SM Branch Statistics	Applicant Projections – 12 Supermarket	Applicant Projections – 1 Main Office
Year 1	1,800 new accounts – Total Deposits $6.3MM	1,115 new accounts – TDs $5.8MM	3,346 new accounts – TDs $17.5MM
Year 2	1,440 new accounts – Total Deposits $12.7MM	672 new accounts – TDs $9.5MM	2,016 new accounts – TDs $28.3MM
Year 3	1,200 new accounts – Total Deposits $19.0MM	355 new accounts – TDs $11.8MM	1,066 new accounts – TDs $35.3MM

Actual branch history and empirical data, as well as, market research from both NCBS and IBT lend credence to the subject proposal's supermarket branch assumptions. Remaining branch assumptions for the main office appear reasonable and attainable based on recent denovo experience, relatively modest volume expectations in relation to total deposits, and intangibles such as the proposed CEO's following within the community.

With regard to the *Internet* channel, the Applicant projects an account acquisition rate of 7 per day and 12 accounts per day for years 2 and 3. As support for these assumptions, the Applicant stated that since inception, its corporate web site has averaged 184 visitors per day (well over the 31,389 reported during the previous investigation) with over 879 registered parties. It is uncertain as to whether these "hits" are attributable to the interest regarding the Applicant's pending application for Federal deposit insurance or merely concerned investors (which number in the thousands) seeking additional financial information. Notwithstanding, the projections appear plausible considering information provided by Anybank, a pure play denovo internet bank in Anytown, Anystate. According to the bank's chairman, Anybank was recently experiencing traffic of over 2,500 visitors per day and adding an average of 20 deposit accounts per day. During its first year, Anybank was adding an average of 50 accounts daily. Anybank reported recent average account balances of $5M for DDA, $40M for MMDA, and $60M for CDs. It is important to note however, that Anybank has been highly aggressive with respect to deposit pricing during its formative months. Applicant deposit projections for this channel appear reasonable based on existing site traffic and recent competitor experience.

Asset Projections and Assumptions

Applicant's loan projections are largely supported by qualitative factors including the proposed CEO's following in the community given his executive position (Chief Credit Officer) with the former Anybank, Anytown, Anystate. In addition, he reportedly knows a network of real estate and commercial lenders, many of whom were reportedly direct reports while at Anybank. Mr. Hamm stated that he has kept in close contact with several lenders who reportedly hold considerable portfolios of high-quality performing loans and are seeking other employment opportunities.

During the formative stages, the projections call for a conservatively weighted real estate portfolio. Year 1 projections assume a 77% real estate weighting with 58% comprising single family mortgage and home equity loans to prime borrowers. A meaningful portion of the residential portfolio will be purchased via established brokers known to both the proposed CEO and senior lending officer. Mr. Hamm reportedly has vast experience in purchasing mortgage pools with favorable yield and prepayment characteristics. This strategy will be important to the Applicant during the first year given its needs to deploy excess liquidity into higher yielding instruments. Commercial loans will focus on small business and SBA loans. Mr. Hamm stated that these products were successfully delivered and managed by he and the proposed senior lending officer while at Anybank. In light of the proposed CEO's experience and reputation in the market, no exceptions were taken to the loan projections scheduled.

Fixed Assets and Organizational Expenses

Capital Investments

The Applicant's investment in fixed assets is within existing OCC statutory limitations, which permit total fixed asset investment of up to 100% of total capital. The total proposed investment in fixed assets to initial capital is 15%. Two insider or related company transactions were disclosed and noted below.

Total investment in fixed assets at inception is proposed as $4,099M versus actual expenses (as of 11/30/2001) of $1,700M. Approximately 77% {$2,984M} of the net investment pertains to the Applicant's technology platform. This includes computer hardware, software, and associated networks. The remaining 27%{$1,115M} investment pertains to the Applicant's customer call center as well as associated expenses and holdings of furniture and fixtures. Capitalized assets are being depreciated utilizing the straight-line basis over a five-year schedule. The only material capital investment subsequent to opening will be the costs incurred to re-establish the in-store branches estimated at $60M per branch.

Related Party Transactions

Front-End Web Application Design and Deployment

Holding Company-1 plc, London, England (the top-tier holding company; refer to page 14 for organizational structure) will provide the insured bank with the initial front-end web application. This technology service will result in a one-time charge to the proposal of $90M and an additional investment of $20M in year one. A license agreement was not available for review during the Application process. Applicant stated that the service will be commensurate with the prevailing market, observe existing arms-length guidelines for related party transactions, and will be independent of the services provided by the Chief Technology Officer (CTO) Frank Gray.

Dual Employees

Proposed CFO Nigel Newbury and CTO Frank Gray will perform their duties in a dual capacity for both the top-tier holding company in London and the proposed national bank. During the formative years, the CFO and CTO will spend approximately 50% and 90% of their time respectively at the proposed West Palm Beach main office. A service agreement will be executed between the bank and holding company at a salary level commensurate with their roles and the exact time they allocate to the proposal. Currently, salaries allocated to the respective executives to be borne by the proposed institution are $55M per annum. A formal agreement was not yet formalized and/or submitted for review.

Organizational Expenses

The Applicant's organizational expenses are *substantial.* Problems with the original business plan, lack of initial fiscal prudence and length of time are all contributing factors. Since the original application of August 2000, which began during Q4 1999, organizers have withdrawn the Application for Deposit Insurance (April 2001), refilled a new proposal (October 2001) with a notably different business model and delivery modes, replaced various board members and certain key executives and hired new replacements. In the process, the Applicant restructured and incurred costs by reducing staff that was prematurely added by the previous CEO. During the previous application, extensive expenses were incurred for salaries (volume of staff) as well as, legal, professional and advisory fees. These fees have continued to accrue, although at a lesser extent since the arrival of proposed CEO Hamm.

The following table outlines the proposed pre-opening expenses versus actual expense items incurred in connection with the chartering process. The actual expenses from the previous submission are shown for illustrative purposes and to identify any large variances subsequent to that time. The Applicant has included expenses from the original submission inasmuch as previous costs/expenses are directly or indirectly related to the current proposal. The Applicant asserts that errors made previously have resulted in a benefit gained during the current Application.

Expense Category	**Application Projection**	**Actual Expense** 11/30/2001	**Actual Expenses @ Last Proposal – 12/31/2000**
Pre-opening Salaries & Benefits	$1,522M	$1,280M	$677M
Living/Relocation Expenses	$6M	$6M	$6M
Recruitment	$82M	$82M	$82M
Travel/Staff Related Expenses	$65M	$69M	$37M
Occupancy and Office Related	$563M	$473M	$156M
Attorneys & Professional Fees	$982M	$968M	$417M
Tax, Audit, Application, Dep, Other	$680M	$523M	$91M
Total Organizational Expenses	$3,900M	$3,401M	$1,466M

Pre-opening salaries are substantial and equal nearly 38% of total organizational expenses (year-to-date). The high volumes are attributable to the number of staff retained by the organizing group during the organizational phase, including that of certain highly compensated proposed officers. As of year-end 2000, the Applicant had hired and retained twenty employees. While this figure has since been reduced to eleven at year-end 2001, a high-level of expenses was still accruing throughout the first half of 2001 from the original higher staffing table. Since the arrival of proposed CEO Hamm, he has taken a proactive role in reducing these related expenses by releasing unwarranted and/or prematurely hired staff.

FINANCIAL HISTORY AND CONDITION (Continued)

Attorneys, professional, and consulting fees are substantial and were highly criticized at the previous Corporation investigation. The criticism involved their excessive levels for the chartering of a denovo bank. It was argued that most of the expenses were discretionary and could have been controlled and managed in a more prudent and cost effective manner.

Included within the expenses are those associated with the Applicant's counsel/advisor. The Applicant retained the firm of Hodson & Hodson (HH), Washington, D.C., for legal and advisory services in connection with the chartering and application process. The engagement letter executed January 6, 2000 provides for an hourly billable rate ranging between $250 - $400. Overall fees for the chartering process were originally estimated by counsel to be between $250,000 and $300,000. In addition to this firm, the Applicant retained and incurred expenses with two other consultants that have since been discontinued under the current proposal. The high rate of legal and professional expenses billed from HH declined considerably after January 2001. Since proposed CEO Hamm's arrival, he has discontinued the previous practice of utilizing HH as regulatory liason during the current Application filing. Mr. Hamm stated that this has saved considerable monies and lowered the expense rate during Q3 and Q4 2001.

In addition to the legal and professional fees billed by HH, the pre-opening expense category includes consultancy fees billed by Holding Company-1 plc, in the amount of $428M. The fees pertain to the time commitment expended by several dual employees (employees of the holding company and proposed bank), which included the current officers (CFO Newbury, CTO Gray), certain software developers, and the former CEO and founder Casey Grant. The consulting fees constituted their salary calculated on a pro-rata basis for the amount of time expended during the organizing process, including application of an overhead component. The calculations were reportedly discussed with Holding Company-1's external auditor who assessed their reasonableness and accompanying tests for transactions with non-affitiliated parties. Documentation regarding this due diligence was not available for review during the Investigation process.

The last pre-opening expense item exhibiting a high variance was the "other" line item. Nearly the entire variance is represented by depreciation expenses associated with the Applicant's technology platform and very conservative prior depreciation schedule of three-years.

A key mitigating factor to the seemingly excessive pre-opening and organizational expenses pertains to the fact that the proposal has successfully raised capital during two separately underwritten offerings (see capital adequacy section on offerings and company structure). The holding company's equity position was recently reported at £19,137,532 or approximately $27.36 million. The proposal calls for an initial capital infusion of $26.9 million. The volume of capital from inception can absorb the high organizational expenses and support the proposed growth of the Applicant. Any actions by Regulatory Authorities to disallow certain organizational expenses above (from the previous submission) will simply result in the holding company having to absorb those costs. Considering the finite resources of the holding company and unlikely prospects of successfully executing a third capital offering, any organizational costs borne by the holding company will likely result in a <u>lower</u> initial capital infusion to the bank. Lower capital at inception would be offset by reduced organizational expenses, thus likely amounting to a wash or little financial impact.

Security Requirements & National Historic Matters

With regards to the proposal's security program, including compliance with Part 326 of the FDIC Rules and Regulations, organizers have committed to fully adhering to all applicable requirements. With regard to the National Historic Preservation Act, the State's Division of Historical Resources, corresponded with the Applicant on June 14, 2000. The department stated that the primary site (main office) would not interfere with any applicable historic sites and/or accompanying statutes. In regards to the retail supermarket branch network, all locations proposed are former branches of a federally insured institution. As such, no historic preservation or environmental impact concerns are anticipated.

Pending the submission of acceptable agreements covering two proposed related party transactions, the overall findings with regard to this factor is <u>FAVORABLE.</u>

FINANCIAL HISTORY AND CONDITION (Continued)

PROJECTED BALANCE SHEET			
	YEAR END BALANCE		
ASSETS	FIRST YEAR	SECOND YEAR	THIRD YEAR
CASH AND NONINTEREST BEARING BALANCES	3,816	5,940	6,893
INTEREST BEARING BALANCES			
SECURITIES – Held-to-maturity			
Available-for-sale	38,280	51,480	34,887
FED FUNDS SOLD AND REPURCHASE AGREEMENTS			
LOANS			
Construction and land development secured by real estate			
Loans secured by farmland			
Loans secured by 1-4 family residential properties	3,893	7,749	8,309
Junior lien loans secured by 1-4 family residential	34,915	44,848	56,463
Loans secured by multifamily (5 or more) residential properties			
Loans secured by non-farm non-residential properties	12,548	35,544	58,226
Credit card and related plans to individuals			
Agricultural loans and other loans to farmers			
Commercial and industrial loans	13,444	25,882	41,457
Loans to individuals for household and personal expenditures			
Other loans	2,075	5,738	11,332
LESS: Unearned income			
Allowance for loan and lease losses	836	1,497	2,197
NET LOANS	66,039	118,264	173,590
PREMISES AND FIXED ASSETS	4,015	3,054	2,202
ALL OTHER ASSETS	2,138	3,329	3,862
TOTAL ASSETS	114,288	182,067	221,434
LIABILITIES			
DEPOSITS			
Demand deposits and noninterest bearing deposits	7,007	12,652	15,463
Interest bearing deposits	49,461	85,363	106,529
Time deposits of less than $100,000	27,098	46,514	56,622
Time deposits of $100,000 or more	11,613	19,935	24,266
TOTAL DEPOSITS	95,179	164,464	202,880
FED FUNDS PURCHASED AND REPURCHASE AGREEMENTS			
BORROWINGS			
OTHER LIABILITIES	638	704	763
TOTAL LIABILITIES	95,817	165,168	203,643
EQUITY CAPITAL			
COMMON STOCK	1	1	1
SURPLUS	26,899	26,899	26,899
UNDIVIDED PROFITS	(8,429)	(10,001)	(9,109)
OTHER EQUITY CAPITAL			
TOTAL EQUITY CAPITAL	18,471	16,899	17,791
TOTAL LIABILTIES AND EQUITY CAPITAL	114,288	182,067	221,434
Tier 1 Leverage Capital Ratio	16.16%	9.28%	8.03%

ADEQUACY OF THE CAPITAL STRUCTURE

Generally, initial capital should be sufficient to provide for the maintenance of an 8 percent Tier 1 capital to assets leverage ratio (as defined in the appropriate capital regulation of the institution's primary Federal regulator) throughout the first three years of operation. The institution must also maintain an adequate allowance for loan and lease losses. Determine if the institution is being established as a wholly owned subsidiary of an eligible holding company (as defined in Part 303, subpart B). Assess the adequacy of proposed capital in light of projected deposits and growth, business plan risk tolerance, and the ability of proponents or parent company to provide additional capital. Special focus depository institutions (such as Internet or credit card banks) should provide projections based on the type of business to be conducted and the potential for growth of that business. All stock of a particular class in the initial offering should be sold at the same price, and have the same voting rights. Proposals which allow insiders to acquire a separate class of stock with greater voting rights or at a price more favorable than the price for other subscribers are not acceptable. Discuss financing arrangements for directors, officers, and 10 percent or more shareholders. Financing arrangements by insiders of more than 75% of the purchase price of the stock subscribed to by one individual or more than 50% of the purchase price of the aggregate stock subscribed by the insiders as a group should be supported to be considered acceptable. Insiders should demonstrate the ability to service the debt without reliance on dividends or other forms of compensation from the applicant.

PROPOSED CAPITAL STRUCTURE

ITEM	COMMON STOCK			SURPLUS	RETAINED EARNINGS	TOTAL	THIRDYEAR AVERAGE ASSETS	CAPITAL ASSET RATIO
	SHARES	PV	AMOUNT					
Minimum Statutory Requirements			0			0		%
Amount Indicated on Application	1,000	1.00	1,000	26,899,000	(9,109,000)	17,791,000	201,602,000	8.82%
Revised Proposal			0			0		%
Recommendation of Examiner	1,000	1.00	1,000	26,899,000	(9,109,000)	17,791,000	201,602,000	8.82%

SALE PRICE PER SHARE OF CAPITAL *(original proposal)*	*(revised proposal)*	FEES OR COMMISSIONS IN CONNECTION WITH SALE OF STOCK
IPO: 2p (£ .02 or 3¢) Secondary IPO: 20p or 30¢ Assumes exchange rate @ £1.00 : $1.50		0.00

Summary and Findings

Initial Capitalization

The top-tier holding company (see ownership structure) has successfully executed two capital offerings totaling £22 million or approximately $35.2 million. The proposal calls for a direct infusion from said holding company.

The organizer's general consensus is that the level of proposed capital will suffice. In the event that additional capital is required, the Applicant has stated that the feasibility of a third public offering (see ownership structure) will be largely contingent upon favorable conditions within the European equity markets. Proposed CEO Hamm suggested a possible listing application to a US stock exchange may be pursued to enhance the likelihood of additional capital sources and share liquidity.

Founding directors are listed as follows: Lance Price (HC Director), Casey Grant (former director/officer), Nigel Newbury (proposed CFO), Stephen Helm (former director/officer), John Wise, Hamilton Trustees Limited.

ADEQUACY OF THE CAPITAL STRUCTURE (Continued)

Top-tier Holding Company – Additional Information on Capital

Shares Authorized: 750,000,000
Shares Outstanding: 350,000,000
Par Value: @ 50p or .75¢; assumes original exchange rate @ £1.00:$1.50
Principal Shareholders:

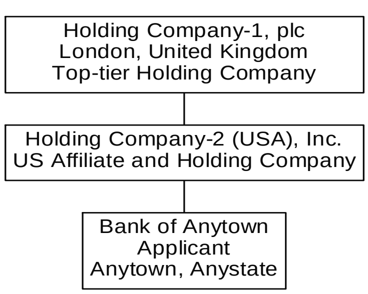
Shareholder	Category	Shares Held	Percent of Outstanding Shares
Casey Grant	Former Director	54,750,000	15.64%
Hamilton Trustees Limited	Institution	36,875,000	10.54%

Casey Grant, *former* proposed CEO of the bank and its holding company, is no longer affiliated with the proposal, other than as its single largest shareholder. Mr. Grant has requested two special board meetings to seek the voluntary dissolution of the holding company. Such proposal was soundly defeated by shareholders with over a 2:1 margin

Hamilton Trustees, Ltd. (10.5% shareholder) is reportedly a passive shareholder (no board or management representation) and trustee to certain trust funds. Hence, the beneficial owner of the shares is a trust, reportedly established to benefit certain charitable organizations. Per Mr. Newbury, no discussions have taken place with the Federal Reserve (as of January 7, 2002) to establish any element of control with respect to such party.

Ownership Structure

As depicted in the chart below, the top-tier holding company, Holding Company-1 plc, is headquartered in London and owns the Applicant via a United States (US) based holding company, Holding Company-2. The top-tier holding company, incorporated November 30, 1999, was established as a Public Limited Corporation (PLC). A PLC retains the status and functionality of a US based corporation and is the proper vehicle should the company wish to tap the country's capital markets. It is a registered entity within the UK, governed by prevailing regulations (Companies Act) including minimum capital requirements. In addition, the liability of its members is *limited* to the amount of shares held. According to proposed CFO Newbury, the top-tier holding company has no other operating subsidiaries besides the US holding company. It was reportedly evaluating other financial opportunities in the United Kingdom (UK) and elsewhere in an effort to establish alternative revenue sources. In this regard, Holding Company-1 plc, had reportedly met with officials of the UK's Financial Services Authority (FSA) with the intent on formally applying to become a UK Depository Institution. No formal applications have been made as of the Application date.



Holding Company-1 plc, is a publicly traded company, which was admitted and listed on the Alternative Investment Market (AIM – tantamount to the NASDAQ small capitalization equity market in the US) of the London Stock Exchange on December 16, 1999. It successfully completed an initial public offering during late 1999, raising £2 million (before associated expenses of £61,928) as well as, a fully underwritten secondary offering in February 2000, which raised an additional £20 million (also before associated expenses of £505,563). Total capital raised in US dollars approximated $35.2 million (before expenses).

Holding Company-1 plc – Financial Position

As of the most recent interim financial report (June 30, 2001), the entity held total assets of £19,581,817 or approximately $27.4 million. Total equity was £19,137,532 with cash representing the bulk at £18,231,943 or $25.5 million. Cash balances are invested within various European correspondents in short term, money market instruments and placements. For the same period above, operating losses after taxes totaled £1,250,942 or $1.7 million; a sharp rise (247%) over prior year losses. Reportedly, then eprime bank (in formation) incurred significant operating costs anticipating the issuance of a National Bank charter, which later failed to materialize. These higher operating costs, which included a high volume of staff were exacerbated by one-time restructuring charges related to personnel and other expense reductions programs. According to Mr. Newbury, the monthly cash "burn rate" or actual costs net of interest income was approximately $112M per month. Given the absence of dividends during the foreseeable period, the holding company will need to continue managing expenses and/or develop other revenue producing avenues to stem operating losses and its accompanying effect on capital.

According to proposed CFO Newbury, the company's stock retains five market makers and is held by over nine institutional investors (mainly mutual funds companies). In December 2001, the company possessed a market capitalization of approximately £8.75 million or approximately $12.3 million, thus representing a steep discount to June 2001's book value.

With a recent share price of 2.5p (£.03 or ¢3.57), the 52 week range consisted of 11.25p (£.11 or ¢16.09) to 2.25p (£.23 or ¢3.21). At this price, the stock was trading nearly 78% off its yearly high. The holding company's low, which it reached in October 2001, was attributable to a combination of the failed charter attempt, as well as, adverse market conditions.

Capital Adequacy Assessment

Proposed Business Model

The proposal calls for launching an integrated model leveraging technology and a traditional physical branch network. These multiple channels include one traditional retail banking office, a network of twelve convenience-driven supermarket branches, a fully transactional website and customer call center. The model attempts to focus on the efficient delivery of banking products with superior customer service. The in-store supermarket branch network will be employed within a large regional supermarket host located in heavily populated and demographically favorable service areas, cities/townships. The proposal also seeks to target the growing Hispanic community within Anycounty-1 and Anycounty-2 and will deliver products and services (Web/phone) in a bilingual format.

Projected Growth and Business Model Risks

Capital levels in light of projected growth and prevailing business model risks appears satisfactory. The business plan's overall risk assessment appears Low to Moderate.

On the asset side of the balance sheet, the proposal seeks considerable loan growth. This loan growth however, appears to be conservatively weighted towards the real estate sector in general and within products secured by primary residences (conventional/prime SFRs and HELs). Refer to the previous comments (page 8) regarding Asset Projections and Assumptions. The proposed loan mix represents a notable reduction in risk versus the previous proposal which was focusing extensively on higher yielding commercial loans. The ability to generate loans during the formative years will be partly facilitated by residential portfolio loan purchases. This is reportedly an area of expertise of the proposed CEO and SLO. Risks in these products will seemingly be limited to the premium paid given the current interest rate environment and accompanying earnings risk (write-down of premium on the asset side) should these underlying assets pre-pay (interest rate risk). The extent of loan volume appears to be coming at the expense of liquidity, which is a little lower than would otherwise characterize a denovo bank (proforma Loan to Deposit Ratios 69%, 72% and 86%, for first three years, respectively). However, given the current interest rate environment and low yields on short term Federal Funds, many institutions are attempting to minimize said holdings in order to achieve a more optimal net interest margin.

With regard to the deposit side of the growth projections, risks have been reduced considerably versus the previous proposal given the adoption of an established and more traditional funding channel. The supermarket branch network proposed in the model has a prior history and reportedly held actual deposit volumes of $120 million as of the year-end 2000[2]. This proven channel along with the main office, transactional website, and business referral prospects of the proposed CEO and select board members should provide reasonable assurances to the proposal's deposit projections.

[2] Raw data from the former Republic supermarket branches were not available for Examiner review. Proposed CEO Hamm stated that internal RSB reports (now property of Wachovia) were proprietary and thus restricted.

ADEQUACY OF THE CAPITAL STRUCTURE (Continued)

Business model risks emanate primarily from the denovo's operating environment. The operating environment is currently faced with a yield curve, which while steep and historically beneficial for financial institutions, contains a very low short-term rate base. The risk, from an asset/liability management and earnings perspective, is that short-term rates remain at historical lows. As such, any additional rate declines (Federal Funds Target Rate and resulting Prime lending rate reductions) may result in a further compression of net interest margins. Short-term rate reductions were recently implied by the 30-Day Federal Funds Futures contracts, which settle in April 2002[3]. Ensuing rate reductions could make net interest income and profitability goals for the denovo more challenging thus increasing the operating losses. Other risks with regard to the operating environment pertain to the current state of the local, state, and national economies. Any prolonged national recession could begin to more negatively impact the State and the bank's proposed service areas. This risk would occur at a time when the bank could be ramping its loan portfolio. Mitigating factors to the economic environment include the apparent strength of the new management team (CEO Hamm, SLO Well and Directors Wart and Marcotte) and the higher concentration on less risky residential mortgage lending.

In the interim, the business model risks also include the current status of the lease or licensing agreements with the retail host, Albertsons. While the organizers contend that the twelve proposed branch locations have been reserved for the denovo bank, firm agreements have yet to be executed. The failure of procuring any or all of these proposed branch locations by the organizers could have a negative impact on the applicant achieving deposit and/or loan projections. While lower growth would result in generally higher capital ratios, it might impact earnings given the sizeable fixed charges and overhead that the Applicant would need to overcome to become profitable.

While the finding on this factor is <u>FAVORABLE</u>, it is contingent on the execution of the licensing (lease) agreements for the in-store branches with Albertsons Inc.

[3] Chicago Board of Trade; January 11, 2002 April Contract settlement price of 98.405.

FUTURE EARNINGS PROSPECTS

Assess the reasonableness of earnings projections and supporting assumptions of the business plan in relation to the economic environment and competition. Projected interest income, expense, non-interest income and expense, and provisions for loan and lease losses should be analyzed and compared to experiences of other new banks in the trade area or in a similar market. When necessary, the examiner should make adjustments to the applicant's projections and discuss the basis for the differences. Incorporators should demonstrate through realistic and supportable estimates that, within a reasonable period (normally three years), the earnings of the proposed institution will be sufficient to provide an adequate profit.

Summary and Findings

The Applicant projected a net operating profit (loss) of ($8,429M), ($1,573M), and $893M for the initial three years of operation, respectively or a cumulative operating loss of ($9,109M). These underlying projections were based on reasonable average earning assets to average assets assumptions (what-if scenario 5) of 89%, 92%, and 94% over the respective periods. Applicant asserts that the average earning asset assumptions are on the conservative range given the proposal's technology platform and lower emphasis on costly traditional retail branches and fixed assets. The Applicant argues that the assigned average earning asset assumptions represent the most conservative scenario possible and that higher earning asset utilization during the formative years are plausible based on peer group data. Any higher utilization may result in improved net interest margins and a higher operating profit in year three.

Margin Analysis

In light of the substantial interest rate volatility during calendar years 2000 (Central Bank tightening of the money supply) and 2001 (aggressive loosening and adding of system liquidity), any meaningful comparative analysis is better served by assessing the net interest income line as opposed to individual yield and cost factors. This facilitates analysis of the proposal's assumptions over varying interest rate environments.

The table below depicts the proposal's estimates for net interest income and non-interest income to average assets during the formative years. Comparisons for reasonableness include an Examiner calculated average of denovo institutions (Banks listed on page 6 of this report) as well as, various peer group and State averages for the period ending September 30, 2001.

Institution	Net Interest Income	Non-Int. Income	AEA/AA
Examiner Denovo Sample -Mean	3.71%	0.79%	93.91%
UBPR Peer Group 9	3.91%	0.74%	94.05
UBPR Peer Group 13	3.99%	0.70%	93.47
UBPR Peer Group 25	3.72%	0.57%	91.72
Mean – All Insured Banks – Anystate.	3.91%	0.83%	92.19%
National Bank Year 1	3.94%	0.38%	89.37%
National Bank Year 2	4.41%	0.54%	92.46%
National Bank Year 3	4.70%	0.55%	93.70%

Notes: Source: Uniform Bank Performance Reports; Peer Group 9=Banks with TA of $100-$300 million within Metropolitan Area; Peer Group 13=Banks with TA of $50-$100 million within Metropolitan Area; Peer Group 25= Banks established within last 3 years<=$50 million. AEA/AA represents Average Earning Assets to Average Assets.

Comparative analysis suggests that the Applicant's Net Interest and Non-Interest Income estimates appear reasonable during the first year of operation. During years 2 and 3, the Applicant's loan mix begins to shift from lower yielding residential and home equity loans (58% year 1 versus 43% and 38% years 2/3) to higher yielding commercial real estate products. While the changes in loan mix are ramped over a two-year period, the rising emphasis on the commercial real estate (19% year 1 mix, 30% and 33% years 2-3) category is accompanied by higher asset yields ranging from 100-125 basis points. This attempts to explain part of the expansion in the subject margins. Proposed CEO Hamm argues that the proposal's ability to underwrite fundamentally sound and higher- yielding commercial real estate loans is heightened by his previous relationships with many of the former lending officers of Anybank, Anytown. Said officers reportedly have established portfolios within the proposed service areas and are seeking other employment opportunities following Anybank's consolidation into Regionalbank.

On the funding side of the balance sheet, two factors emerge which seemingly justify lower cost of funds and consequently wider margins. First, the Applicant proposes to open with $26.9 million in capital or over 2 to 2.5 times the capital typically employed by denovo banks in Southern Anystate. The higher paid-in capital effectively lowers funding costs associated with initial balance sheet activity (loan/bond purchases and origination). Secondly, the proposal would be procuring funding liabilities in a very favorable interest rate environment. This environment characterized by historically low short-term interest rates enables the Applicant to attain a lower *average* cost of funds. This lower cost, coupled with the present steep yield curve, could justify the higher margins.

Of the eight denovos listed on page 6, Grand Bank in its third year of operation achieved a 4.44% net interest income (NII) to average assets ratio. This ratio, which is in the 75th percentile, occurred during an arguably more difficult interest rate environment (negative yield curve during 2H 2000) than the Applicant would likely experience. Nonetheless, the Examiner adjusted year 3 NII to average assets ratio to 4.44% to determine the impact on year three profitability and ensuing capital ratio. Despite the decline in margin, the Applicant would still exhibit profitability and a year 3 capital ratio of 8.56%.

Sensitivity Analysis

The Applicant submitted an analysis of the impact that certain scenarios would have on proforma earnings (Year 3 stress testing). These scenarios, which were part of the base plan, appear to be well formulated and realistic based on current market conditions and inherent risks within the Applicant's operating plan. The scenarios examined include the following:

- *Loan Growth would only amount to 75% of year 3 base forecasts.* Under this scenario, projected net loans would ramp at a slower rate of growth and culminate in 75% of the base plan. In this scenario, net loans and percentage of plan figures would equate to $58 million (88%), $94 million (80%), and $131 million (75%), during the three respective years.

- *Deposit Growth would only equate to 75% of original forecasts.* In this scenario, the Applicant would stress test the outcome of a less than favorable deposit gathering event. With regard to scenario 2, total deposits would amount to $71 million, $124 million, and $152 million, during the respective three years.

- *Failure to attain a lower-cost deposit mix.* Under this event, the Applicant examines the impact of achieving a less than optimal deposit mix or a high concentration of costlier time deposits. Specifically, time deposits would increase to 53% or more throughout the first three years versus original forecasts of 40-41%. This scenario assumes that marketing/pricing strategies would fail to generate the optimal level of generally less costly MMDAs.

- *Interest rate shocks of 100 basis points*. Applicant assumes parallel shifts in rates (upward/downward) and that the bank would be able to adjust rates paid on deposits to reasonably match the change in yield bearing instruments.

Net Income / Sensitivity Analysis $000	Year 3
Scenario One – *Slower Loan Growth*	$751M
Scenario Two – *Lower Deposit Growth*	<$100M
Scenario Three – *Higher Cost Deposit Mix*	$806M
Scenario Four – *Rate Rise 100 bps*	$1,449M
Scenario Four – *Rate Drop 100 bps*	$1,090M

The Applicant projects year 3 profitability in all scenarios tested. The highest risk to the business model is presented by scenario 2, slower deposit growth. Aside from actively managing its cost structure to minimize the probability of losses in year 3, proposed management is reasonably confident that it can attain 75% or more of the deposit forecasts reflected in the plan. Supporting arguments for its claim are (1) General success of denovos in the Southern Anystate market in attracting funding at a reasonable cost, (2) The level of reported public interest in the proposal to establish depository relationships prior to conditional approval. This includes various verbal commitments reportedly made from various organizations in Anytown to the Applicant. Additional deposit referral business (in excess of $10MM for DDA/NOW) has also been alluded by the Applicant's influential Anytown board members (Wart and Marcotte). (3) The success of the supermarket branch network as it existed twelve months ago. Applicant stresses the last factor adds considerable credibility to the deposit forecasts. Despite having been in the Anytown market for less than three years, the investigating Examiner believes that proposed CEO Hamm enjoys a relatively strong reputation in the banking community. This reputation and extent of contacts should greatly assist the Applicant in garnering deposits from both the supermarket network and the retail banking office.

The finding on this factor is <u>FAVORABLE.</u>

FUTURE EARNINGS PROSPECTS (Continued)

ESTIMATED INCOME AND EXPENSES			
	ESTIMATED AMOUNT		
DESCRIPTION	FIRST YEAR	SECOND YEAR	THIRD YEAR
Interest Income			
Real Estate loans	2,542	5,287	8,178
Installment loans	98	332	728
Credit Card loans			
Commercial and all other loans	614	1,611	2,758
Lease financing receivables			
Balances due from depository institutions			
Taxable securities issued by states and political subdivisions			
Tax-exempt securities issued by states and political subdivisions			
U.S. Government and other debt securities	954	2,683	2,556
Other securities			
Federal Funds sold and securities purchased under agreements to resell			
Total Interest Income	4,208	9,913	14,220
Interest Expense			
Transaction accounts (NOW, etc.)	60	175	242
Time Deposits of less than $100,000	448	1,307	1,831
Time Deposits of $100,000 or more	192	560	784
Money Market deposit accounts	432	1,245	1,752
Other savings deposits	33	95	133
Federal Funds purchased and other borrowings			
Total Interest Expense	1,165	3,382	4,742
Net Interest Income (NII)	3,043	6,531	9,478
NII % of Average Earning Assets	3.94%	4.41%	4.70%
Provision for Loan and Lease Losses	836	797	918
Non-interest Income	291	796	1,112
Non-interest Expense			
Salaries and Benefits	7,027	8,103	8,779
Net Occupancy Expenses			
Other Operating expenses:			
Advertising and Marketing			
Professional Services (legal, accounting, etc)			
Computer Services/Data Processing			
Miscellaneous			
Net organization expenses *(1st year only)*	3,900		
Total Non-interest Expense (NIE)	10,927	8,103	8,779
NIE % of Average Assets	14.14%	5.47%	4.35%
Income (Loss) before Income Taxes	(8,429)	(1,573)	893
Income Tax Expense			
Net Income (NI)	(8,429)	(1,573)	893
NI % of Average Assets	(10.91)%	(1.06)%	0.44%
Average Assets	77,277	148,135	201,602

Explain examiner adjustments made to applicant's projections.

FUTURE EARNINGS PROSPECTS (Continued)

ESTIMATED AVERAGE DEPOSITS AND AVERAGE ASSETS						
DESCRIPTION	AVERAGE DURING					
	FIRST YEAR	Yield or Cost	SECOND YEAR	Yield or Cost	THIRD YEAR	Yield or Cost
AVERAGE DEPOSIT AND BORROWINGS						
Transaction Accounts (NOW, etc.)	5,440	1.10%	12,505	1.40%	17,277	1.40%
Time Deposits of less than $100,000	16,133	2.78%	36,806	3.55%	51,565	3.55%
Time Deposits of $100,000 or more	6,914	2.77%	15,774	3.55%	22,100	3.55%
Money Market deposit Accounts	19,040	2.27%	42,930	2.90%	60,396	2.90%
Other Savings deposits	2,274	1.19%	6,353	1.50%	8,898	1.49%
Transaction Accounts (DDA Noninterest)	6,484	%	15,453	%	23,438	%
		%		%		%
Federal Funds Purchase		%		%		%
Total estimated average deposit/ borrowings	**56,285**		**129,821**		**183,674**	

AVERAGE ASSETS						
Real Estate loans	36,401	6.98%	69,626	7.59%	105,254	7.77%
Installment loans	1,372	7.14%	3,894	8.52%	8,508	8.54%
Credit card loans		%		%		%
Commercial and all other loans	8,892	6.92%	19,620	8.21%	33,598	8.20%
Lease financing receivables		%		%		%
Interest-bearing balances due from banks	2,552	%	4,882	%	6,417	%
Taxable securities issued by states and political subdivisions		%		%		%
Tax-exempt securities issued by states and political subdivisions		%		%		%
U.S. Government and other debt securities	22,988	4.15%	44,851	5.98%	43,393	5.89%
Other securities		%		%		%
Federal funds sold and securities purchased under agreements to resell		%		%		%
		%		%		%
		%		%		%
		%		%		%
		%		%		%
Total estimated average earning assets	69,070		136,827		188,911	

Explain examiner adjustments made to applicant's projections.

Note: Cost factors above are as a percentage of Average Interest Bearing Liabilities only.

GENERAL CHARACTER OF THE MANAGEMENT

Proposed management, including the board of directors or trustees, is evaluated against all factors necessary to operate the institution in a safe and sound manner, including the ability to identify, measure, monitor and control the internal and external risks presented by the proposed business plan. Proposed directors and officers should be evaluated on the basis of their financial institution and other business experience, duties and responsibilities in the proposed institution, personal and professional financial responsibility, reputation for honesty and integrity, and familiarity with the economy, financial needs and character of the trade area. Examiners should consider, at a minimum, proposed board oversight and support; management expertise and depth; proposed credit, funds management, interest rate risk and investment guidelines and internal and external audit programs. Comments should provide a forward-looking assessment of an institution's management team, including its operating philosophy and tolerance for risk-taking.

Summary and Findings

Meeting with Organizers

An organizer's meeting was held December 12, 2001 to discuss the application process, as well as, various other safety and soundness matters. Supervisory Examiner Ivie Smart attended on behalf of the Corporation.

Proposed Members of Active Management

Joe Hamm – Chairman/Chief Executive Officer (CEO)

Mr. Hamm's duties will include responsibilities for planning and establishing policy and ensuring all board objectives are executed. In addition, he will supervise senior officers, as well as establish parameters for profitability, business and strategic planning. While Mr. Hamm has not previously served in this capacity of an insured institution, he does possess extensive executive level leadership and credit experience. Previous roles have also included active participation on various board committees notably, strategic planning, executive, loan, and asset/liability management. His commercial credit experience in particular is viewed as a key strength within the organizing group. This experience, along with information obtained from available regulatory sources suggest that he will employ a conservative operating philosophy with regard to risk selection. Actions taken by Mr. Hamm during his brief association with the group appear to confirm this philosophy. During interviews with the undersigned examiner, Mr. Hamm stated he recognized the salient risks with the previous proposal and recommended that the operating plan be materially changed. In addition, he also recognized that HH's role in the regulatory application process should be reallocated to him as CEO. The latter has seemingly made the process more efficient from both a cost and regulatory perspective. Finally, Mr. Hamm eliminated the reliance on outside consultants (other than HH as Counsel) that were frequently employed by the previous CEO and President. He stated that it is his role to formulate a credible strategy, plan, and accompanying assumptions.

Nigel Newbury – Chief Financial Officer (CFO)

Mr. Newbury's proposed duties include supervising all internal management and financial reports, treasury function including asset allocation strategies, producing risk management and profitability reports and budgets, and participating in strategic planning. The position description defines that he will directly supervise the financial controller/treasurer. While Mr. Newbury has not served in this capacity within a commercial or community bank, he does possess a background in accounting and financial management at both a recognized public accounting firm and other large multinational corporations.

Frank Gray – Chief Technology Officer (CTO)

Mr. Gray will have direct oversight over the senior technology officer and development manager. The position's function includes overall responsibility for the design, implementation, and maintenance of all the Applicant's software, computer hardware, and technology infrastructure. Mr. Gray will also identify and recommend solutions to the Applicant's technology needs and problems. In summary, his responsibility is to manage the systems to ensure that efficient customer service is maintained. Mr. Gray appears to possess extensive experience for the proposed position. In the interview, Mr. Gray stated that the senior technology officer (his direct report) would be the US based technology officer, while Mr. Gray executes his other roles at the top-tier holding company in London.

John Well - Chief Lending Officer

Mr. Well's duties will encompass responsibility for loan growth and the preservation of asset quality. Inherent in this role will be the employment of conservative underwriting and risk management systems. His background contains considerable lending, credit administration and operations experience within both commercial and consumer portfolios, which appear compatible with the proposed Application and business model.

Proposed Board Members

The proposed board includes eight members, five of which are designated as non-executive (outside directors). The outside directors have a vast array of experience in banking and finance, law, communications, technology, and criminal investigations. A key improvement in the current management team over the prior proposal includes the addition of directors (either inside in the case of Mr. Hamm, outside with regard to Mr. Lamar) with previous commercial bank executive/board experience.

A second strength includes the addition of directors Wart and Marcotte. Both individuals appear to hold prominent roles in the community and may serve to provide meaningful business referrals for the proposal during the formative stages. Other strengths include Mr. Mason' background and appearances that he will ask the necessary questions from executive management. Based on the organizational minutes and discussion with other proponents, Mr. Mason is among the most vocal individuals on the board. In the interview, Mr. Mason stated that his residence in the Northeast would not preclude him from fulfilling his supervisory duties or attending board/committee meetings.

Proposed Operating Programs

According to information contained in the Application and Mr. Hamm, the Applicant will adopt comprehensive operating guidelines with regard to lending, funds management and interest rate risk, investments, and audit. A pre-opening visitation by the primary regulator should confirm and validate the appropriateness of these policies.

GENERAL CHARACTER OF THE MANAGEMENT (Continued)

List alphabetically, by group, all *Directors, Non-Director Officers, and Others owning 10% or more of total capital.* Indicate the status of each individual listed by checking the appropriate box *(D-Director; O-Officer; S-Shareholder).* Under "Summary and Findings" indicate *(a)* years and reputation in the community; *(b)* director or officer positions held in other banks and the names of such banks; *c)* dominant individuals and the extent, character, and effect of such domination; and *(d)* capabilities of each individual with reference to his duties and responsibilities, and the amount of time devoted to the institution.

NAME AND ADDRESS	AGE	RELATIONSHIP WITH BANK		
	38	☐ **Director** ☒ **Officer** ☐ **10% Shareholder**		
Well, John 13821 Folkstone Circle Anytown, Anystate	LIABILITIES 139,084	NET WORTH 116,338	SHARES OF STOCK 140,500	ANNUAL SALARY 90,000
	TITLE Proposed Chief Lending Officer			
OTHER BUSINESS AFFILIATIONS OR PROFESSIONS Career Credit and Lending Officer				

Summary and Findings

Mr. Well was born in Middletown, Connecticut and has resided in the area since 1999. He holds an undergraduate degree in economics from Dartmouth, College, Hanover, New Hampshire. Mr. Well has over fourteen years banking experience including senior level positions in lending and credit administration. He reportedly has considerable experience within consumer and commercial loan portfolios, policy formulation, credit scoring and loan pricing strategies, as well as, auditing, operations and retail branch oversight. He has spent nearly his entire banking career working under the tutelage and supervision of proposed CEO Hamm.

Banking Experience

From 1999 until his recent appointment, Mr. Well served as SVP and Senior Credit Officer of Anybank, Anytown, Anystate. In this position, he was responsible for credit quality of the bank's consumer, mortgage, and small business portfolios. Leading a staff of seventeen, Mr. Well established a Small Business Operation which generated monthly loan volume of $5 million. In addition, he managed the credit scoring process for small business and consumer lending including, validation and oversight of system parameters. Prior to that, he served ten years at Anybank, Anytown, Anystate, in several lending and managerial roles including VP and Consumer Credit Manager, Branch Manager, and Regional Consumer Loan Officer. Notable accomplishments included managing the bank's credit scoring system, managing a large loan staff, and successfully generating nearly $100 million in new loans during a three year period.

Interview Comments

Mr. Well became associated with the proposal at the request of Mr. Hamm, whom he reported to while employed at Anybank. He stated that he brings considerable experience with regard to commercial and consumer credit underwriting, portfolio and risk management. He added that these areas have been the cornerstone to his entire banking career. Additionally, Mr. Well stated he also has a perspective in audit and controls given his experience as a staff auditor. He added that he experienced the real estate recession in the Northeast and has an understanding and aversion for speculative transactions. While Mr. Well could not estimate the volume of loan business he would attract during the formative stages, he does know many seasoned lenders who retain established and profitable relationships. He anticipates, as does Mr. Hamm, employing former lenders who are actively seeking other opportunities. Mr. Well stated he was very involved in preparing the loan projections in the proposed business plan. He stated the projections were reasonable based on the proposed development officers and their respective portfolios, as well as, the generating ability of the former supermarket branches. He added that this two pronged approach is also enhanced by his experience in selectively purchasing high-quality consumer mortgage portfolios. Such activity, he said, could be employed to fill budget shortfalls and otherwise more efficiently employ earning assets during the first year. With regard to the former supermarket branches, Mr. Well stated that the eleven branches produced monthly consumer loan volumes ranging from $100M-$500M.

Financial Information and Stock Ownership

As of November 2001, Mr. Well's primary assets consisted of $38M in cash and a personal residence valued at $175M. Liabilities consisted primarily of a $126M mortgage payable. His $5000 investment in the proposal was reportedly purchased with cash.

<table>
<tr><td rowspan="3">NAME AND ADDRESS

Mason, Perry
130 Old Army Road
Anytwon, Anystate</td><td>AGE
62</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☐ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES
0</td><td>NET WORTH
3,213,000</td><td>SHARES OF STOCK
25,000</td><td>ANNUAL SALARY
0</td></tr>
<tr><td colspan="4">TITLE
Proposed Director (nonexecutive)</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Consultant. Retired executive credit officer for counterparty risk and former English trial lawyer.</td></tr>
</table>

Summary and Findings

Mr. Mason was born in Limassol, Cyprus and became a U.S. Citizen in 1989. He also holds citizenship in the United Kingdom. Mr. Mason received a Masters and Bachelor of Arts degrees in Law from Cambridge University, Cambridge, England and subsequently realized his Barrister-at-Law license in 1960. For nearly eight years prior to retiring in 1999, Mr. Mason served as Executive Vice President, Global Trading Credit Group at Anybank, Anytown, Anystate. Responsibilities included management of all counterparty credit exposure for the Derivatives Products Group. Additionally, he supervised and developed risk management systems for the trading group, and served on various committees including, Asset Liability Management, Credit Policy, and Payment Systems Risk. He held similar responsibilities for nearly five years as Managing Director while at Regionalbank, Anystate. Other notable responsibilities include various Vice President level assignments at Anybank, Anystate and London. These duties entailed the development of marketing and credit strategies, lending, and asset management, including trading assets within Europe, Pacific Rim and U.S.

Interview Comments

Mr. Mason became involved with the Applicant as a result of some consulting work he performed for Risk Management, plc, London, England, and its Chairman John Wise. Mr. Wise is also a 1.8% shareholder of Holding Company-1 and serves as a nonexecutive director. Mr. Mason stated that he has experience dealing with complex financial problems and understands how to manage risks. He stated that he would not be able to introduce many deposit or lending relationships given his lack of contacts within the market area. Mr. Mason acknowledged that he has little or no financial stake in the proposal, but views his reputation as a key contribution. In this regard, he would feel inclined to notify the Regulatory Authorities should any material supervisory issues become apparent. Mr. Mason is more enthusiastic and confident about the current proposal versus the previous model. He feels that the deposit base is better quantified given that many of the proposed branches were active and successful less than a year ago. In addition, he feels the proposal now has a more experienced board and executive management team given the addition of Messrs. Hamm (Proposed CEO) and Lamar (Outside Director).

Financial Information and Stock Ownership

As of August 2001, Mr. Mason reports no liabilities and liquid assets (bonds, equity securities and cash) of nearly $2,217M. Other material assets include his residence valued at $550M. According to Mr. Mason, his limited investment ($2,400) in the proposal was purchased with cash.

IV. GENERAL CHARACTER OF THE MANAGEMENT (Continued)

<table>
<tr><td rowspan="4">NAME AND ADDRESS

Marcotte, Janet
2 McCairn Court
Anytown, Anystate</td><td>AGE
49</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☐ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES

175,740</td><td>NET WORTH

821,946</td><td>SHARES OF STOCK
26,000</td><td>ANNUAL SALARY
0</td></tr>
<tr><td colspan="4">TITLE
Proposed Director (nonexecutive)</td></tr>
<tr></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Vice President and General Sales Manager, BellSouth.</td></tr>
</table>

Summary and Findings

Ms. Marcotte was born in Columbus, Ohio and has resided in Anytown for over 40 years. She holds undergraduate and graduate degrees in Business Administration from University of Anystate, Anytown and SouthEastern University, Anytown, Anystate, respectively. She currently holds a senior management level position with BellSouth, a company for which she has been employed with for nearly 30 years in various marketing capacities. In her current capacity, Ms. Marcotte is responsible for BellSouth's sales and technology operations, a regional business unit accounting for nearly $700 million in total revenues. She does not have any prior commercial/community banking experience.

Interview Comments

Ms. Marcotte became associated with the proposal through her civic relationships with proposed director Wart. She appears active in local community circles and serves on the board of the Anytown Economic Development Council. She stated that her community contacts and professional longevity within the county could assist in providing meaningful business opportunities for the proposal. Given her position with a technology-based company, Ms. Marcotte stated she could provide valuable insight into the needs of the bank's target market and potential internet users. She has reportedly gained extensive experience in marketing to a comparable demographic segment within her company and knows how to serve customer's technology needs. Ms. Marcotte stated that proposed President Hamm has crafted a credible business model; integrating a traditional retail site and supermarket branch banking with an internet component, within two high growth Markets.

Financial Information and Stock Ownership

As of December 2000, Ms. Marcotte reports liquid assets (cash and listed securities) of $238M and stock options with a estimated value of $460M. A personal residence valued at $300M represents her other primary asset. Liabilities consist primarily of a $165M mortgage payable. According to Ms. Marcotte, her limited investment ($1,000) in the proposal was purchased with cash.

NAME AND ADDRESS	AGE	RELATIONSHIP WITH BANK		
Hamm, Joe 112 Olympic Circle Anytown, Anystate	47	☒ **Director** ☒ **Officer** ☐ **10% Shareholder**		
	LIABILITIES 415,400	NET WORTH 1,096,600	SHARES OF STOCK 665,000	ANNUAL SALARY 150,000
	TITLE Proposed Chairman, President, and Chief Executive Officer			
OTHER BUSINESS AFFILIATIONS OR PROFESSIONS Career Banker and Senior Lending Officer.				

Summary and Findings

Mr. Hamm was born in Troy, New York and has resided in Anytown for over two years. He attended the Stonier Graduate School of Banking at the University of Delaware and State College, Antyown, Anystate. Mr. Hamm has over twenty-seven years of experience in the banking and financial services industry.

Bank Experience

Prior to joining subject proposal, Mr. Hamm served as Senior Executive Vice President and Chief Credit Officer at Anybank, Anytown, Anystate, a $3.4 billion state member bank, which was recently acquired by Regionalbank. In addition, he served as a member of the bank's Executive Committee, which was designed to establish near term strategic guidance and policy. While employed at Anybank (2-year tenure until acquisition by Regionalbank), he also served as Chairman of the Board of two of Anybank's wholly owned subsidiaries; First Financial, Inc., a national yacht finance company with annual loan volumes of $300MM. Reportedly, the company was the largest originator of yacht loans in the Nation, prior to Mr. Hamm's departure. His second Chairperson role was with Spectrum, a factoring entity generating annual receivable/inventory facilities of $120MM.

Prior to his role at Anybank, he served for eleven years as a Senior Vice President and Chief Corporate Lender and then as Executive Vice President and Chief Credit Officer at Financial Services Corp, Anytown, Anystate, the holding company for AnyNational Bank. While there, Mr. Hamm was responsible for a department of fifty credit and administrative personnel and a $1.4 billion commercial, mortgage, and consumer portfolio. Notable assignments and accomplishments during his eight year tenure was the operation and oversight of special assets and the reduction of non-performing assets from a high of 6.5% to 0.6%. Mr. Hamm also served on various board committees including, Executive, Strategic, Loan, Asset/Liability, and Human Resources. Prior to his EVP/SVP roles he served for five years as a VP and Regional Commercial Loan Officer within the same institution.

Additionally, he has approximately eight years of lending and related experience while employed by MoneyCenterBank, Anytown, Anystate. Mr. Hamm was active in the Anystate Banker's Association for nearly seventeen years and served as a member of the Association's Board of Directors. According to the association's CEO, Mr. Hamm was highly respected by colleagues and active as a Loan Quality instructor at the Anystate School of Banking.

Regulatory History and References

Available information from the Corporation's database suggests that Anybank and AnyNational Bank were fundamentally sound entity's during Mr. Hamm's tenure. Additionally, regulatory information from the Federal Reserve yielded no comments of any supervisory concern regarding his credit background or professional abilities. The undersigned examiner also contacted the State Comptroller's Office. The State's regulatory experience with Mr. Hamm was very favorable.

The undersigned examiner also interviewed the former Chairman and CEO of Anybank during Mr. Hamm's tenure. The former Chairman was very complimentary of Mr. Hamm's leadership skills and credit experience. According to him, Mr. Hamm was hired to ensure that asset quality and risk management systems were preserved during Anybank's growth phase. In this defined role, the former Chairman stated that he did an excellent job at executing and formulating policy.

Interview Comments

Mr. Hamm stated he was disenchanted with Regionalbank's methods of operation after its acquisition of Anybank and sought to pursue other opportunities. The denovo's legal counsel, Hodson & Hodson (HH), contacted Mr. Hamm about becoming an organizer shortly after the former president resigned from the group in April 2000.

Mr. Hamm stated he was skeptical about the prior proposal's business model as well as, the viability of the kiosk as a key delivery channel. His main issue with the kiosk strategy was that it had not been successfully executed within the market place. As a result, Mr. Hamm stated he recommended that the model be changed to incorporate more proven and traditional retail delivery channels. Another key change he recommended was the addition of other board members with strong community ties and/or previous banking experience (proposed director Wart, Marcotte, and Lamar). Mr. Hamm also sought to replace the previous proposed senior lending officer with one he viewed as possessing a stronger skill set and educational background.

Mr. Hamm indicated he has market intelligence over the success of the proposed supermarket branch network, inasmuch as eleven of the twelve branch sites were previous Anybank branch locations. He believes this aspect to be a key strength over the previous proposal. Mr. Hamm stated that despite his less than three years in Anytown, he has a sound foundation within the market area and has developed many contacts, which could lead to lucrative future business for the proposal. Regarding future lending, Mr. Hamm has retained a chief lender (Well) with whom he directly supervised while at AnyNational Bank and Anybank. In addition, other senior lenders have expressed a desire to join the group. Said lenders, according to Mr. Hamm, all would bring seasoned commercial and consumer portfolios generated from the former Anybank.

Financial Information and Stock Ownership

As of August 2001, Mr. Hamm reports a considerable liquid net worth, with $542M in cash and marketable securities. He reflects a personal residence with an assigned valued of $550M and deferred savings plan (401k/IRAs) assets of $420M. Liabilities consist primarily of a mortgage payable of $390M. Mr. Hamm's initial investment of $30M was reportedly purchased with his cash holdings.

IV. GENERAL CHARACTER OF THE MANAGEMENT (Continued)

<table>
<tr><td rowspan="4">NAME AND ADDRESS
Newbury, Nigel
12 Circus St.
Anytown, Anystate</td><td>AGE
42</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☒ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES</td><td>NET WORTH</td><td>SHARES OF STOCK</td><td>ANNUAL SALARY</td></tr>
<tr><td>177,000</td><td>2,218,000</td><td>7,366,665</td><td>55,000</td></tr>
<tr><td colspan="4">TITLE
Proposed Chief Financial Officer</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Accountant. Also serves as Financial Director and Director of Holding Company-1, London, England.</td></tr>
</table>

Mr. Newbury was born in Hazelgrove Cheshire, England. He holds citizenship in the United Kingdom and also maintains temporary residency in Anystate. He attended Reading University in England and subsequently became a Chartered Accountant with the firm, Touche Ross, London.

From 1996 until his involvement with Applicant in 2000, Mr. Newbury served as Finance Director with Risk Management Systems, London, England. This firm, whose Chairman and founder John Wise is also an invester and noneceutive director of the Applicant's holding company in London, provides financial trading and risk management systems for financial institutions in Europe. They also provide training and advisory services related to risk management. For nine years prior to 1996, he served as Director and Chief Financial Officer for Knight Financial, Inc., in both London and New York, as well as, associated companies throughout Europe and Asia. In this capacity, he led the company's financial planning and accounting group. Mr. Newbury does not have any prior commercial/community banking experience in the UK or US.

<u>Interview Comments</u>

Mr. Newbury stated he collaborated with proposed CEO Hamm in revising the proposed business plan and accompanying financial projections. Mr. Newbury added that while he lacked direct banking experience, he attained a comprehensive finance and accounting background including financial institution auditing, while employed at Touch Ross. He indicated that he had a strong background in risk management practices and financial controls. As Mr. Newbury was one of the authors of the previous business plan and forecasts, which incorporated dubious assumptions and resulted in the Applicant’s ultimate withdrawal, he was asked to compare and contrast the current proposal. Mr. Newbury stated that the revised business model emphasizes more traditional and proven delivery channels. He is especially pleased that eleven of the twelve proposed supermarket branches were viable deposit and loan production offices of the former Anybank. As such, he is more comfortable with the model’s assumptions and accompanying financial forecasts.

<u>Financial Information and Stock Ownership</u>

As of August 2001, Mr. Newbury reported $22M in cash and $399M related to his equity holdings and warrants in the proposal. Other material assets include his residence in London valued at $1,033M as well as, pension plans and life insurance valued at $940M. Liabilities primarily consist of a mortgage payable with a balance of $163M. Mr. Newbury’s investment in the proposal was reportedly purchased with cash and personal savings.

<table>
<tr><td rowspan="4">NAME AND ADDRESS
Gray, Frank
Morlich Lodge
Anytown, Anystate</td><td>AGE
38</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☒ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES</td><td>NET WORTH</td><td>SHARES OF STOCK</td><td>ANNUAL SALARY</td></tr>
<tr><td>325,000</td><td>314,000</td><td>225,000</td><td>55,000</td></tr>
<tr><td colspan="4">TITLE
Proposed Director and Chief Technology Officer</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Information Technology Professional & Software Designer. Also serves as an Officer of Holding Company-1, London, England.</td></tr>
</table>

Mr. Gray was born in Shropshire, England and holds British citizenship and residency. He is a graduate of Loughborough University, United Kingdom (UK) and received a degree in Mathematics and Engineering.

From 1995 up to his involvement in the proporsal (March 2000), Mr. Gray served as the Head of Front Office Technology/Europe for InternationalBank in London. In this role, he coordinated and led the Year 2000 project as well as, the Euro currency conversion. His primary responsibility, while at the institution was the development and implementation of front office trading systems for financial derivatives and fixed income securitites. Prior to this, Mr. Gray worked for nine years on numerous IT and software design projects including remote sensing technology (satalite systems) for end users such as the European Space Agency and Defense Research Agency in the UK.

Interview Comments

Mr. Gray stated his primary emphasis thus far has been on writing the Applicant's technology plan and designing and implementing the technology infrastucture. Mr. Gray stated he has extensive software design and project management experience and successfully recruited other highly talented designers from his previous employer, InternationalBank. He feels the current proposal offers a more viable business model, given its previous success with RSB. He also added that the Board has been strentghened considerably by the additions of former commercial bankers, Messrs. Hamm and Lamar.

Financial Information and Stock Ownership

As of June 2001, Mr. Gray' reported net worth, was primarily centered in his personal residence, with an assigned value of $547M. Liabilities of $325M consist of a mortgage payable on his residence in the UK. Mr. Gray' investment in the proposal of $9,900 was purchased with personal savings.

<table>
<tr><td rowspan="3">NAME AND ADDRESS
Lamar, Austin
12770 Jernigan Avenue
Anytown, Anystate</td><td>AGE
59</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☐ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES
290,000</td><td>NET WORTH
7,511,000</td><td>SHARES OF STOCK
110,000</td><td>ANNUAL SALARY
0</td></tr>
<tr><td colspan="4">TITLE
Proposed Director (nonexecutive)</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Retired Banker.</td></tr>
</table>

Summary and Findings

Mr. Lamar was born in LaGrange, Georgia and has resided in Anytown, Anystate for approximately one year. He is a graduate of Auburn University, Auburn, Alabama. Mr. Lamar recently retired from RegionalBank, an NYSE listed entity in Anystate, following its acquisition by ForeignBank. During his twenty-six year tenure at the state member bank, he served in a variety of executive and operational capacities.

<u>Bank Experience</u>

From 1990 to 2000, Mr. Lamar served in various executive roles including, RegionalBank's Vice-Chairman of the Board and Chief Financial Officer. At the time of its acquisition by ForeignBank, RegionalBank was an $11 billion commercial bank, operating in Anystate. Prior to that, Mr. Lamar served (1975-1990) at MidsizeBank, Anytown, Anystate, which was merged into RegionalBank in 1990. While at MidsizeBank, he served as a Director as well as its President and Chief Executive Officer (1988-1990). In addition to his executive officer roles during his tenure at MidsizeBank, Mr. Lamar served as CFO, Controller and Audit Manager.

<u>Regulatory History and References</u>

Available regulatory information (from FRB, State, and OCC) suggests that the institutions were fundamentally sound and operated. Contacts at the Federal Reserve Bank confirmed his executive level experience and had no supervisory concerns to report.

<u>Interview Comments</u>

Mr. Lamar became associated with the proposal through the Applicant's legal counsel, HH, an entity with whom he collaborated with on many issues while at RegionalBank. Mr. Lamar stated that he has considerable experience within finance, asset securitization, as well as, mergers and acquisitions. Regarding the latter, he stated he was involved in the acquisition of some forty or more institutions. He also stated that his institutions had experience with the supermarket branch delivery channel. While employed at RegionalBank, they operated over 20 rural supermarket branches with a moderate degree of success. He conveyed that the branches were profitable but did not enjoy the degree of returns as other parts of the institution. According to Mr. Lamar, the supermarket branches generally achieved $4-5 million in deposits and a loan to deposit ratio of 60% within 2 years of opening. He added that he is compelled by the more favorable demographics within the Anystate market, particularly the existing deposit base and retail branch networks employed by the myriad of institutions. This was an aspect that was far less prevalent in the rural areas of Anystate. Mr. Lamar stated that his residence's distance from the main office would not preclude him from being an active director.

<u>Financial Information and Stock Ownership</u>

Mr. Lamar's personal statement dated August 2001, reflected $80M in cash and $4,266M in marketable securities. Other material assets include residential properties valued at $650M and pension plans valued at $2,806M. Liabilities consist primarily of a mortgage payable of $240M. Mr. Lamar's $5,000 investment in proposal was reportedly made with cash.

<table>
<tr><td rowspan="3">NAME AND ADDRESS
Miller, Dennis
5678 Muirfield Village Circle
Anytown, Anystate</td><td>AGE
55</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☐ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES
149,012</td><td>NET WORTH
293,000</td><td>SHARES OF STOCK
57,850</td><td>ANNUAL SALARY
0</td></tr>
<tr><td colspan="4">TITLE
Proposed Director (nonexecutive)</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Retired Special Agent, Federal Bureau of Investigation (FBI).</td></tr>
</table>

Summary and Findings

Mr. Miller was born in Dearborn, Michigan and has resided in Anystate since 1980. He received his Bachelors degree in Biological Sciences from Michigan Technological University, Houghton, Michigan.

Mr. Miller recently retired from the FBI in Anytown, Anystate. He has extensive experience with investigations involving white-collar crimes including, crimes against financial institutions. Particularly noteworthy is his experience regarding bank fraud, embezzlement, and Internet related financial crimes.

Interview Comments

Mr. Miller became associated with the proposal through Casey Grant's (Joe Hamm's predecessor who resigned during 1H2001) father, who resides in the same residential development. Mr. Miller stated that he has many years of experience investigating and prosecuting white-collar crimes in Anystate, particularly, money laundering, as well as, bank, mail and wire fraud. He is reportedly very knowledgeable of Internet related crimes. With regard to strengths he could bring to the Applicant, Mr. Miller stated he would add depth and experience to the audit committee. As a proposed director of the previous Application, Mr. Miller stated he is more comfortable with the supermarket branch network given it has had a proven record at Anybank.

Financial Information and Stock Ownership

As of September 2001, Mr. Miller's net worth was primarily centered in a deferred savings plan. As of the reporting period, the balance of this other asset (Federal Thrift Savings Plan) was $218M. Other material assets included his residence, with a value of $200M. Liabilities primarily consisted of a mortgage payable on his residence of $130M. Mr. Miller's investment in the proposal of about $5,500 was made with his personal savings.

NAME AND ADDRESS	AGE	RELATIONSHIP WITH BANK		
Wart, Philip 118 Olympus Circle Anytown, Anystate	46	☒ **Director** ☐ **Officer** ☐ **10% Shareholder**		
	LIABILITIES	NET WORTH	SHARES OF STOCK	ANNUAL SALARY
	921,896	1,661,484	250,000	0
	TITLE Proposed Director (nonexecutive)			
OTHER BUSINESS AFFILIATIONS OR PROFESSIONS Attorney. President and Managing Partner of the law firm, Wart, West, and West, P.A. (WWW).				

Summary and Findings

Mr. Wart was born in Robana, Illinois and has resided in the Anytown area since 1984. He received an undergraduate degree in economics from Dartmouth College, Hanover, New Hampshire, and Juris Doctorate in law from University of Miami, Miami, Florida. Mr. Wart is a practicing attorney, specializing in corporate, real estate, banking, and securities law. Additionally, he is Chairman of the Anytown Development Board, a not for profit organization committed to advancing the county's business, technology, and educational endeavors.

Interview Comments

Mr. Wart became associated with the proposal through Joe Hamm, whom he advised on several lending transactions, while at Anybank. He stated he is an active member in the community and knows many influential business professionals who can serve as potentially lucrative deposit clients during the formative stages. In that regard, he specifically spoke of the New Technical School in Anytown. He anticipates being able to refer the School's operating account, which reportedly retains balances of $10 million.

Mr. Wart stated he has performed legal work for many financial institutions in Anystate. He was active in processing various regulatory applications for Anybank, in Anytown when he served as general counsel. Additionally, he represented Anybank on many real estate transactions. In addition to proposed CEO Hamm, Mr. Wart knows proposed director Marcotte, a fellow member of the Anytown Development Board.

With regard to the business model, Mr. Wart stated it was conceived on sound research and partly on the success of the eleven- branch supermarket network, while employed by Anybank. He cited the favorable deposit market share in AnyCounty-1 and AnyCounty-2, the depth of the Hispanic market, and relatively low cost structure of the supermarket branch vis a vis the traditional bricks and mortar retail branch site.

Financial Information and Stock Ownership

As of August 2001, Mr. Wart reported $163M in cash and marketable securities, as well as, $1,577M in residential and commercial real estate holdings. Other assets include his 43% interest in the law firm, WWW, with an assigned value of $600M. The firm WWW reported revenues of $3 million for the year ending 2000, representing a 54% increase over the previous year. Mr. Wart's liabilities consist primarily of three mortgage payables with an aggregate balance of $914M. He reports no contingent liabilities. According to Mr. Wart, his $10,000 investment in the proposal was made with cash.

GENERAL CHARACTER OF THE MANAGEMENT (Continued)

Discuss proposed board and management committees and their associated responsibilities. Assess the reasonableness of fees and other expenses associated with the application and organization, including insider involvement. Evaluate the reasonableness of stock benefit plans, including stock options, stock warrants, and other similar stock based compensation plans. The structure of stock benefit plans should encourage the continued involvement of the participants and serve as an incentive for the successful operation of the institution. Assess reasonableness of fidelity coverage. An insured depository institution should maintain sufficient coverage on its active officers and employees to conform with generally accepted industry practices.

Summary and Findings

Board Committee Structure and Fidelity Coverage

The organizers have provided for a usual and customary committee structure to assist in overseeing and managing the bank's operations. No exceptions were noted to these proposals and structures. Organizers stated that sufficient fidelity coverage would be procured and maintained.

Reasonableness of Organizational Expenses

Organizational and pre-opening expenses appear excessive for the formation of a denovo national association and do not reflect favorably on the Applicant.

Most of the responsibility for these high expenses can arguably be attributed to the previous leadership during the prior Application submission (August 2000). Casey Grant, the lead organizer and proposed Chairman/CEO displayed a lack of fiscal discipline during his tenure and was responsible for formulating the previous nontraditional and seemingly higher risk business model. This model was poorly supported and thus required extensive time to procure supporting documentaion and fesibilitiy studies. During this lengthy process, Mr. Grant relied extensively on legal cousel and consultants which added to the expense burden. Finally, Mr. Grant prematurely added a staff of twenty, including highly compensated officers, which impacted pre-chartering costs.

Since the previous management's departure and filing of the new Application, organizational expenses while high, appear to have moderated. Despite the high organizational expenses, management has been successsful, during two separaterly underwritten capital offerings, in forming a substantial amount of capital. It is believed this capital is sufficient to absorb the high costs and provide for the growth of the proposal.

Employment Agreements & Compensation

The Applicant anticipates negotiating employment agreements with several officers. The officers (to date) with corresponding annual salaries are as follows: Chairman/CEO Joe Hamm, $150M; CFO Nigel Newbury* $55M; CTO Frank Gray, $55M; CLO John Well, $90M. In addition, Controller Sue Herrera $65M; and Senior Technology Officer Brian Bain $110M will reportedly be under contract. The agreements generally include the following standard terms:

- Employment Term: Generally one year. Continues thereafter unless terminated by either party;
- Other Benefits: Medical, and participation in any existing stock benefit plan.
- Bonus: Sole discretion of Board of Directors
- Termination without Cause: Lump sum payment equal to the present value of the unexpired portion of the employee's term (effectively less than or equal to 1 year). Discount derived using the prevailing Federal funds rate.

<u>Stock Benefit Plan</u>

The Applicant intends to formulate a plan for certain executive officers, directors, and other employees. To date, this plan has not been formalized or submitted for Regulatory review. Organizers have committed to enacting a plan that is consistent with existing regulatory guidelines. Said plan should be scrutinized for reasonableness in light of exceptions taken by the Examiner during the prior

Messrs. Newbury and Gray' respective salaries represent the proposed bank's pro-rata expense only. Additional compensation of $55M for each will be paid by Holding Company-1, London, England. This represents compensation for services performed at the top-tier holding company level. Refer to biographical information for their respective roles.

Application. Exceptions involved excessive option grants to the proposed president, that were nearly 3x the volume of initial shares purchased.

Warrant Holders and Intrinsic Value

Based on the most recent bid of 2.5p (£0.03) per share (or ¢3.75), and existing strike price above of 2p, the intrinsic value of the Mr. Newbury's warrants is less than $50,000. Given the current pricing, this additional form of compensation does not appear unreasonable.

The overall finding on this factor is FAVORABLE, pending receipt of acceptable stock benefit plans.

RISK TO THE FUNDS

As a general matter, the FDIC interprets this factor very broadly, relying on any information available including, but not limited to the applicant's business plan. Assess the proposed institution's business plan. The business plan's goals should be commensurate with the capabilities of its management and the financial commitment of the incorporators. The business plan should demonstrate an ability to achieve a reasonable market share, reasonable earnings prospects, the ability to attract and maintain adequate capital, and demonstrate a responsiveness to community needs. The plan should also demonstrate adequate risk management policies. Business plans that rely on high risk lending, a special purpose market, or significant funding from sources other than core deposits, or that otherwise diverge from conventional bank related financial services require detailed analysis as to the suitability of the proposed activities for an insured institution.

Summary and Findings

The Applicant is proposing to execute a traditional integrated business model with respect to deposit acquisition and funding. Funding will primarily draw on two key delivery channels, a supermarket branch network and traditional retail banking office and to a lesser extent, a fully transactional web-site.

Business Model Strengths

The business model enjoys a strong initial capitalization base, a seemingly conservative management team and investment philosophy, a viable and multi-faceted branch network strategy, and a vast deposit market within its operating environment. These factors comprise the proposal's prevailing strengths.

The most integral change in the proposal versus the prior previous bank model consists primarily of the upgrade in the executive management team and secondly, the adoption of a more fundamentally sound and traditional business model. The new team is led by an executive (CEO Hamm) possessing an extensive commercial banking and lending background. Equally important has been the addition of seemingly strong outside directors, one of whom (Director Lamar) possesses previous executive and director level experience. The remaining new outside directors (Wart and Marcotte) appear to be very influential within various County economic development endeavors. By all accounts, the outside directors may be in a position to influence and stimulate the proposal's funding and business development initiatives. The proposed management's aversion for risk is best manifested in the proforma asset-mix, which is heavily weighted towards residential real estate during the first year of operation. With regard to funding, the business model is seeking to replicate the deposit generating success of the supermarket branch network once operated by Anybank. Its previous success within demographically favorable and densely populated towns and cities adds credence to the model's funding projections.

Business Model Risks

As depicted in the Applicant's sensitivity analysis and stress testing, the model is most vulnerable to a slower rate of deposit growth {Scenario 2} during the formative years. What-if scenarios depict an earnings risk should funding fall below 75% of original projections. A deposit shortfall without any commensurate and effective cost containment plans may adversely impact profitability and the model's ultimate success. In light of funding's importance during the formative stages, any shortfalls may induce management to compete more aggressively on price thereby jeopardizing margins, profitability or risk selection. Executive management's ability to attract funding at a reasonable cost will be critical to the model's success.

The finding on this factor is <u>FAVORABLE.</u>

CONVENIENCE AND NEEDS OF THE COMMUNITY TO BE SERVED

Discuss the proposed institution's primary trade area(s) including location and population. Address economic conditions, primary industries, and major employers. Assess trade area(s) population demographics and the proposed institution's willingness and ability to meet the deposit and credit needs of the community to be served. Assess the competitive dynamics of the market and how the proposed institution will compete for market share.

Summary and Findings

Proposed Service Areas

Per the Applicant, the primary trade areas are contained within AnyCounty-1 and AnyCounty-2, Anystate. A retail branch network encompassing one traditional branch (main office) as well, a supermarket branch network will form the bank's surrounding service areas. During the first year, a total of six branches (five supermarket and one main office) are planned for AnyCounty-1, while seven are envisioned for AnyCounty-2. Given the internet component of this business model, other market areas outside of the proposal could conceivably be pursued.

Community Growth and Demographic Indicators[4] – AnyCounty, Anystate - MSA

Item	2005 *Forecast*	2000	1999	1998
Population (000)	1,247.1	1,131.2	1,106.7	1,084.0
Residential Building Permits	7,637	6,769	6,428	6,387
Mortgage Origination ($Mil)	$6,207	$6,740	$6,946	$8,476
Unemployment Rate	5.1%	4.4%	5.0%	5.6%
Total Employment (000)	560.0	491.4	469.4	457.3
Gross Metro Product $Billion	$45.2	$37.7	$35.2	$33.3
Top Employers & Industries in Trade Area				
Name	**Business Type**	**Employees**		
Columbia Beach Health Care	Medical/Health	4,000		
Intracoastal Health Systems	Management Svc	3,200		
Motorola, Inc	Technology	2,300		
Power and Light	Utility	2,300		
Pratt & Whitney	Mfg./Technology	1,300		

Demographic and Economic Trends – Anytown - MSA

The overall Anytown market remains moderately strong due to the County's higher per capita income and strong job growth, particularly in the services and retail trade sectors. Real Estate markets and favorable adsorption measures (residential housing demand) have been driven by population growth, in-migration from the Southern State Counties, as well as, tourism.

Key short-term risks remain the weak national economy, which has been exacerbated post September 11, 2001. These factors have negatively impacted tourism and its accompanying service industries. In addition, segments of the County, including the Anytown area, have experienced very active new commercial real estate construction activity that has reportedly impacted rental rates for new space. While current vacancy rates of around 14%, are below the 30% prevailing nearly a decade ago, any prolonged recession could make it a more difficult environment for underwriting and funding quality commercial real estate credits. Manufacturing has endured considerable layoffs and remains a weak area for the County. Motorola, State's largest Technology employer, has experienced declining revenue, weakening margins, as well as market share erosion. As a result, substantial layoffs have occurred company wide in addition to its facilities in Anytown.

[4] Source: FDIC Division of Insurance

Community Growth and Demographic Indicators [5] – Anytown, Anystate - MSA

Item	2005 *Forecast*	2000	1999	1998
Population (000)	1,786.9	1,623.0	1,588.7	1,555.2
Residential Building Permits	8,865	9,160	8,574	8,753
Mortgage Origination ($Mil)	$8,227	$9,159	$8,911	$10,453
Unemployment Rate	4.3%	3.7%	4.1%	4.5%
Total Employment (000)	755.4	676.0	652.7	639.5
Gross Metro Product $Billion	$54.8	$46.2	$43.4	$41.3
Top Employers & Industries in Trade Area				
Name	**Business Type**	**Employees**		
North Hospital District	Medical/Health	6,652		
Winn-Dixie, Inc.	Retail/Grocery	6,110		
American Express	Financial Svc.	4,700		
Publix Supermarkets, Inc	Retail/Grocery	4,200		
Motorola, Inc.	Technology	4,000		

Demographic and Economic Trends – Anytown, Anystate - MSA

Economic trends convey strong growth despite a weaker national economy. Growth has been led by the services, wholesale trade, and finance industries.

The residential housing market is particularly active. Tourism and leisure (hotel/cruise ship lines) remains one of the MSA's key economic drivers, However, its outlook has been impacted by the general state of the economy and September 11, 2001 attack on the US. In addition, international trade with Latin American trading partners may decline somewhat considering the adverse market conditions within Argentina, South America's second largest economy. Manufacturing risks are similar to the Anytown MSA in light of Motorola's size and scale within the area. With regard to commercial real estate, vacancy rates within the Broward office market rose significantly during Q2 2001 to 16.3% versus 9.3% for the same period a year ago[6]. Robust new construction activity, an increase in sublease space, weaker demand, and a softer economy appear to be contributing factors. These trends, should they continue, will pose the same lending risks and challenges previously cited.

Competition – Financial Services

The Applicant will encounter intense competition for funding within both market areas. The FDIC's Summary of Deposits Report for June 2001, indicates that the AnyCounty MSAs hold 450 and 405 banking and thrift offices with aggregate deposit shares of $22.3 and $23.9 billion, respectively. A compelling level of the market share (over 70% for both MSAs) is held by the offices of out of state regional and super-regional bank and thrift holding companies.

The Applicant professes that its multiple delivery channels coupled with attractive rates and efficient service will enable it to compete within the proposed PSA/MSA. The organizers also contend that the recent performance of the eleven supermarket branches as well as, contacts from several directors within the community will enhance the proposal's probability for successfully acquiring deposits within these markets.

The finding on this factor is <u>FAVORABLE.</u>

[5] Source: See Supra
[6] Grubb & Ellis Research , Second Quarter 2001; <u>Vacancy Rates Increase as Construction Continues., Page 1.</u>

CONSISTENCY OF CORPORATE POWERS

Discuss trust powers or any other corporate activities contemplated by the applicant, including those covered by Section 24 of the FDI Act. Address any problems with the Articles of Incorporation or the Bylaws.

Summary and Findings

There is nothing to indicate that the proposal's activities would be inconsistent with the purposes of the Federal Deposit Insurance Act.

The finding on this factor is FAVORABLE.

OTHER PERTINENT INFORMATION

If applicable, provide a summary of comments made by bankers and other interested parties. Address problems with stock offering circular. For applicants delivering services over electronic channels (such as the Internet or wireless devices) assess the information systems infrastructure, policies and security.

Summary and Findings

Summary of Banker Comments

Loren Greene, President & CEO – Anybank & Trust, Anytown, Anystate

Mr. Greene stated he knew proposed CEO Hamm by reputation primarily and suggested he was a very conservative banker. He knows about the proposed bank and opined that the discontinuance of the former delivery channels appeared to be a positive development. With regard to the operating environment, Mr. Greene stated that loan demand has picked up considerably in the county since late 2000, particularly in the SBA, commercial and residential real estate sectors. Funding has been relationship driven and continues to exceed expectations. According to Mr. Greene, the failure of Anybank, which retained a branch directly across from his bank and subject proposal, will assist in reducing the cost of funding for area banks. This is the case given Anybank's aggressiveness with regards to deposit pricing.

Rick Savage, Executive Vice President, Lending – Anybank & Trust, Anytown, Anystate

Mr. Savage served as proposed CEO Hamm's colleague while at Anybank in Anytown. As a Senior Lending Officer, he worked closely with Mr. Hamm who retained the title of Chief Credit Officer. Mr. Savage stated that Mr. Hamm had a strong credit and special assets background. In addition, he stated that Mr. Well (proposed Senior Lending Officer) was also a very competent lender and proficient in operational matters. Mr. Savage suggested that Mr. Hamm would need strong officer support in the operational areas of the bank.

James Brown, Chairman & CEO – Anybank, Anytown, Anystate

Anybank is a federally chartered thrift and a second year denovo. It operates a pure internet business model.
Mr. Brown stated that market acceptance over the bank's model had been positive since the bank's inception. However, according to him, the growth rate has been purely a function of pricing. He added that premium pricing across all deposit categories is what attracts the higher net worth Anytown clientele. The institution is currently experiencing a transaction/CD account mix of approximately 34%/66%. His experience has been that technology for this type of business model was costlier than perceived to be in the planning stages.

Doug Jones, SVP/Retail and Alternative Delivery – Anybank, Anytown, Anystate

Prior to its acquisition by RegionalBank, Anybank was an established National bank which operated 32 in-store retail branches throughout Anystate. The in-store branches are hosted within Albertsons Supermarkets.

Mr. Jones stated that Anybank started this program over four years ago. It is expected to be a profit center for the bank but requires loan production to achieve that goal. Not all locations have been successful thus far. He stated that clientele is very sensitive to deposit pricing and primarily drawn to the time deposit products. He estimates time deposit/MMDA mixes of up to 60%/20%. Given the configuration of their in-store facilities, their loan production mainly caters to consumer type products such as auto and HELs. Mr. Jones stated that customer acquisition becomes a delicate balance of pricing, customer traffic, and marketing abilities of the staff. He concluded that customer traffic was very important for the success of the in store branch. Their institution currently performs studies to locate retail stores which achieve average weekly store traffic of 28,000 shoppers.

OTHER PERTINENT INFORMATION (Continued)

Technology Platform and Ensuing Security Risks

Overview

The Applicant plans to offer banking services via multiple electronic delivery channels including the Internet, automated telephone, Customer Call Center (telephone, facsimile, secure web message, e-mail, and regular mail), WAP (handheld wireless), and traditional retail branches.

Services that will be offered are customer identification for account opening, bill pay, check printing, fulfillments, electronic funds transfer (EFT), item processing, AS/400 mainframe hosting, ATM and Visa checkcards. Internet banking will allow account review, bill pay, transactions entry, check order, statements, printing statements, on-line applications, and wire transfers. {A schematic rendering of the operational support service is provided on a subsequent page.}

Vendors/Service Providers

Aurum Technologies (MISER III), Orlando, Florida, will provide the CBS (Comprehensive Banking System) software for processing core banking applications, EFT, Visa checkcards, item processing, network services, Internet connection, VRU as well as, interface to De Luxe check printing, and Equifax credit scoring. Aurum Technologies will host and manage the bank's AS/400 server.

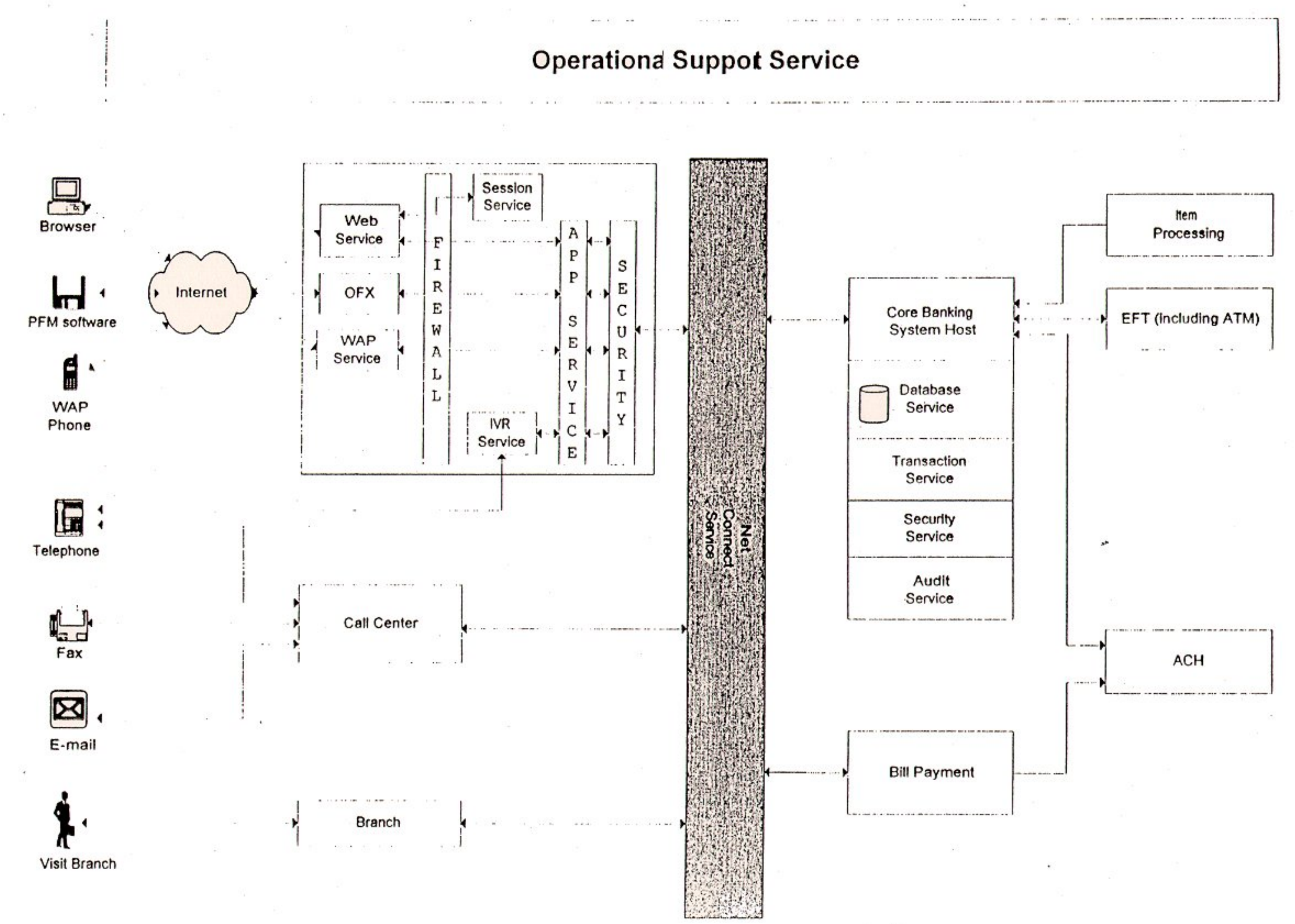
Equifax Credit Services, Inc., Atlanta, Georgia, will provide credit scoring and authentication using Decision Power and eID-Verifier, respectively. Shoreline Business Forms, Inc., Wallingford, Connecticut will provide ATM and Visa check cards. Checkpoint will provide network firewall maintenance. Princeton ecom Corporation, Princeton, New Jersey, will provide bill payments and collections.

Internet access is provided by UUNET through a 1.5 MB T1 line. Fuzion will provide a future second wireless service. There are two local area networks (LANs), located in the London office and in the Anytown office, which are to be joined by a virtual private network (VPN) connection, secured by Checkpoint network firewalls. The web site will be hosted (load balanced) jointly by Applicant and an external provider (Aurum).

According to proposed Senior Technology Officer Brian Bain, the proposed infrastructure retains the sufficient degree of scale and capacity to accommodate forecasted customer account volumes throughout the formative stages.

Facilities

The Applicant has dedicated T1 point-to-point links to Aurum Technologies, Charlotte, NC (hosting center) using redundancy circuits to ensure continuous service at all times. Disaster Recovery is with Sunguard, Philadelphia, Pennsylvania. Telecommunications connectivity was tested and the full system was restored successfully in September 2000. Additionally, the AS400 center in Charlotte is equipped with an emergency system consisting of an uninterrupted power supply (UPS), fire suppression, air conditioning and security access system.



Source: Application for Federal Deposit Insurance

Audit

In addition to monitoring logs; as further delineated within the Security section below, the Applicant will establish a Help Desk to catalogue and report incidents, as well as, follow-up escalation procedures when needed. A third party will be engaged to review all internal products, software and documentation, for compliance with internal standards and ensure that company procedures are implemented.

Security

The ability of the Applicant to provide secure data transmission over its proposed delivery channels will be of paramount importance. Its successful application and accompanying internal controls are believed critical to the success of the Internet as a proposed delivery channel and ultimately, overall customer acceptance.

OTHER PERTINENT INFORMATION (Continued)

In addition to the security measures delineated below, the Applicant is contracting with Aurum, an entity that has attained the requisite SAS 70 certification. This certification, rendered by an independent accounting firm, affirms that a provider's computer systems are being managed and operated in a manner consistent with accepted industry practices.

Security measures proposed for the fully transactional web channel include the following:

Encrypted Transactions

All banking and Internet communications will be encrypted. This will preclude sensitive financial data from being easily read and/or deciphered. Encryption will be accomplished via the use of Secure Sockets Layer Technology. This technology, considered the standard for encryption, is currently utilized by large nationally recognized web browsers. Data transmission from the Applicant's server and Aurum will be encrypted using Data Encryption Standard (DES) encryption, as further described below.

Secure Logon

To preclude the possibility of a third party downloading the Applicant's or a customer's password file, user identification and passwords will be encrypted and stored on a separate database server, not on the Internet or the web server. In addition, password parameters will be structured in a format, which makes the probability of randomly acquiring or guessing said password, extremely low.

Isolated Bank Server

The computer used to provide the Applicant's services would not be directly accessed via the Internet. It will be on a private connection, or intranet, that provides two-way communication between the isolated bank server and Internet server. Consequently, an Internet user will be prevented from accessing the computer that provides the Applicant's services. All banking services will be routed from the Internet server through a firewall. The firewall is a combination of software and hardware devices that specifically defines, controls, and limits access to internal computers from outside computers across a network. The firewall framework means that only authenticated bank customers or administrators may send or receive transactions through it. The firewall will also be immune to penetration from within the network. All messages transmitted or received between the Internet server and the operating server will be encrypted using DES encryption.

This consists of a symmetric key algorithm. Such technology is highly secure as it is not vulnerable to standard ciphertext attacks. Therefore, even if an individual was to route a message to the Applicant's server and through the firewall, the message could not be encrypted in a manner, which would be considered valid by the server. Consequently, the Applicant's server would reject the message.

Authenticated Session Integrity

An authenticated user pertains to any user who signs onto the Applicant's web site with a valid user ID and password. The Applicant's server will be configured to limit exposure to authenticated users who attempt to defraud it. If an authenticated user alters a command (URL), which is sent from the web browser to the server, in any way in an attempt to gain access to another user's account, the Applicant's server immediately detects that the session integrity variables have been violated. Once detected, the Applicant's server will terminate the session and record the unsuccessful attempt in a log so that staff can investigate.

Physical Security & Secure Modem Access

All servers and network computers will reside in secure facilities. Computer operations supporting the Applicant's internet access will also reside in secure back-up facilities. Only employees with a valid access card may enter the physical premises. Access to server systems will require further password authentication. A private line, which is not accessible by or from the public, will connect the Applicant's server with Aurum. A dial-up maintenance port will also permit access to the server. The modem that provides the only access to this port will be specially protected and will only be enabled when necessary.

Service Continuity & Monitoring

The Applicant's server will be "mirrored" so that any existing software and/or hardware bugs should cause no more than a few minutes of service outage. "Mirroring" means that the Applicant's server is backed up continuously so that all data is stored in two distinct physical locations. This level of redundancy is necessary to ensure that access to the Applicant's systems will be reliable. All customer transactions utilizing the Applicant's server will produce one or more entries within a transactional log. The Applicant will regularly review these logs, along with Aurum, to ascertain whether any unusual transactions have occurred.

INVESTIGATION REPORT SUMMARY

DESIGNATED CORRESPONDENT	
NAME Joe Hamm	TITLE President and CEO
COMPLETE ADDRESS *(Include ZIP code)* 2001 Palm Blvd, Anytown, Anystate	

WORKING HOURS					
HOURS EXPENDED				TRAVEL TIME	
EXAMINERS	INVESTIGATION	REPORT WRITING	TOTAL HOURS	DURING NORMAL WORK HOURS	OUTSIDE NORMAL WORK HOURS
Ivie Smart	45	106	151	3	6
			0		
			0		
			0		
			0		

Examiner Comments

None.

INTRODUCTION

This section describes the long standing philosophy and methods of the FDIC for examining institutions using a risk-focused, forward-looking approach. Each supervised institution is unique, based on its business model, complexity, and risk profile. Accordingly, examiners and case managers are expected to apply the instructions in this policy, as well as related instructions elsewhere in the FDIC's Risk Management Supervision Manual of Examination Policies (Manual) consistent with each institution's unique circumstances. The instructions set forth in this section are directed to FDIC supervisory personnel[1] in the conduct of supervisory activities and do not require action on the part of insured institutions. The principles discussed herein apply to both point-in-time and continuous examination approaches, though some specific activities discussed may differ.

Purpose of Examinations

An examination is the process whereby supervisory personnel of a regulatory agency evaluate financial institutions' conditions, management processes,[2] and future prospects; identify deficiencies that may threaten their soundness; assess their compliance with applicable laws and regulations; and develop recommendations for corrective action, as appropriate.

Consistent with its mission, the FDIC conducts financial institution examinations to ensure public confidence in the financial system and to protect the Deposit Insurance Fund. Maintaining public confidence in the financial system is essential because customer deposits are a primary funding source that depository institutions use to meet fundamental objectives such as providing financial services. Safeguarding the integrity of the Deposit Insurance Fund is necessary to protect customers' deposits and resolve failed institutions.

On-site examinations help ensure the stability of insured depository institutions by identifying undue risks and weak risk management practices. Additionally, examinations play a key role in the supervisory process by helping the FDIC identify the root cause and severity of problems at individual institutions and emerging risks in the financial-services industry. Accurately identifying existing problems and emerging risks helps the FDIC develop effective corrective measures for individual institutions and broader supervisory strategies for the industry.

Uniform Financial Institutions Rating System

The federal financial institution supervisory agencies endeavor to ensure that all financial institutions are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends. To promote this goal, the Federal Financial Institutions Examination Council (FFIEC) adopted the Uniform Financial Institutions Rating System (UFIRS) on November 13, 1979. The original rating system was designed to reflect, in a comprehensive and uniform fashion, an institution's financial condition, compliance with laws and regulations, and overall operating soundness.

The FFIEC revised the UFIRS on December 19, 1996, effective January 1, 1997.[3] The revised rating system, known as CAMELS,[4] reflects an increased emphasis on risk management processes. The Federal supervisory agencies historically considered the quality of risk management practices when applying the UFIRS, particularly in the management component; however, by 1996, changes in the financial services industry had broadened the range of financial products offered by institutions and accelerated the pace of transactions. Those trends reinforced the importance of institutions having sound risk management systems. Accordingly, the revised rating system added an explicit reference to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating descriptions.

Management practices, particularly as they relate to risk management, vary considerably among financial institutions depending on their size and sophistication, the nature and complexity of their business activities, and their risk profile. Each institution must properly manage its risks and have appropriate policies, processes, or practices in place that management follows and uses. Activities undertaken in a less complex institution engaging in less sophisticated risk-taking activities may only need basic

[1] This term includes Risk Management Supervision staff such as examiners, field managers, case managers, and regional office management and is used throughout this document when a responsibility may be handled by varying parties based on regional management discretion.

[2] Management processes include an institution's corporate governance structure, policies, and procedures.

[3] See 62 Fed. Reg. 752, *January 6, 1997, effective January 1, 1997*.

[4] Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation of six financial and operational components, which are also rated. The component ratings reflect an institution's capital adequacy, asset quality, management capabilities, earnings sufficiency, liquidity position, and sensitivity to market risk (commonly referred to as the CAMELS ratings).

management and control systems compared to the detailed and formalized systems and controls needed for the broader and more complex range of activities undertaken at a larger and more complex institution.

The UFIRS takes into consideration certain and compliance factors that are common to all institutions. Compliance with laws and regulations is considered under the management component. Specialty examination findings (Compliance, Community Reinvestment Act, Government Security Dealers, Information Technology, Municipal Security Dealers, Transfer Agent, and Trust (or Fiduciary)) and the ratings assigned to those areas are taken into consideration, as appropriate, when assigning a composite rating and component ratings under UFIRS.

Peer comparison data are not included in the rating system. The principal reason is to avoid over reliance on statistical comparisons to justify the component rating being assigned. Examiners are encouraged to consider all relevant factors when assigning a component rating. The rating system is designed to reflect an assessment of the individual institution, including its size and sophistication, the nature and complexity of its business activities, and its risk profile.

Over the years, the UFIRS has proven to be an effective internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern.

Risk-Focused Approach to Examinations

Risk-focused supervision was adopted by the FDIC, the Board of Governors of the Federal Reserve System, and the Conference of State Bank Supervisors on October 1, 1997, as a framework for carrying out examination activities. The FDIC described the then new framework as employing a tiered approach to supervision to assist examiners in establishing an appropriate examination scope and managing resources by focusing those resources on the areas in an institution presenting the greatest risks.[5]

The objective of a risk-focused examination is to evaluate the safety and soundness of the financial institution by assessing its risk management systems, financial condition, and compliance with applicable laws and regulations, while focusing on the bank's highest risks. The risk-focused examination process seeks to strike an appropriate balance between evaluating the condition of an institution at a certain point in time[6] and evaluating the soundness of the institution's processes for managing risk in all phases of the economic cycle. By evaluating an institution's risk management practices, examiners look beyond the financial condition of a bank at a point in time, to how well it can respond to changing market conditions given its particular risk profile. The UFIRS emphasizes the importance of sound risk management processes by including them as a significant factor in the definition for each component rating and the overall composite rating.

To achieve the risk-focused examination objective, FDIC supervisory personnel are expected to adhere to the following risk-tailoring principles and practices:

- Recognize there are financial institutions, or areas within institutions, that present low risk, and in those cases, minimum (or baseline) examination procedures are generally sufficient to assess the institution's condition and risks.
- Allocate more examination resources to higher risk areas and fewer resources to lower risk areas.
- Use data from the quarterly Call Report filings and other available information to monitor changes to the institution's business model, complexity, and risk profile between examinations.
- Leverage available information, including analyses and conclusions from ongoing off-site monitoring and previous examinations, to determine the financial institution's risk profile and the scope of the next examination or examination activity.
- Consider the financial institution's ability to identify and control risks when risk-focusing examinations.
- Tailor the pre-examination request list to the institution's business model, complexity, and risk profile.
- Contact the institution between examinations or prior to finalizing the scope of the examination to help inform an examiner's assessment of an institution's risk profile.
- Follow up between examinations on the institution's actions taken to address areas in need of improvement.

Further, FDIC personnel are expected to adhere to the following communication principles:

- Provide appropriate prior notification of the upcoming examination and address staffing and logistical issues.

[5] See FDIC 1997 Annual Report.

[6] In addition to point-in-time examinations, the FDIC utilizes targeted reviews conducted under a supervisory plan, guiding a continuous examination program for certain institutions. These other programs are generally warranted to ensure effective monitoring and examination activity related to larger and more complex institutions. While the supervisory plan and continuous examination processes and procedures may differ in some respects from the point in time approach, the principles contained within this section are applicable to examination activities for all institutions supervised by the FDIC.

- Tailor the examination request list and scope to the unique risk profile and business model of the institution.
- Facilitate the secure exchange of information between institution management and examiners.
- Inform institution management of areas under review and provide management the opportunity to communicate any additional information or clarification before the conclusion of the examination.
- Establish clear expectations regarding items and examination findings that the financial institution is expected to address.[7]

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RISK-FOCUSED, FORWARD-LOOKING EXAMINATION PROCEDURES

Section 10(b) of the FDI Act requires the FDIC to conduct full-scope, on-site safety and soundness examinations of its supervised institutions.[8] Risk-focused, full-scope examinations assess the types and extent of risks to which a banking organization is exposed, evaluate the organization's methods of managing and controlling its risk exposures, ascertain whether management and directors fully understand and are actively monitoring the organization's exposure to these risks, and evaluate compliance with banking laws and regulations. Risk-focused, full-scope examinations are forward looking in that they address weaknesses in risk management practices before they lead to financial deterioration or operational problems.

The risk-focused supervision approach to examinations is not composed of a fixed set of routine procedures. Rather, the procedures that constitute a full-scope examination depend on the nature and complexity of the institution's business activities, and its risk profile. At a minimum, however, full-scope examinations must include sufficient procedures to reach an informed judgment on the financial, managerial, operational, and compliance factors rated under the CAMELS rating system.[9] An examination meeting those requirements would meet the FDIC's definition of a full-scope examination.

Understanding the Institution

To conduct a risk-focused examination, examiners must understand the nature, scope, and risk of an institution's activities. The nature and scope of an institution's activities are commonly referred to as the institution's business model. The examiner will develop a written description of the bank's business model by identifying the activities in which a banking organization has chosen to engage.

The risk associated with an institution's business model is commonly referred to as the risk profile. The examiner will develop a written description of the bank's preliminary risk profile by determining the types and quantities of risks inherent in the bank's business model and the quality of the risk management practices used by bank management to control these risks.

A key component of both an institution's business model and risk profile is the complexity of its operations. The examiner will develop a written description of the complexity of an institution's operations through a review of its balance sheet structure and scope of operations.

Business Model – To evaluate and develop a written description of an institution's business model, an examiner will consider:

- The primary market area and customer base served;
- The organizational/ownership structure, strategic plan/focus, and philosophical approaches/risk appetite management is using to pursue its objectives;
- The primary lending activities and funding sources, including any concentrations;
- Any product line, activity, or service that represents a significant portion of assets or revenue;
- Any unique or niche characteristics;
- Any significant third-party relationships, including technology service providers; and
- Any significant use of new or emerging technologies to support customer products or bank operations, whether offered alone by the institution or offered with a third party.

[7] The FDIC participated in the FFIEC Examination Modernization project to identify and assess ways to improve the effectiveness, efficiency, and quality of financial institution safety and soundness examination processes, with the expectation to help reduce unnecessary regulatory burden. Expectations for examiners to adhere to risk-tailoring and clear communications practices are part of the project. See FFIEC press releases related to Examination Modernization dated March 22, 2018 and November 27, 2018.

[8] Federal Deposit Insurance Act.

[9] This could include, as appropriate, risk management for Information Technology (IT), Bank Secrecy Act (BSA)/Anti-Money Laundering (AML)/Office of Foreign Assets Control (OFAC) reviews, Trust, Registered Transfer Agent, Municipal Securities Dealer, and Government Securities Dealer examination programs. These specialty examination areas are incorporated into CAMELS through the Management component rating, as outlined in the UFIRS. See 62 Fed. Reg. 752, *January 6, 1997, effective January 1, 1997.*

Risk Profile – To evaluate and develop a written description of an institution's preliminary risk profile, the examiner reviews the bank's business model, its current financial condition, and trends in its financial condition. The examiner reviews information available within the FDIC, including prior Reports of Examination and workpapers, correspondence, applications and other filings, the Uniform Bank Performance Report, interim contacts, and off-site review reports. Further, the examiner communicates with the case manager and other FDIC stakeholders to obtain additional information.

The examiner also considers the quality of institution management's policies, practices, and processes in determining the risk profile of an institution. Such policies, practices, and processes are indicators of an institution's governance and risk management framework, and can provide information to evaluate the institution's ability to withstand and respond to internal and external challenges, including unforeseen scenarios (e.g., competition, adverse economic conditions).

The nature and scope of an institution's activities influence the robustness of risk management practices for mitigating credit, market, operating, or transaction, strategic, compliance, legal, liquidity, and other risks. The examiner considers the inherent risks of the bank's activities and the strength of risk mitigation practices when developing and documenting the current risk profile of the bank. This process enables the examiner to identify areas of greater risk that will be emphasized in conducting the examination.

Risk management practices are primarily assessed considering the guidelines for the safe and sound operation of banks set forth in Section II of Part 364 of the FDIC Rules and Regulations, Appendix A,[10] though other regulations are also considered These guidelines set out safety and soundness standards that the agencies use to identify and address problems at institutions before capital becomes impaired.[11] The guidelines are qualitative rather than quantitative; they establish the objectives of proper operations and management, but leave the specific methods of achieving those objectives to each institution. They are also designed to be flexible based on the nature of activities at the bank. The guidelines cover the following areas:

- Internal controls and information systems;
- Internal audit systems;
- Loan documentation;
- Credit underwriting;
- Interest rate exposure;
- Asset growth;
- Asset quality;
- Earnings; and
- Compensation, fees, and benefits.

Complexity – A key component of both the institution's business model and risk profile is the complexity of its operations. To determine complexity within an institution's products, services, and delivery channels, the examiner evaluates a combination of factors, including, but not limited to, the sophistication of a particular activity or business line, risk presented by the activity, volume and scope of the activity, and interconnectedness among various activities and business lines within the institution. The examiner also considers strategic initiatives of the institution that impact the business model, risk profile, and complexity of the institution. In describing complexity, the examiner considers:

- Structure – balance sheet composition, off-balance sheet activities, asset and funding concentrations, organizational and management structure, branching activities, merger and acquisition activities, and geographic footprint; and
- Operations – business lines, customer base, product and service offerings, number and type of deposit and lending transactions, delivery systems, international exposure, operational risk,[12] and specialty areas.[13]

Planning the Examination[14]

Section 21.1 entitled Examination Planning provides information in relation to preparing for a Risk-Focused, Forward-Looking Safety and Soundness Examination. This section notes that the purpose of the examination planning process is to ensure that the institution's operations and activities are understood prior to the start of the examination, so that examination procedures can be appropriately tailored to the institution.

[10] See *Appendix A to Part 364 - Interagency Guidelines Establishing Standards for Safety and Soundness*.

[11] If an institution fails to meet a standard prescribed by guideline, the FDIC may request the institution to submit an acceptable plan to achieve compliance with the standard. The FDIC generally expects to request submission of a compliance plan from an institution whose failure to meet one or more standards is of such severity that it could threaten the safe and sound operation of the institution. In other situations, the FDIC may elect to rely on an existing plan or enforcement action to ensure that an institution achieves compliance with the guidelines, rather than requiring the submission of a separate safety and soundness compliance plan. The FDIC may also seek corrective action through a Matter Requiring Board Attention.

[12] Includes BSA/AML and IT, including cybersecurity.

[13] Includes trust and asset management, consumer compliance, Community Reinvestment Act, registered transfer agent, government-securities dealers, and municipal-securities dealers.

[14] For the purposes of this discussion, planning of targeted reviews conducted as part of a continuous examination approach focuses on the subject of the review, where the point-in-time examination would encompass all aspects of a full scope examination.

The Examination Planning process includes several key activities, including contacting the institution, developing an understanding of the risks, tailoring the request list, identifying on-site and off-site procedures, and developing a written examination plan.

Refer to Section 21.1 for additional details regarding examination planning.

Conducting the Examination

Prior to the on-site portion of the examination, the examination team conducts off-site examination activities to review and analyze available information, including materials provided by the bank. During this timeframe, the EIC updates the examination plan, factoring in the review of requested materials, and submits the plan to field management for final approval.

During the off-site examination process, or on the first day of the examination, the EIC invites board members to attend any or all meetings conducted during an examination. Their attendance often improves communication with outside directors and increases director knowledge of the examination process. These meetings also provide an opportunity for directors to discuss their views with examiners on bank-related matters, and give examiners the opportunity to gain further insight into the experience levels and leadership qualities of bank management. While encouraging participation in these meetings, the EIC should emphasize that attendance is voluntary and that a lack of participation will not be viewed negatively.[15]

As soon as practicable, on or after the first day of the on-site portion of the examination, the EIC and on-site portion of the examination team meet with appropriate institution management to open lines of communication, develop plans for ongoing communication during the examination, and discuss any other informational needs or other issues. The EIC describes how document request materials obtained from the institution are being used during the examination. Informal meetings are held as needed throughout the examination to discuss various topics, including but not limited to following up on previous examination issues, discussing strategic and business plans, discussing loan review results, and discussing other material preliminary findings.

The EIC is expected to coordinate regular communication among examination team members, such as examination team meetings, conference calls, or group emails, so that team members may share and discuss observations and findings. Team communication should occur at least once per week; more frequent communication may be appropriate if examination teams are dispersed.

Based on the risk presented by the institution, examiners are expected to perform an appropriate level of transaction testing to verify: the adequacy of and adherence to internal policies, procedures, and limits; the accuracy and completeness of management reports and financial reports; the adequacy and reliability of internal control systems; the effectiveness of the bank's risk management processes and practices; and compliance with laws and regulations.

Examiners have the flexibility, subject to appropriate concurrence, to adjust the examination scope at any point during the examination based on findings to date. EICs will discuss proposed changes with their manager. EICs are to obtain written concurrence from their manager[16] prior to implementation of material changes to the examination scope.

The manager will provide a copy of the written concurrence to the appropriate regional office case manager. The rationale for changes in the examination plan will be clearly communicated to institution management, along with any significant adjustments to the breadth or depth of procedures, personnel, examination hours, and examination schedule.

Communicate Preliminary Findings

Sufficiently in advance of exit meetings with institution management, the EIC provides and discusses preliminary findings, ratings, and supervisory recommendations with the Field Supervisor and Case Manager.

Prior to the conclusion of the examination, examiners thoroughly discuss the tentative findings and supervisory recommendations with senior institution management, including the tentative CAMELS ratings assigned under the UFIRS, clearly indicating that ratings are subject to FDIC regional office review. Such meetings are critical in communicating tentative examination findings to institution management and providing management an opportunity to respond.

During exit meetings, the EIC fully apprises institution management of examination findings and conclusions, including explaining the reasoning for proposed ratings and supervisory recommendations that will be cited in the ROE. Examiners also describe how document request materials

[15] See Risk Management Manual of Examination Policies, pages 1.1-14 -15.

[16] The appropriate manager will be the supervisory examiner or field supervisor for point-in-time examinations and the assistant regional director for continuous examinations.

obtained from the institution were used during the examination to support findings.

Prepare the Report of Examination[17]

The EIC prepares the ROE in accordance with the FDIC's ROE Instructions[18] contained within the Risk Management Supervision Manual of Examination Policies (Manual). Consistent with the forward-looking aspects of the risk-focused examination process, the ROE is designed to clearly convey issues that are cause for concern, explain the risks to the institution's operations or financial performance if not addressed in a timely manner, and recommend appropriate corrective/remedial action.

Within the ROE, supervisory recommendations are used to inform the institution of the FDIC's views about changes needed in the bank's practices, operations, or financial condition. Matters Requiring Board Attention (MRBA) is a subset of supervisory recommendations that need prompt action by the board of directors and senior management. The intent of supervisory recommendations and MRBAs is to establish clear expectations regarding items the institution should address in order to correct deficiencies before they cause deterioration in the bank's financial condition.

Meet with the Institution's Board of Directors

The FDIC conducts meetings with boards of directors to encourage director involvement in, and enhance director awareness of, FDIC's supervisory efforts and to increase the effectiveness of such efforts.[19] Such meetings also provide an opportunity to discuss and exchange views on bank specific and industry related issues that may be outside the scope of the examination, but are important for promoting safe and sound operations; examples include planned bank initiatives or new or proposed banking regulations.

The EIC meets with the board or a board committee during or subsequent to the examination when 36 months or more have elapsed since the last such meeting; the management component of the CAMELS rating is 3, 4 or 5; any other CAMELS performance rating is 4 or 5; or any two performance ratings are 3, 4 or 5. Other factors that may be relevant to the decision of holding a board meeting include whether:

- The ROE contains MRBAs;
- The institution has undergone a recent change in control, ownership, or top management;
- The institution is operating in adverse economic conditions;
- The institution's management or board has requested a meeting; or
- There exist any other unique conditions or trends pertinent to the institution.

An institution's composite rating is an important variable in determining regional office participation in a board meeting. While regional office participation in meetings with banks rated composite 1, 2, or 3 is at the regional director's discretion, the regional director or designee will participate in the board meeting of a bank with a composite rating of 4 or 5.

Submit the ROE for Regional Office Review and Issuance to the Institution

The EIC notifies institution management when the draft report is submitted to the assigned regional office case manager for review. The assigned case manager is expected to ensure that the ROE clearly identifies areas of risk and contains appropriate supervisory recommendations to mitigate those risks, supervisory recommendations address the causes of deficiencies, supervisory recommendations that warrant board attention are scheduled as MRBAs in accordance with existing Manual instructions, and CAMELS ratings are supported and are consistent with UFIRS definitions.

Supervisory personnel keep institution management informed of any changes made to the ROE findings that differ significantly from the initial findings disclosed at the exit meetings with institution management. Examples of significant changes include, but are not limited to, a revision to any rating or the addition or deletion of a supervisory recommendation or an apparent violation. FDIC supervisory personnel will explain the reasons for the changes to initial examination findings, and institution management will be given a reasonable amount of time to re-confirm or change responses and commitments, as appropriate.

The FDIC has established internal goals to ensure the timely sharing of information with financial institutions. These goals include transmitting Safety and Soundness ROEs to financial institutions within a median 75 days from the on-site examination start date and concluding regional office processing of Safety and Soundness ROEs within a median 45 days from the EIC's submission of the ROE to the regional office. The FDIC reports its performance relative

[17] For targeted reviews where a full ROE is not to be issued, these concepts apply similarly to a supervisory letter.

[18] See Risk Management Manual of Examination Policies, Section 19.1.

[19] Risk Management Manual of Examination Policies, page 1.1-16.

to these goals on the FDIC's *Trust through Transparency* webpage. The case manager keeps institution management informed should unusual processing delays occur and provides the reasons for such delay.

The regional office transmits the ROE to the institution's board of directors with a letter summarizing the examination findings. In some cases, the transmittal letter will also request that the board provide a written response to the examination. Institution management is also invited to complete a post examination survey after each examination.[20] The survey is part of the FDIC's continuing effort to improve the quality and efficiency of the examination process. Institution management is invited to complete the survey via a secure FDIC Website using an access code provided in a separate invitation letter. All responses are submitted directly to the FDIC's headquarters office and will be confidential. The FDIC uses the survey results to identify ways to improve the examination process.

Post-Examination Responsibilities

Safety and soundness supervision is an ongoing process of planning and conducting examinations, following up on the resolution of supervisory findings and supervisory recommendations, and monitoring institutions between examinations.

Enforcement Actions

Should an enforcement action be deemed necessary to address deficiencies identified during the examination, regional office personnel, with input from the EIC, develop the appropriate level of supervisory action (formal or informal) and engage the board of directors and management to ensure understanding and procure adoption. Once an enforcement action has been adopted, case managers review implementation progress reports submitted under the enforcement action to monitor the institution's corrective actions.

Following up on Examination Findings

The institution's assigned case manager reviews institution management's response to the ROE, as applicable, and follows up on the disposition and resolution of MRBAs. Staff assigned to the Division Director will contact institution management in response to any request for post-examination contact within the post examination survey.

Ongoing Monitoring and Interim Contacts

The assigned case manager serves as the institution's point-of-contact within the FDIC and will conduct ongoing monitoring of the institution's risk trends and financial condition between examinations. Should the institution be flagged on any internal FDIC reports as an outlier based on quarterly Call Report data, the case manager reviews the data that caused the flag and may contact institution management, if needed, to obtain any additional information needed to review the matter. Further, the assigned case manager or field supervisor contacts institution management between examinations to inquire about any changes in institution operations, discuss topics of interest such as regulatory changes or industry trends, and answer questions from bank management.

[20] Post-Examination Survey.

PURPOSE OF PLANNING A RISK-FOCUSED, FORWARD-LOOKING SAFETY AND SOUNDNESS EXAMINATION

As described in Section 20.1 of the Risk Management Manual of Examination Policies - Risk-Focused, Forward-Looking Safety and Soundness Supervision, the objective of a risk-focused examination is to evaluate the safety and soundness of the financial institution by assessing its risk management systems, financial condition, and compliance with applicable laws and regulations, while focusing on the institution's highest risks. The risk-focused examination process seeks to strike an appropriate balance between evaluating the condition of an institution at a certain point in time and evaluating the soundness of the institution's processes for managing risk in all phases of the economic cycle. By evaluating an institution's risk management practices, examiners look beyond the financial condition of an institution at a point in time, to how well it can respond to changing market conditions given its particular risk profile.

Risk-focused supervision involves employing a tailored approach to each examination. The risk-focused supervision approach to examinations is not comprised of a fixed set of routine procedures. Rather, the procedures that constitute a full-scope examination depend on the nature and complexity of the institution's business activities and risk profile. At a minimum, full-scope examinations must include sufficient procedures to reach an informed judgment on the financial, managerial, operational, and compliance factors rated under the CAMELS rating system.[1] An examination meeting those requirements would meet the FDIC's definition of a full-scope examination.

The purpose of the examination planning process is to ensure that the institution's operations and activities are understood prior to the start of an examination, so that examination procedures can be appropriately tailored to the institution. By understanding the unique nature of each institution, examiners can evaluate fundamental risks of the institution's activities and the strength of management practices in mitigating those risks, and focus examination activities and procedures on risks that are not as well-mitigated or that have not been previously assessed because they are new.

Three Phases of Examination Planning

The examination planning process can be broken into three phases: initial contact, initial examination planning, and final examination planning and conducting off-site work.[2] Each of these phases is discussed below.

Phase 1: Initial Contact

The field supervisor (FS)/supervisory examiners (SE)[3] must develop a timeline of examination activities for the upcoming examination at least 90 days ahead of the projected start date of the examination. At this time, the FS/SE must contact institution management to inform them of the upcoming examination date. During this contact, the FS/SE will provide notice that profile scripts for general safety and soundness, which includes Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT), and Trust (when applicable), and Information Technology will be sent to the financial institution. The FS/SE will explain that these scripts will help plan examination procedures based on the financial institution's business model, risk profile, and complexity and help to tailor a document request list for the institution. In addition, the FS/SE needs to ask institution management for the names and contact information (phone/email) of the institution's points of contact for AML/CFT, IT, and Trust (if applicable) in order to facilitate the completion of required complexity tools. The FS/SE will then ensure that the start date is entered into the FDIC's database, which will initialize the request list and examination workpaper systems.

Immediately after contacting management, the FS/SE will generate an Examination Profile Script (EPS), an Information Technology Profile (ITP), an IT Products and Services Template, and Areas of Responsibility (bank contacts) forms. These items will be transmitted under the same cover letter to avoid creating burden and confusion for financial institution management via the FDIC's secure system of information exchange between institution management and the FDIC. Institution management will

[1] This could include, as appropriate, risk management for Information Technology, Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT), Sanctions Compliance, Trust, Registered Transfer Agent, Municipal Securities Dealer, and Government Securities Dealer examination programs. These specialty examination areas are incorporated into CAMELS through the Management component rating, as outlined in the Uniform Financial Institutions Rating System. See *62 Fed. Reg. 752, January 6, 1997, effective January 1, 1997.*

[2] The principles discussed herein apply to both point-in-time and continuous examination approaches, although some specific activities discussed may differ.

[3] The FS/SE are responsible for scheduling, approvals, and the ordering of a digital circuit and thus responsible for the initial 90-day call. Other FS/SE duties can be delegated to other appropriate RMS staff, such as setting up the secure exchange of information with the institution.

have approximately two weeks to complete the EPS[4] and ITP. Providing management with the EPS and ITP well before developing the actual request list facilitates a more tailored request list.

Section 1 of the EPS is designed to collect information necessary to help the examiner understand material changes to the business model, risk profile, and complexity of the institution since the previous Safety and Soundness examination. Section 2 of the EPS is tied to scoping questions in the request list tool and helps examiners understand which products and services are applicable to the financial institution. Subsequent sections of the EPS for AML/CFT and Trust (if applicable) relate to the specialty examination scoping questions and help examiners understand the complexity of these activities. Similarly, the ITP identifies applicable IT activities, while also gathering information about the complexity of the institution's IT operations.

Additional sections of the EPS relate to (1) ascertaining options for potential off-site loan review and (2) evaluating connectivity available for examiners at the institution's physical location(s). The FS/SE has the option of verbally asking these questions of institution management and completing these sections prior to sending the EPS to the institution. This option could provide additional lead time in determining where loan review will be conducted as well as arranging for appropriate examiner connectivity while on-site at the institution, such as ordering a temporary digital circuit if needed.

Sections of the EPS can be adjusted based on scoping questions within the request list tool. If examiners are already aware that an institution does, or does not, have a particular product or service, the examiner should answer the scoping question by selecting yes or no, and the item will not be added to the EPS. This is particularly important for the AML/CFT and Trust sections of the EPS, as community institutions typically do not have complex AML/CFT or Trust operations.

The information gathered from the completed EPS will then help examiners develop an examination plan and request list tailored specifically to the activities of the institution.

An example of a cover letter and EPS is available as Appendix A of this section.

The FS/SE will also evaluate options at the institution regarding remote connectivity. If it appears the connectivity options available will not be sufficient for a particular examination's needs, FDIC field management should request a digital circuit from FDIC technical staff.

The FS/SE should also inquire about loan imaging and various off-site loan review options. If institution management is willing and able to provide off-site access to loan files, the FS/SE should begin the coordination of logistical and technical arrangements between the institution and the FDIC well ahead of the examination start date in order to facilitate off-site loan review activities.

Lastly, the FS/SE will schedule examiners for Phases 2 and 3 of examination planning. In particular, the FS/SE will select the Examiner-in-Charge (EIC) and schedule the EIC for sufficient dedicated time in the field office to conduct all activities of Phase 2 (Initial Examination Planning) six to eight weeks prior to the start date of the examination. Further, the FS/SE has flexibility to initiate the start of Phase 3 (Final Examination Planning and Conducting Off-Site Work) more than one or two weeks before the examination start, should the complexity of the institution or other circumstances warrant.

Additionally, appropriate personnel should be scheduled and provided sufficient dedicated time to perform specialty area examination planning activities,[5] including assessing specialty examination complexity, so that the results are finalized and ready for the EIC's review and consideration at the start of the Initial Examination Planning. The EIC is to use the information on the institution's complexity to assist with the completion of the Examination Planning Memorandum (EP Memo) and tailoring the specialty area request lists.[6]

Phase 2: Initial Examination Planning

The goal of completing the initial planning six to eight weeks ahead of the examination start date is to allow the EIC sufficient time to learn about the institution and prepare an examination plan tailored to the institution's areas of greatest risk.[7] Attention to these activities at an early stage allows the examiner to make a more targeted information request to institution management, thereby reducing burden on the financial institution while ultimately providing for a more efficient and effective examination.

[4] The FS/SE may provide institution management with the option of discussing the EPS items with the FS/SE, who then may complete the EPS on the institution's behalf.

[5] Refer to examiner instructions on each of the specialty complexity tools. Optimally, the FS/SE should assign the complexity tool responsibilities to the same individuals reviewing the specialty areas at the upcoming examination.

[6] FS/SEs are to schedule examination planning time for specialty area examiners.

[7] For the purposes of this discussion, planning of targeted reviews conducted as part of a continuous examination approach focuses on the subject of the review, where the point-in-time examination would encompass all aspects of a full-scope examination.

Understanding the Institution

To conduct a risk-focused examination, examiners must understand the nature, scope, and risk of an institution's activities. The nature and scope of an institution's activities are commonly referred to as the institution's business model. The risk associated with an institution's business model is commonly referred to as the risk profile. A key component of both the business model and the risk profile is the complexity of the institution's operations.

In order to get an understanding of the business model, risk profile, and institution's complexity, the EIC will review the institution's responses to the EPS and ITP; read prior Reports of Examination (ROEs); review correspondence, FDIC databases, and economic data; and review specialty area information and complexity assessments. Further, the EIC should contact the case manager (CM), the FS/SE, and the external auditor to gain additional insight and perspective on the institution.

Based on the review of available information and discussions with others, the EIC will then develop (or update) preliminary written descriptions of the institution's business model, risk profile, and complexity following the considerations outlined in the Risk-Focused, Forward-Looking Safety and Soundness Supervision section of the manual.

Discussion with Institution Management

The EIC then contacts institution management to discuss the preliminary descriptions of the institution's business model, risk profile, and complexity, and to describe how those definitions are being used to determine the planned examination scope and request list content. The EIC should seek management's views regarding recent changes in operations, economic conditions, or competition, and answer any questions that institution management may have.

Drafting the Examination Planning (EP) Memorandum

During Phase 2, the EIC is responsible for drafting an EP Memo. The EP Memo template and instructions for its preparation are included in Appendix B. The EP Memo outlines the examination activities and procedures deemed necessary to fulfill the statutory requirement to complete an on-site, full-scope examination of the institution, given the institution's business model, risk profile, and complexity. Further, as described in the attached instructions, the EP Memo will also outline the EIC's plans for loan review.

Discussing the Draft Examination Plan with the FS/SE and CM

Once the draft EP Memo is written, the EIC will provide the draft to the FS/SE and CM for discussion of the initial assessments of risk, anticipated procedures, and initial information requests. The EIC will provide an estimate to the FS/SE regarding projected examination hours (inclusive of anticipated training hours), staffing needs (addressing the need for specialists or subject matter experts), and the plan for on-site/off-site activities. The FS/SE and CM are to provide feedback on the draft examination plan to assist the EIC with finalizing the examination plan.

Based on discussions and review of the draft examination plan, the FS/SE will assign appropriate staff to the examination, including specialty areas.

Tailoring and Sending the Information Request List

The EIC is expected to tailor the information request letter to include only those materials necessary to examine the institution based on its unique business model, risk profile, and complexity. The EIC sends the information request letter to institution management sufficiently in advance of an upcoming examination to allow ample time for management to compile and submit requested documents. The EIC establishes a due date for the materials sufficiently in advance of the anticipated start date of the examination to allow for off-site examination work prior to the on-site start date. Further, the EIC facilitates the secure exchange of information between institution management and the FDIC, by ensuring that the delivery method(s) used meet the security measures discussed in the FDIC's policies for the exchange, use, and storage of electronic information.

Best practices for requesting examination information include that:

- Information requests should be risk-focused and relevant to the examination.
- Supervised institutions should be given sufficient time to produce new or additional requested information.
- Examiners should coordinate information requests among the examination team to avoid duplicative and/or redundant requests.
- Unless otherwise agreed to with institution management, information requests should be made through the institution's designated regulatory examination point-of-contact, if applicable, to avoid placing burden on other institution staff.
- Information requests and supplemental information requests should be clearly articulated in writing.

Identifying Off-site/On-site Procedures

During the examination planning stage, the EIC is expected to identify examination activities that are appropriate for off-site review and those that are better suited for on-site review. The EIC discusses these activities with field management and incorporates them into the written examination plan. The determination of the extent of off-site or on-site for each examination activity will depend, in part, on the type and extent of electronic information available and whether the activity requires interaction with institution personnel. Examiners are expected to consider conducting examination procedures off-site, to the extent reasonably possible, in order to minimize disruptions to an institution's normal business activities and leverage remote work capabilities.

Examiners should consider the following factors in determining which examination activities to perform off-site and those to perform on-site:

- Institution risk profile, business model and complexity, including risk appetite and local economic conditions and trends;
- Prior examination findings and ratings;
- Preliminary risks identified during examination planning;
- Technological capabilities of the institution, including availability of imaged loan files and electronic access to other institution documents;
- On-site/off-site plans of the state (joint examinations) or the Division of Depositor and Consumer Protection (joint examination team);
- Access to key institution personnel;
- Size, experience, and training needs of the examination team;
- Experience with institution management, management turnover, and dominant officer influence;
- Financial reporting history and accuracy; and
- New developments (new products/services, IT system conversions, changes in control, de novo status, charter conversions, mergers/acquisitions, new entrant to Continuous Examination Program, etc.).

Examiners are encouraged to conduct the following portions of a financial institution examination off-site:

- Determine the scope of the examination and identify the loan review sample;
- Review historical financial and supervisory data and perform initial analysis of capital, asset quality (such as loan loss trends and methodology and investment portfolio composition), earnings, liquidity, and sensitivity to market risk;
- Review the institution's internal reports;
- Review the institution's written policies and procedures;
- Review risk assessments and independent audit reports or reviews;
- Review board and committee packages and minutes;
- Complete financial schedules and certain other pages of the ROE; and
- Finalize workpapers.

Regarding credit review, typically the most labor intensive part of a financial institution examination, the examiner may conduct the following off-site:

- Review loan policies;
- Review performance report ratio data and management reports;
- Preliminarily review the methodology used for estimating loan losses;
- Determine the areas to be emphasized in the on-site review;
- Determine the loan sample to be reviewed, and select and assign individual credits;
- Group loans to related obligors; and
- Review credit and investment files for quality, documentation, and compliance with institution policy and laws and regulations, if information is available in a format for off-site review.

Examiners are expected to conduct the following examination activities on-site:

- Conduct in-depth discussions with management;
- Verify financial information;
- Observe and assess institution operations and internal controls;
- Collect follow-up documentation to complete the financial analysis;
- Review credit and investment files for quality, documentation, and compliance with institution policy and laws and regulations, if information is not available in a format for off-site review;
- Review documents that would be inappropriate or impractical to provide off-site; and
- Conduct exit meetings with management.

<u>Phase 3: Final Examination Planning and Conducting Off-Site Work</u>

Supervisors are required to allocate appropriate time for the examination team to complete all examination planning activities, including the downloading, electronic filing, and reviewing of materials provided by the institution.[8] These other examination activities should begin at least one to two weeks prior to the on-site examination start date. In particular, the EIC must be scheduled sufficient time prior to the start date of the examination to review the request list response and finalize the Examination Plan and EP Memo. The finalization of the EP Memo includes determining staff assignments, as well as identifying any benchmark training needs of pre-commissioned team members. The EIC will submit the final EP Memo to the FS/SE during Phase 3 with sufficient time for the FS/SE to review and approve. The FS/SE must approve the EP Memo prior to the start date of the examination. Once approved, the EIC distributes the EP memo to the CM and the examination team. The CM will place a copy of the finalized EP memo in the institution's correspondence file system of record.

In addition to examination planning, off-site work prior to the on-site start date will include the activities discussed previously in Phase 2. The FS/SE will provide additional staff, as available, prior to the start date to conduct off-site examination procedures. This additional staff, which can include both key roles such as Operations Manager and/or Asset Manager, as well as other staff, allows the examination team to become knowledgeable of the institution and begin their analysis prior to arriving on-site.

The FS/SE is expected to be mindful of an institution's space and personnel limitations when scheduling the number of examiners working on institution premises.

Contacting the Institution

After the EIC has reviewed the requested materials provided by the institution, the EIC contacts institution management again to discuss examination logistics, including the size of the examination team. The EIC also shares plans for work to be completed off-site and on-site. For example, the EIC could advise management that four examiners will review electronic loan files off-site for the first week and then come to the financial institution for loan discussions during week two of the examination.

The EIC should also discuss the plan for communicating during the examination with institution management and document that plan in the Examination Planning Memo. The plan should address the timing and frequency of on-site and off-site discussions and meetings, and the manner and protocol for requesting additional information in order to avoid duplicative requests.

Primary Point(s) of Contact

Typically, a regulatory liaison or compliance officer serves as the institutional point of contact for examinations. In some cases, reliance on a sole individual may not be sufficient to ensure timely exchange of documentation and requests. For these instances, the EIC may request that a limited number of individuals serve as institutional points of contact to ensure timely and efficient receipt of information. Similarly, the EIC may establish a primary and secondary examination FDIC point of contact to help facilitate communication and information requests between the examination team and institutional management. The EIC and institution points of contact should work together to establish the frequency and expectations of communication, including how meetings will be handled, how information requests should be submitted, and how findings will be conveyed.

Joint/Concurrent Examination Considerations

When examinations are conducted in a joint or concurrent capacity with the State authority, examiners are expected to coordinate and collaborate with the State EIC to ensure open and consistent communication throughout the examination planning process. The lead agency will guide the examination planning activities and process. The lead agency is determined through agreements between the State authority and FDIC managers. The FDIC EIC will work with the State EIC in accordance with their defined processes to ensure the planning and resource needs of each agency are being met, while being mindful that the non-lead agency may assist in the process, but may not provide the same level of resources as the lead agency.

<u>State-Led Joint/Concurrent Examinations</u>

For joint or concurrent examinations where the State is the lead agency, if the State has adopted Examination Planning as outlined in this chapter, then the FDIC and State should collaborate to accomplish the various tasks.

If the State in in the lead, but has not adopted Examination Planning (in whole or in part), the state agency will guide the examination planning activities and process. In such cases, the FDIC would still be responsible for collaborating with the State to ensure that certain Examination Planning activities are conducted, as follows:

[8] The Phase 3 principles discussed herein also apply to specialty area EICs/examiners, including need for sufficient examination planning time and availability of performing some work off-site.

Phase 1 (done in conjunction with, or soon after, the initial contact with the institution)

- Entering the start date into the FDIC's database;
- Ensuring a secure method is established for transmission of institution-requested materials;
- Scheduling appropriate personnel and providing sufficient dedicated time to perform examination planning activities;
- Obtaining the names and contact information (phone/email) of the institution's points of contact for AML/CFT, IT, and Trust (if applicable) in order to facilitate the completion of required complexity tools; and
- Ensuring the ITP is sent to the institution.

Specialty Exam complexity tools

- Ensuring that the complexity tools for AML/CFT, IT and Trust (if applicable) are completed, with the results considered within the risk scoping process.

Phase 2:

- Reviewing available information;
- Discussing the upcoming examination with the case manager and field supervisor/supervisory examiner;
- Developing descriptions of the institution's business model, risk profile, and complexity;
- Ensuring the request list is tailored to the institution; and
- Identifying activities available for on-site and off-site work.

Phase 3:

- Reviewing institution-provided materials;
- Conducting off-site examination work prior to the start date;
- Participating in discussions with institution management;
- Finalizing an examination planning memorandum; and
- Providing finalized business model, risk profile, and complexity descriptions to the case manager (either via the examination planning memorandum or other means).

Other Exam Planning tasks not included above should still be conducted if these activities align and can be coordinated with the State-led examination planning process.

APPENDIX A -EXAMINATION PROFILE SCRIPT (EPS)

FDIC

Federal Deposit Insurance Corporation
Division of Risk Management Supervision
Address

xxxxxxxxx Field Office
Phone xxx-xxx-xxxx

DATE

CEO xxxxxxxx
Institution Name
Street Address
City, State Zip

Dear CEO **xxxxxxxxxx**:

A Safety and Soundness Examination of your institution, including an Anti-Money Laundering/Countering the Financing of Terrorism review and Sanctions review, is scheduled for DATE **20xx**. A concurrent Information Technology (IT) Risk Examination [and Trust Examination] will also be conducted.

The attached Examination Profile Script (EPS) has been developed to help examiners tailor their examination procedures to your institution's operations. Comment boxes are available for items marked "yes" if you wish to provide additional information. Please be sure to label each comment box statement with the corresponding, descriptive item number. Examiners will tailor the request list to exclude materials specific to items marked "no." Also attached is an Areas of Responsibility form, which will help us contact the appropriate designated institution personnel during the examination.

For the IT examination, an Information Technology Profile (ITP), an IT Products and Services form, and an IT Areas of Responsibility are attached to help examiners with their planning activities.

Please complete the attached EPS, Area of Responsibility contact sheet, ITP, IT Products and Services form, and IT Area of Responsibility contact sheet and post the five Word files (**not pdf files**) to FDICconnect-EFX by **XX/XX/XXXX.**

Supporting documentation is not needed at this time but will be requested via a risk-focused information request list that will be sent to your institution approximately six to eight weeks before the on-site examination.

If you have any questions, please call me at the **xxxxxxxx** Field Office at **xxxxxxxxxx** or e-mail me at **xxxxxxxxx**.

Sincerely,
Name
Title
Federal Deposit Insurance Corporation

Enclosure

EPS SECTION 1

Please indicate 'yes' or 'no' if there have been material changes to the following items since the previous regulatory Safety and Soundness examination dated XX/XX/XXXX. Such material changes in any function related to safety and soundness, including, but not limited to, Anti-Money Laundering/Countering the Financing of Terrorism, Information Technology, and Trust (if applicable) should be addressed in the responses below. If 'yes' is selected, please provide an explanation in the Comments box along with the corresponding descriptive item number (e.g. #7 – New CFO hired since previous examination). The answers will help us tailor the list of items that we will request for the examination.

Organizational, Background, and Operating Environment	Yes	No
1. Organizational structure of the financial institution or holding company		
2. Strategic direction/plan or business model, including new or expanded products or services (e.g. loans, investments, deposits, funding)		
3. Ownership (shareholders owning 5% or more of controlling stock)		
4. Competitive factors impacting the financial institution		
5. Local economic factors (that impact or could impact financial institution performance)		
6. Local businesses or industries affecting a significant part of the financial institution's deposit or loan customer base		
7. Board composition or key role managers in any department (such as, but not limited to, those responsible for lending, treasury functions, Information Technology, Anti-Money Laundering/Countering the Financing of Terrorism, and Trust).		
8. Governance structure and authority levels		
9. Major policies or procedures		
10. Auditors or audit programs		
11. Management information systems		
12. Asset and/or liability structure		
13. Loan review programs		

Section 1 Comments:

EPS SECTION 2 – Safety & Soundness[9]

Please indicate 'yes' or 'no' if the financial institution has the following items or is involved in the following activities. If 'yes' is selected, please provide an explanation in the Comments box along with the corresponding descriptive item number. The answers will help us tailor our list of items that we will request for the examination.

Lending Areas	Yes	No
1. Loans with delinquent real estate taxes or loans with negative balance escrow accounts		
2. Interest only or payment option residential mortgage loans		
3. Construction loans with cost overruns or insufficient funds to complete construction		
4. Floor plan lending		
5. Loan participations purchased and sold		
6. Loans made to facilitate the sale of bank owned other real estate		
7. Loans made to facilitate the purchase of the financial institution's stock or the financial institution's holding company stock		
8. Credit concentrations warranting portfolio level or portfolio segment stress tests or sensitivity analysis		
9. Government-guaranteed lending activities and government-insured mortgage loans (e.g. USDA/FSA, HUD/FHA, SBA, VA)		
10. Lease financing loans serviced or collected by the financial institution for other parties		
11. Please indicate whether the institution has engaged in loan modifications, extensions, or deferrals related to borrowers impacted by the COVID-19 pandemic (Y/N)		
Employee Incentives & Compensation	Yes	No
12. New employment contracts and/or deferred compensation agreements		
13. Incentive compensation programs		
14. Financial institution sponsored employee benefit plan		
Asset/Liability Management Items	Yes	No
15. Deposits accepted by the financial institution or its affiliate through third party (such as "affinity" groups) marketing arrangements		
16. Large depositors (greater than 2% of total deposits)		
Supplemental Activities	Yes	No
17. Third Party Payment Processing		
18. Related Organizations		
Emerging Technology or Fintech Initiatives	Yes	No
19. Digital lending solutions marketed by third parties		
20. Digital lending solutions with automated credit decisions		
21. Deposit products delivered digitally and marketed by third parties		
22. Fully automated deposit account opening		
23. Artificial intelligence/machine learning		
24. Use of alternative data/big data		
25. Distributed ledger technology		
26. Smart contracts		
27. Crypto-asset-related activity		
28. Other emerging technology or fintech initiatives		

[9] Information Technology specific items will be covered in the separate Information Technology Profile script.

Section 2 Comments:

EPS SECTION 3 –Anti-Money Laundering/Countering the Financing of Terrorism

Please indicate 'yes' or 'no' if the financial institution has the following items or is involved in the following activities for Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT). If 'yes' is selected, please provide an explanation in the Comments box along with the corresponding descriptive item number. The answers will help us tailor our list of items that we will request for the examination.

Most items will not be applicable for the typical AML/CFT operations at community financial institutions. **All items checked "no" will be deleted from the tailored request list.**

Refer to FFIEC BSA/AML Glossary for definitions and explanations of AML/CFT terms.

Bank Secrecy Act/Anti-Money Laundering (AML/CFT) Complex Areas	Yes	No
1. Correspondent Accounts – Domestic (Institution acts as correspondent)		
2. Sale of Insurance Products		
3. Concentration Accounts (Accounts established to facilitate the processing and settlement of multiple or individual customer transactions)		
4. Professional Service Providers (Acting as liaisons for clients)		
5. Non-Government Organizations and Charities (Accounts of private nonprofit organizations, like a charity, that pursues activities intended to serve the public good)		
6. Electronic Banking		
7. Automated Clearing House		
8. Third Party Payment Processor		
9. Independent ATM Owner/Operator Customer		
10. Nondeposit Investment Products		
11. Nonresident Aliens and Foreign Individuals		
12. Business Entities as Customers (Including limited liability companies, corporations, trusts, and other entities that may be used for many purposes, such as tax and estate planning)		
13. Prepaid Access Products (including prepaid access cards or acting in concert with another party to provide prepaid access, such as for travel or public transportation programs)		

Section 3 Comments:

EPS SECTION 4 – Trust

Please indicate 'yes' or 'no' if the financial institution has the following items or is involved in the following activities for AML/CFT and Trust. If 'yes' is selected, please provide an explanation in the Comments box. The answers will help us tailor our list of items that we will request for the examination.

Refer to FDIC Trust Examination Manual Glossary for definitions and explanations of Trust terms.

Trust	Yes	No
1. Bank Sponsored Employee Benefit Plans		
2. Irrevocable Life Insurance Trusts (ILITs)		

Comments:

EPS SECTION 5 – Off-site Loan Review Options

For institutions that have imaged loan files, and are interested in having FDIC examiners review these files remotely, the FDIC has several potential options for such off-site review. Such options include Imaging Service Provider's Standardized Export of Image Data*, screen sharing/remote control capabilities, or an institution's own internal solution.

Please indicate 'yes' or 'no' to the following questions, or leave blank if not applicable. The Comments box may be used to indicate which option(s), if any, are preferred by institution management.

For more information on this option, please see Financial Institution Letter (FIL)-22-2018: Advisory: FDIC Conducting Testing of the Standardized Export of Imaged Loan Documents, and FIL-4-2019: Banker Webinar: Update on the Standardized Export of Imaged Loan Documents Initiative.

Off-site Loan Review	Yes	No
1. Are the institution's loan files imaged?		
2. If yes to #1, is management interested in having the FDIC conduct a portion of the loan review off-site?		

Comments:

EPS SECTION 6 – Examiner Connectivity to Internet

The FDIC relies significantly on Internet Connectivity to conduct examinations. The FDIC has several authorized potential options to support connectivity.

Please indicate 'yes' or 'no' regarding connectivity options, or leave blank if not applicable. The Comments box may be used for additional information.

Connectivity	Yes	No
1. Is strong cellular coverage available in the examination work room location(s)? (if yes, please indicate in the Comments section on what cellular provider(s) have strong coverage, if known)		
2. **If no to #1**, does the institution have a guest WiFi connection that the institution would like to make available to the examination team for examination-related activities?		
3. **If no to #1 and #2**, is the institution willing to allow the FDIC (at FDIC's expense) to have a temporary digital circuit (Internet line) installed for examination team use? (if yes, please indicate, in the Comments below, a contact person from your institution)		

Comments:

APPENDIX B -INSTRUCTIONS FOR COMPLETING THE EXAMINATION PLANNING MEMORANDUM

Examination Planning Memorandum (EP Memo). Insert institution-specific data and examination information. Estimated hours should include specialty areas.

Examination Ratings and Data. Document the ratings and data for the most recent examinations.

Examination Planning Ratios. List the specified ratios from the Uniform Bank Performance Report for the most recent quarter and the previous two year-ends.

Other Risk Measures. Briefly comment on each listed risk flag.[10] If elevated risk is identified in any of the below areas, these risks should be discussed in the Overview section. Additionally, comment on any other significant risk factors identified within internal FDIC outlier reports, tracking systems, and watch lists.

REST Score. Real Estate Stress Test (REST) is an estimate of the institution's potential vulnerability to a downturn in the real estate market. Comment on the risk level and driving factors for the score. Consider the REST score when scoping the asset review.

IRRSA Red Flags. Interest Rate Risk Standard Analysis (IRRSA) produces a report that focuses on an institution's interest rate risk exposure. IRRSA calculates financial analysis measures derived from Call Report data and historical market interest rate information. Comment on any red flags noted for institution ratios that are outside benchmarks set within IRRSA. Consider any IRRSA Red Flags when scoping the examination.

SCOR. The Statistical CAMELS Off-site Rating (SCOR) system is designed to identify institutions that have experienced noticeable financial deterioration. Comment on any rating that has a significant probability for downgrade.

Preliminary Risk Assessment

Overview of the institution's business model, risk profile, and complexity. To conduct a risk-focused examination, examiners must understand the nature, scope and risk of an institution's activities. The nature and scope of an institution's activities are collectively commonly referred to as the institution's "business model." Develop a written description of the business model by identifying the activities in which a financial institution has chosen to engage.

The risk associated with an institution's business model is commonly referred to as the "risk profile." Develop a written description of the financial institution's preliminary risk profile by determining the types and quantities of risks inherent in the financial institution's business model and, based on past examinations and supervisory activities, the quality of the risk management practices used by financial institution management to control these risks.

A key component of both an institution's business model and risk profile is the complexity of its operations. Develop a written description of the complexity of an institution's operations through a review of its balance sheet structure and scope of operations.

Within the overview, briefly summarize significant discussions with institution management during Examination Planning. This summary should cover key topics such as: significant risk areas, management's concerns regarding economic conditions, and any other information meaningful to the planning process. Include the name and title of the institution official and the date on which the discussion was held.

Also within the overview, briefly summarize discussions with the case manager (CM), field supervisor (FS)/supervisory examiner (SE), and the institution's external auditor. The CM discussion should cover the areas of perceived risk, enforcement actions, application activity, and loan review scoping. Note that during this initial examination contact, the EIC and CM should establish a plan for discussing examination findings prior to the exit meeting. The FS/SE discussion should cover hours, staffing, and scheduling items including anticipated training, on-site/off-site activities, and any specialists/subject matter experts needed

[10] REST scoresand IRRSA Red Flags are available in FDIC's confidential internal supervisory data systems.

for the examination. The external auditor contact should summarize information gained on the institution's operations and condition and any recommendations to management.[11]

If the examination involves a Minority Depository Institution, a comment should be included noting that examiners will inform institution management of the availability of technical assistance.

Examination Areas and Planned Procedures. Comment on each CAMELS component, specialty examination area, and any other areas based on the preliminary review of available information (such as the UBPR, risk profile, and request list items) and discussions with the CM, FS/SE, and institution management. Provide direction to examiner(s) reviewing the area on the procedures to be performed to address identified risks. Note if additional procedures are being performed for training purposes.

Under the Asset Quality subheading, comment on the plan for loan review. Document the date of the asset review, the number of loans and credit relationships to be reviewed, and the use of the Loan Portfolio Audit Tool. The comment should describe the specific types of loans and/or risk characteristics planned for review based on the institution's business model, risk profile, complexity, and lending activities. Loan review should emphasize meaningful loan sampling for new or higher risk lending activities, notable concentrations, a review of the appraisal program, and follow-up on any previously identified underwriting deficiencies.

The Other subheading should include the examination plan for any specialized business lines or characteristics, as applicable. Such areas may include the following:

- Concentrations
- Dominant Management
- Mortgage Banking, particularly if coupled with rapid growth
- Subprime/Nontraditional Lending
- Securitization Activities
- International Banking
- Related Organizations
- Credit Card Related Merchant Activities
- Third Party Arrangements
- Government Assistance Programs (for example: TARP, SBLF, or loss share agreements)
- Commercial Real Estate (if workprogram being used)
- De novo Institution (Planned procedures should evaluate the institution's adherence to continuing conditions or requirements imposed through the order approving deposit insurance)
- Foreign Ownership (e.g. Foreign Banking Organization, Parallel Banking Organization)

Consider prior specialty examination or review findings (and ratings, when applicable), and complexity assessment scores during the Examination Planning process. In addition, include relevant comments for each type of specialty examinations or review being conducted concurrently. Refer to specialty examination or review instructions for required procedures to be performed. Also identify any specialty subject matter expertise needed to address notable risk areas listed in the business model/risk profile review. Include estimated hours planned for each specialty area.

Briefly discuss any outstanding supervisory action (formal or informal), including type, date, and provisions within the action. Also note any Matters Requiring Board Attention (MRBA) issued by the FDIC or the state banking authority. Describe management's progress to date in addressing the action/MRBAs.

Staffing and Assignments. List examiners, their assigned roles, and location of examination work (on-site, off-site, or both). Briefly describe activities identified for off-site work. Note whether other agencies or divisions are involved. Also note the communications plan between institution and examination staff, including the timing and frequency of on-site and off-site discussions and meetings, and the manner and protocol for requesting additional information.

[11] If the institution's management has not provided a copy of a management letter issued by the auditor in connection with the most recent financial statement audit and/or internal control attestation, confirm with the auditor whether a letter was issued. Regardless of the type of auditing work performed, if no management letter was issued, discuss any other type of verbal or written recommendations that the auditor may have provided to management.

Training. List pre-commissioned examiners, trainers, and the training benchmarks being addressed during the examination.

Logistical Information. Communicate key information to examination staff regarding location, work hours, dress code, connectivity, key management absences, and other examination logistics.

EXAMINATION PLANNING MEMORANDUM

	Examination Information
Name of Financial Institution:	
Location (City, State)	
Certificate Number	
EIC/Prepared By:	
As of:	
Start:	
Estimated End:	
Estimated Hours:	

EXAMINATION RATINGS and DATA

	Prior Examination (Date)	Prior Examination (Date)	Prior Examination (Date)
CAMELS Rating			
IT Rating			
Trust (if applicable)			
Compliance (rating/date)			
CRA (rating/date)			
Adversely Classified Items Coverage Ratio			

EXAMINATION PLANNING RATIOS

	Current Quarter Ratios (Date)	Year-end Ratios (Date)	Prior Year-end Ratios (Date)
Total Assets			
Tier 1 Leverage Ratio			
Asset Growth Rate			
Net Interest Margin			
Return on Avg. Assets			
Total PD*/Gross Loans			
Allowance for Credit Losses on Loans and Leases/Total Loans and Leases			
Net Loans/Total Assets			
Net Non Core Dependency ($250M)			

*All past-due loans plus nonaccrual divided by gross loans

OTHER RISK MEASURES

Other Risk Flags	Comments
REST Score/Date: ___	
IRRSA Red Flags:___	

	C	A	M	E	L	S	Comp
SCOR:							
Probability of Downgrade (%):							

PRELIMINARY RISK ASSESSMENT
• *Provide a brief description of the institution's business model, risk profile, and complexity.* • *Summarize discussions held with institution management and case manager.* • *Briefly comment on risk for each examination area.* • *Discuss planned procedures and workpaper documentation, commensurate with the risk presented for each examination area.*

Overview of the institution's business model, risk profile, and complexity: ***Describe the institution's business model, including identification of the financial activities in which the institution has chosen to engage. Describe the risk profile through a determination of the types and quantities of risks to which the institution is exposed and the quality of the risk management practices used by institution management to control these risks. Describe the complexity of the institution's operations, including a review of its balance sheet structure and scope of the business lines, customer base, and product and service offerings.***

BUSINESS MODEL

RISK PROFILE

COMPLEXITY

Discussions: ***Include the date, names, and summary of discussions held with management. Also include the date, name, and summary of key risks discussed with the case manager, field supervisor(FS)/supervisory examiner(SE), and institution's external auditor.***

Examination Areas and Planned Procedures: ***Comment on CAMELS, specialty examinations, and other areas based on the preliminary review of available information (such as the UBPR, risk profile, request list items, etc.) and discussions with the case manager, FS, and institution management. Evaluate risk for each examination area. Provide direction on planned examination procedures, and describe procedures being conducted for training purposes, if applicable.***

CAPITAL

ASSET QUALITY (including loan scope)

MANAGEMENT

EARNINGS

LIQUIDITY

SENSITIVITY TO MARKET RISK

ANTI-MONEY LAUNDERING/COUNTERING THE FINANCING OF TERRORISM (Including complexity assessment)

INFORMATION TECHNOLOGY (Including complexity assessment)

TRUST (if applicable) (Including complexity assessment)

OTHER (if applicable, including any specialized business lines or characteristics)

SUPERVISORY ACTIONS OR MRBAs (including dates, requirements, and progress in addressing those items, whether issued by the FDIC or State banking authority)

STAFFING AND ASSIGNMENTS

Examiner	Assignment	Location (On-site/Off-site)
1	EIC	
2	OM	
3	AM	
4	IT	
5	AML/CFT	
6		
7		
8		
9		
10		

Other Staffing Notes:

Communications Plan:

TRAINING

Pre-Commissioned Examiners	Trainer	Benchmarks
1		
2		
3		
4		
5		
6		
7		
8		
9		
10		

LOGISTICAL INFORMATION

	Information
Institution Address & Parking Info	
Working Hours	
Dress Code	
Connectivity Plan	
Key Institution Management Absences	
Other	

EXAMINATION NUMBERS

Safety and Soundness	AML/CFT	Information Technology	Trust (if applicable)

EIC	
FS/Designee Approval	Date

APPENDIX C - EXAMINATION PLANNING MEMORANDUM SAMPLE

	Examination Information
Name of Financial Institution:	Bank of Anytown
Location (City, State)	Anytown, Anystate
Certificate Number	99999
EIC/Prepared By:	Sandra E. Smart
As of:	June 30, 20x6
Start:	August 1, 20x6
Estimated End:	September 9, 20x6
Estimated Hours:	610

EXAMINATION RATINGS and DATA

	Prior Examination 11/13/20x5 (state)	Prior Examination 10/21/20x4	Prior Examination 4/16/20x3 (state)
CAMELS Rating	243422/3	233322/3	232322/2
IT Rating	1/2112	2/2212	2/2212
Trust (if applicable)	2	2	2
Compliance (rating/date)	2 (1/1/2016)		
CRA (rating/date)	S (1/1/2016)		
Adversely Classified Items Coverage Ratio	102.71	94.92	80.13

EXAMINATION PLANNING RATIOS

	Current Quarter Ratios (6/30/20x6)	Year-end Ratios (12/31/20x5)	Prior Year-end Ratios (12/31/20x4)
Total Assets	80,604	78,207	77,879
Tier 1 Leverage Ratio	7.44	7.53	7.64
Asset Growth Rate	2.66	0.42	0.20
Net Interest Margin	3.82	3.62	3.54
Return on Avg. Assets	0.27	(0.15)	(0.30)
Total PD*/Gross Loans	6.74	8.42	9.06
Allowance for Credit Losses on Loans and Leases/Total Loans and Leases	3.67	3.20	2.75
Net Loans/Total Assets	64.45	68.79	69.24
Net Non Core Dependency ($250M)	14.71	8.69	6.66

*All past-due loans plus nonaccrual divided by gross loans

OTHER RISK MEASURES

Other Risk Flags	Comments
REST Score/Date: 2.8 - 6/30/20x6	The RE lending portfolio is 40.5 percent of total loans.
IRRSA Red Flags: 2	The Bank has red flags for earnings and capital.

	C	A	M	E	L	S	Comp
SCOR:	**1.95**	**2.26**	**2.14**	**3.10**	**2.10**	**1.82**	**2.63**
Probability of Downgrade (%):	9	4	11	2	3	5	9

PRELIMINARY RISK ASSESSMENT
• *Provide a brief description of the institution's business model, risk profile, and complexity.* • *Summarize discussions held with institution management and case manager.* • *Briefly comment on risk for each examination area.* • *Discuss planned procedures and workpaper documentation, commensurate with the risk presented for each examination area.*

Overview of the institution's business model, risk profile, and complexity: ***Describe the institution's business model, including identification of the financial activities in which the institution has chosen to engage. Describe the risk profile through a determination of the types and quantities of risks to which the institution is exposed and the quality of the risk management practices used by institution management to control these risks. Describe the complexity of the institution's operations, including a review of its balance sheet structure and scope of the business lines, customer base, and product and service offerings.***

BUSINESS MODEL
This $80 million community bank is a locally owned, full-service commercial Bank offering traditional deposit and credit products with a particular focus on customers directly and indirectly reliant upon maritime-related businesses. The trade area is centered in Anytown, Anystate, and is a regional economic area that is heavily dependent upon a depressed fishing industry.

RISK PROFILE
Credit risk is elevated at Bank of Anytown; weak underwriting and poor loan administration practices have led to a large volume of classified credits. Credit risk problems have been exacerbated by significant and increasing weaknesses in the local economy. Additionally, management has struggled with operational and governance issues, such as problems with filing accurate call reports and failure to monitor President Lincoln's lending authority limits. Primarily as a result of asset quality issues, revenues and earnings have been weak and have not been sufficient to build capital. Loan growth has subsided as management has worked on problem asset resolution, and compliance with the outstanding Memorandum of Understanding (MOU)[1] has been progressing, although several provisions have not been met.

COMPLEXITY
Assets consist primarily of commercial and real estate loans to small, local businesses. The bank has attempted to diversify away from the maritime-related businesses that dominate the local economy by buying commercial loan participations, primarily from Other Bank, Othertown, Other State. Bank of Anytown's level of other real estate (ORE) has been increasing, as the bank has been working its way through loan problems. The securities portfolio is invested in mortgage-backed securities issued by government sponsored entities (GSEs) with various maturities. Deposits are gathered from business loan customers and local retail depositors, and the bank has one branch on the west end of Anytown. The trust department manages approximately $3.3 million in assets, most of which is in non-discretionary accounts. Information technology services are provided by Existing Service Company, and President Allie Lincoln indicated that no changes in the agreement or services have occurred since the previous examination.

Discussions: ***Include the date, names, and summary of discussions held with management. Also include the date, name, and summary of key risk discussions with the case manager, field supervisor(FS)/supervisory examiner(SE), and institution's external auditor***.

Bank Management: A discussion with President Lincoln was held on July 5, 20x6 to discuss the FDIC's views regarding the Bank's business model, current risk profile and any changes to the complexity of the organization. President Lincoln also indicated the following:

- Significant progress had been made in addressing previous examination findings and the outstanding MOU.
- Bank management remains concerned about the level of classified assets, and its ability to manage problem assets has been challenged by the increased level of ORE, which requires different skill sets.

[1] The Bank was placed under an MOU on January 21, 20x6 based on findings from the October 21, 20x5 examination. This MOU replaced a January 20x4 MOU that was issued to address problems noted at the October 20x4 examination.

- Challenges continue in the local economy, and a moderately large employer, Blue Boat Building, Inc., recently filed for bankruptcy. While Blue Boat is not a Bank customer, many of its customers and suppliers are bank customers.
- A desire for examiners to keep Chairman of the Board (COB) Roger White informed of examination findings and include him in meeting invites during the examination.

Case Manager: A discussion with Case Manager Melinda Gary was held on June 24, 20x6. She indicated the following:

- President Lincoln and COB White continued to dominate the management team of the Bank and she was concerned that the Board may not be effectively challenging the decisions made by those two individuals.
- President Lincoln had been very communicative since the prior examination and had been keeping the regional office updated on progress in complying with the MOU.
- Progress reports provided to the regional office are in RADD and should be reviewed off-site to identify the steps that management has taken to address outstanding issues.
- EIC Smart provides her updates on a weekly basis, given the risk profile of the institution. She also asked that she be provided ample notice about any exit meetings, as she would like to attend them telephonically.

External Auditor: On July 14, 20x6, EIC Smart held a phone conversation with CPA Michael Jones of Michael P. Jones and Associates, LLP. Mr. Jones indicated that although the Bank has had problems in the past with financial reporting, he believed that all of those issues had been corrected.

Field Supervisor: On June 20, 20x6, EIC Smart discussed the risk profile, examination plan, and staffing needs with FS Paul Roberts, Jr. FS Roberts and EIC Smart agreed that an allocation of 610 hours, inclusive of specialty areas, should be sufficient to examine the Bank given the risk profile. FS Roberts noted that pre-commissioned examiner George Woods had recently completed loan school and would need additional loan review and ACL training. He also stated that the loan review scope should target new credits, as well as problem credits, given the history of poor credit underwriting and administration. He indicated that an examiner from another office would be requested to perform the trust examination due to limited trust experience in the office. FS Roberts confirmed that the State would not be joining the examination, but will participate in either the exit meeting or Board meeting at the conclusion of the examination.

Examination Areas and Planned Procedures: ***Comment on CAMELS, specialty, and other areas based on the preliminary review of the UBPR, risk profile, request items, etc., and discussions with case manager, FS, and institution management. Evaluate risk for each examination area. Provide direction on planned documentation procedures, and describe procedures being conducted for training purposes, if applicable.***

ASSET QUALITY (INCLUDING LOAN SCOPE)

Asset review date: June 30, 20x6
Relationships reviewed / number of loans: 57 / 100
Number of loans included in review scope due to Loan Portfolio Audit Tool (LPAT) query: 9

Asset Quality will be the primary review area, due to negative portfolio performance metrics noted in the UBPR and adverse findings at the previous two examinations. During the previous FDIC examination, the loan scope was expanded during the examination due to significant administration and control problems that became evident during the loan review. At the current examination, the focus will be on newer originations, outstanding credits that could be impacted by the bankruptcy of Blue Boat Company, Inc., a sampling of larger loans and participations, and a review of all loans to insiders. Additionally, due to previous examination concerns with the credit rating system, internally classified loans of various sizes and grades will be sampled. LPAT queries were run, and a selection of potential irregular and outlier credits are included in the review scope. Further, a sampling of loans originated by President Lincoln will be reviewed due to previous issues related to her lending authority. Additionally, the proceeds will be traced for those loans in President Lincoln's portfolio that recently paid off. Larger ORE properties and newly acquired parcels will be sampled. The Bank does not have loan file imaging, so all loan and ORE files will be reviewed on-site.

President Lincoln indicated that the loan policy has been updated, so a thorough review of each change will be completed. Although President Lincoln indicated a level of comfort with the level of the ACL (3.67% of TL), the ACL methodology and calculation will be subjected to in-depth review, due to problems consistently being noted in this area. The concentration in loans to borrowers in the shell fishing industry will be reviewed to assess risk management, monitoring, and control processes.

Since the securities portfolio is entirely comprised of investments in GSE securities, investment policies have not changed, and adequate monitoring is evident in reports reviewed, no additional examination work will be performed in this area.

MANAGEMENT

The history of poor administration, controls, and governance at this institution warrants significant review of policies, procedures, and overall risk management practices for each of the CAMELS component areas, as well as transaction testing of internal controls. In particular, examiners will test the accuracy of several Call Report schedules. Since President Lincoln and Chairman White tend to dominate the affairs of the bank, all Board minutes since the previous examination will be reviewed off-site to determine the involvement and level of Board oversight. Examiners will review the strategic plan and all internal audits completed since the previous examination off-site. Additionally, an assessment of efforts to address the provisions of the MOU will be a priority of the examination.

EARNINGS

Poor asset quality has caused earnings performance to be less than satisfactory, though there are some improving trends. The ROAA has returned to a positive, albeit low level, and the NIM is also trending upward. Overhead expense has increased due to ORE holding costs and new loan workout staff hired to address problem credits. President Lincoln does not expect overhead expense to decline in the near term due to continued asset quality challenges, and the bank is considering closure of the west-end branch to reduce overhead. The budget and profit plan will be reviewed off-site. Additionally, given past call report errors regarding income and expense items, Call Report Schedule RI will be reconciled off-site. On-site follow-up of specific accounts will be performed if necessary.

CAPITAL

Capital levels have been declining, although they currently comply with the provisions of the MOU; the decline has been the result of the slight increase in assets and losses in 20x5. President Lincoln indicated that since issuance of the MOU, the Bank has focused on reducing loan levels and was taking a more conservative approach to growth. A thorough assessment of capital will be conducted to determine whether capital is sufficient to support the level of asset quality issues at the Bank. Policies regarding capital maintenance and strategies for capital augmentation will be reviewed along with the Board's monitoring of capital. Examination procedures related to capital will primarily be conducted off-site.

LIQUIDITY

On-balance sheet levels of liquidity total approximately 15 percent of total assets. A review of how management calculates and reports on-balance sheet liquidity will be completed along with a review of sources and uses of funds. While the bulk of the funding comes from local commercial and retail depositors, the bank also relies on borrowings from the Federal Home Loan Bank of Anyregion and draws on a commitment from Other Bank, Otherstate. Usage of these borrowings will be reviewed, along with policies, procedures, and risk management around liquidity and funds management, including contingency funding plans. Most of the review of this area can be conducted off-site.

SENSITIVITY TO MARKET RISK

The bank's balance sheet is fairly well matched. Examination procedures will focus on a review of the minutes of the Asset Liability Management Committee minutes, a review of the economic value of equity model used by the bank, as well as the reasonableness of the assumptions used in the model. This review will be conducted off-site.

ANTI-MONEY LAUNDERING/COUNTERING THE FINANCING OF TERRORISM (INCLUDING COMPLEXITY LEVEL)

The BCAT completed on June 15, 20x6 indicated a score of 60 or Low Complexity. As such, the lack of complexity in bank operations, coupled with satisfactory AML/CFT program performance noted at the prior examination and lack of new initiatives or products, indicate a lower risk profile for money laundering, terrorist financing, and other illicit financial activities. Examiners will work off-site and focus on determining the adequacy of the five components or pillars of the program. Examiners will utilize the FFIEC BSA/AML Examination Manual and the related electronic workprograms to document the review. The AML/CFT review will be allotted 40 hours.

INFORMATION TECHNOLOGY (INCLUDING COMPLEXITY LEVEL)

The IT Profile completed on June 3, 20x6, resulted in a Technology Profile Score of 60, indicating a "Level C – Low Complexity". The Bank is serviced and primarily relies on third parties for its IT infrastructure and oversight. As discussed with FS Roberts, the IT examination will be allotted 60 hours and commence on-site on the same date as the Safety and Soundness examination. The IT examiner is expected to be at the Bank for the first week and then finish off-site.

In the prior examinations, the overall IT program was rated satisfactory. The review will review actions to address prior recommendations and assess the overall IT posture, based on the Information Technology Risk Examination (InTREx) program. Conformance with Appendix B of Part 364, Interagency Guidelines Establishing Information Security Standards, will also be evaluated, as well as cybersecurity preparedness. Findings of the IT examination will be embedded in the Safety and Soundness ROE.

TRUST (IF APPLICABLE) (INCLUDING COMPLEXITY LEVEL)
The Bank has a small trust department and scored a 40 on the Trust Profile Scoring Matrix. Trust Department assets total $3.3 million, held in 8 personal trust accounts, 44 burial trust accounts, and 1 farm management agency account. The review will include a review of policies, practices, and procedures, trust-related comments in Board minutes, and the last external audit to be performed off-site, and selected accounts, compliance with applicable laws, follow-up on matters criticized at previous examinations, and management discussions to be conducted on-site. The Trust examination will be allotted 50 hours.

OTHER (IF APPLICABLE, INCLUDING ANY SPECIALIZED BUSINESS LINES OR CHARACTERISTICS)
Not applicable.

SUPERVISORY ACTIONS OR MRBAs (including dates, requirements, and progress in addressing those items whether issued by the FDIC or State banking supervisor)

January 21, 20X5 MOU – The institution has 6 ongoing provisions in its MOU:

1. The Bank shall maintain an Allowance for Credit Losses at an appropriate level.
2. The Bank shall maintain a Leverage Capital ratio equal to or greater than 7 percent.
3. The Bank shall maintain a Total Capital ratio equal to or greater than 10 percent.
4. The Bank shall file accurate Call Reports
5. The Bank shall not extend or renew, directly or indirectly, credit to, or for the benefit of, any borrower who has a loan or other extension of credit with the Bank that has been charged off or classified, in whole or in part, Loss, Doubtful, or Substandard, unless rationale for the extension is noted in the official Board minutes and the appropriate credit file.
6. The Bank shall not declare or pay any dividends without the written consent of the FDIC.

A review of each of the provisions will be completed within each of the respective component reviews.

STAFFING AND ASSIGNMENTS

Examiner	Assignment	Location (On-site/Off-site)
1. Sandra Smart	**EIC, Capital, Management**	Will be on-site for two weeks beginning on August 1. One week off-site prior and after.
2. Melissa Johnson	**OM, (all operations items not assigned to others)**	Review policies off-site. On-site beginning on August 3.
3. Bill Wilson	**AM, Loan Policy, Concentrations**	Will be on-site for two weeks beginning on August 1.
4. Bob Franks	**IT**	On-site the week of August 1st and off-site 2nd week.
5. Todd Marks	**AML/CFT**	On-site for kick-off meeting on August 1, then off-site. Will return for transaction testing and exit meeting second week.
6. George Woods	**Loan Review/ACL**	On-site beginning August 1 until loan review is finished, will review ACL off-site.
7. Pauline Justice	**Loan Review/ACL**	On-site beginning August 1 until loan review is finished, will review ACL off-site.
8. Mark Jacobs	**Trust Review**	Week of August 1 off-site. On-site August 8 and 9.

Other Staffing Notes: All Request List items have been provided electronically and placed in appropriate electronic workpaper files.

Communications Plan: Examiners should check previously submitted information from the bank prior to making additional information requests. Requests for additional documents should be coordinated through EVP Guiterrez (S&S) or the appropriate specialty area bank officer. Loan reviewers may request loan-specific documents from the appropriate loan officer. Information requests from off-site examiners should be in writing via secure email to the appropriate bank individual. Bank staff will provide requested materials via EFX.

Meetings will be held on-site or via MS Teams. President Lincoln stated that the CFO and CLO should be involved in all major meetings involving operations and loans, respectively. A status update meeting will be held each Friday at 11 a.m. with President Lincoln. The president wants to be involved in all exit meetings, including specialty examinations.

TRAINING

Pre-Commissioned Examiners	Trainer	Benchmarks
George Woods	**Pauline Justice**	Review ACL and complete loan review

LOGISTICAL INFORMATION

	Information
Institution Address & Parking Info	557 Madison Parkway, Anytown, Anystate There are ample parking spaces around the Bank's building and some parking in front of the Bank. Closest spots should be left for customers.
Working Hours	7:30 A.M. to 5:30 P.M.
Dress Code	Business Casual Attire
Connectivity Plan	FS Roberts ordered a high-speed digital circuit for examiner use.
Key Institution Management Absences	President Lincoln will be out of the office on Thursday, August 4.
Other	

EXAMINATION NUMBERS

Safety and Soundness	AML/CFT	Information Technology	Trust (if applicable)
999995	999996	999997	999998

EIC Sandra Smart	
FS/Designee Approval: Paul Roberts, Jr.	**Date** July 31, 20x6

Supervisory Planning – Continuous Examinations

Section 21.2

SUPERVISORY PLANNING OVERVIEW

The purpose of supervisory planning is to develop an efficient, risk-focused examination strategy that is tailored to the institution's business model, risk profile, and complexity. The examination principles discussed in this Manual apply to all institutions, but since institutions subject to continuous examinations are often larger and/or more complex, some planning activities differ from those outlined in this Manual's Section 21.1 Examination Planning – Point-in-Time Examinations.

Risk-focused supervision involves employing a tailored approach to each examination. The risk-focused supervision approach to examinations is not comprised of a fixed set of routine procedures. Rather, the procedures that constitute a full-scope examination depend on the nature and complexity of the institution's business activities and risk profile. At a minimum, full-scope examinations must include sufficient procedures to reach an informed judgment on the financial, managerial, operational, and compliance factors rated under the CAMELS[1] rating system[2]. An examination meeting those requirements would meet the FDIC's definition of a full-scope examination.

The purpose of the examination planning process for all institutions is to ensure that the institution's operations and activities are understood prior to the start of an examination, so that examination procedures can be appropriately tailored to the institution. By understanding the unique nature of each institution, examiners can evaluate fundamental risks of the institution's activities and the strength of management's practices for mitigating those risks, and focus examination activities and procedures on risks that are not as well-mitigated or that have not been previously assessed because they are new or have been expanded or changed.

The supervisory planning process is designed to provide sufficient flexibility to scale the planning and examination program to each institution's size, complexity, and risk profile. Due to the size and/or complexity of institutions subject to continuous examinations, the planning process for these institutions involves a more structured risk assessment of key business and operational segments. The risk assessment process is segmented by "Risk Area" to identify key lines of business (LOB), support functions, and risk management functions that meaningfully impact the institution's risk profile, and are used to determine examination activities. Continuous examination activities include a mix of targeted reviews (TR), which provide an in-depth assessment of the risk profile of selected Risk Areas, and ongoing monitoring (OGM), which includes a range of activity used to maintain a holistic view of the institution and its risk profile. Both types of activities are conducted throughout the course of the year with results consolidated into the Report of Examination (ROE) at the end of the examination cycle, rather than conducted over a short period of time as during a point-in-time examination.

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TARGETED REVIEWS

A TR is examination work that is risk-focused and tailored to provide a sufficient assessment of the risk profile of a Risk Area. TR findings are used in conjunction with OGM and other supervisory activities to assign CAMELS and specialty ratings at the conclusion of the examination cycle, and when appropriate, on an interim basis. Examination activities from TRs will generally include an evaluation of selected first-line risk management practices, an evaluation of second-and third-line oversight, and an evaluation of the Risk Area's impact on the institution's financial condition. Examination procedures for TRs generally include examination scoping, transaction testing, and interaction with institution management.

TRs of first-line Risk Areas are essential for assessing risk exposures; however, an equal, if not more important goal is to assess risk management functions (i.e., second-line of defense) and internal audit (i.e., third-line of defense). The effectiveness of an institution's control structure through its second-and third-lines of defense is fundamental to its risk management and a priority for FDIC to monitor and assess; therefore, when developing the Supervisory Plan (Plan), examiners should consider how to design the strategy to assess the risk management practices, products, lines of business (LOBs), and systems as well as the effectiveness of the entirety of the risk management program. An institution may have strong lines of defense over certain business activities, but have risk management weaknesses in other LOBs. Therefore, designing a Plan that provides for examiners to assess the adequacy of oversight throughout the examination cycle and periodically aggregating findings can aid in identifying thematic weaknesses and is key to performing a holistic review of the risk management frameworks for the second-and third-lines of defense.

[1] Under the Uniform Financial Institution Rating System (UFIRS), the component ratings for capital adequacy, asset quality, management capabilities, earnings sufficiency, liquidity position, and sensitivity to market risk are commonly referred to as CAMELS ratings.

[2] This could include, as appropriate, risk management for Information Technology, Bank Secrecy Act (BSA)/Anti-Money Laundering (AML)/Office of Foreign Assets Control (OFAC) reviews, Trust, Registered Transfer Agent, Municipal Securities Dealer, and Government Securities Dealer examination programs. These specialty examination areas are incorporated into CAMELS through the Management component rating, as outlined in the Uniform Financial Institutions Rating System. *See 62 Fed. Reg. 752, January 6, 1997.*

If the design and effectiveness of the institution's risk management frameworks satisfactorily identify, measure, monitor, control, and report risks, the Plan may allow for examiners to leverage internal reporting in assessing risk. In developing a Plan, examiners should expand their understanding of an institution's risk profile and form examination strategies using the institution's Enterprise Risk Management (ERM), internal audit, internal loan review, and other second-and third-line risk management programs, as long as those functions perform adequate independent risk assessments based on independent testing. Strengths and weaknesses identified by the second-and third-lines and examiner identified gaps in second-and third-line coverage are important considerations in planning efficient, risk-focused examinations.

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ONGOING MONITORING

OGM is performed throughout the examination cycle or planned for a specific purpose (OGM-Scheduled) and works in conjunction with TRs to maintain a holistic view of the institution and its risk profile. Results of OGM activities are to be reflected in the Core Analysis Decision Factors within ED Modules, in the assignment and support for supervisory ratings, and in the analysis needed to complete the ROE at the conclusion of the examination cycle.

The primary objectives of OGM include the following:

- Monitor and assess the institution's financial condition, risk profile, and strategic direction through regular real-time review of board and committee meeting agendas, information packets and minutes; line of business reporting; enterprise risk management assessments; internal and external audit reports and responses; SEC and other regulatory financial reports; press releases, industry analysts reports, etc.;
- Proactively identify emerging risks and trends through horizontal review and comprehension of target review findings and the monitoring activities listed immediately above;
- Identify, inform, and support adjustments to the supervision strategy, including upcoming TRs;
- Monitor and assess efforts to remediate Supervisory Recommendations, including Matters Requiring Board Attention and identify potential common root causes; and
- Facilitate completion of the ROE, assignment of CAMELS ratings, completion of the Plan, and contribution to any Horizontal Reviews.

OGM is necessary to properly oversee institutions subject to a continuous examination due to their relative size and complexity. The range of appropriate OGM activities developed to efficiently and effectively supervise the institution will vary based on each institution's business model, risk profile, and complexity. OGM may consist of both a recurring set of baseline activities conducted throughout the examination cycle (i.e., ad hoc/monthly/quarterly) as well as a range of examination activities (i.e., transaction testing) during a specific time frame for a specific purpose. The latter is referred to as OGM-Scheduled.

Scoping, transaction testing, and communication activities for any type of OGM are comparatively lesser in extent, comprehensiveness, and formality than for TRs. OGM activities provide a planning mechanism that offers flexibility to conduct examination procedures and analysis sufficient to assign and support ratings without conducting a TR, when appropriate, and in some instances, can provide a way for staff to adjust the, examination strategy throughout the cycle. The Plan provides the basis for supporting the examiner's rationale to conduct examination procedures through either a TR or OGM.

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USE OF TARGETED REVIEWS VS ONGOING MONITORING

Whether a review is characterized as a TR or OGM should not be driven by the physical location of the work (onsite versus offsite, for example) or the timing and number of individuals participating. The primary distinction between a TR and OGM is the depth and breadth of the review activities and the difference in objectives. The purpose and nature of examination activity should be the determining factors that distinguish a TR from OGM activities. Conclusions from the Risk Assessment section of the Plan determine the mix of TR and OGM activities, which should then be scheduled based upon existing authorized staffing levels, recommendations for new dedicated or designated staff, and support from FT, RO, or WO resources. Factors to consider when distinguishing between a TR and OGM include, but are not limited to, the following:

- Objective of the examination activity (assessment of the risk profile of a Risk Area (TR) or maintaining a holistic view of the institution (OGM), for example),
- Breadth of assessments made (multiple risk management practices versus one practice, for example),
- Level of planning and scoping necessary,
- Scope of request lists,
- Level of transaction testing performed, and
- Degree of interaction with management.

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SUPERVISORY PLAN DOCUMENTATION

Plans for continuous examinations are documented in two components: the Plan narrative and the Supervisory Planning Tool (SP Tool). The narrative portion of the Plan documents the annual risk assessment and outlines the examination strategy. The SP Tool is an internal software application that documents the estimated hours and resources needed to execute the strategy. The components of the Plan are designed to achieve the following objectives:

- Provide a consistent and transparent process for developing an examination strategy and documenting the resources needed to execute that strategy;
- Use the hours projections and support contained in the Plan as the basis for staffing allocations for dedicated, designated, and Field Territory (FT) examiners; and
- Project staffing requests for FT, Regional Offices (RO), and Washington Office (WO) to aid in scheduling decisions for the calendar year.

This supervisory planning process applies to continuous examinations regardless of the staffing approach used for a particular examination. Typically, dedicated examiners are assigned to a continuous examination by RO management and are expected to work almost exclusively on that examination. Dedicated examiners provide continuity to manage the continuous examination, complete ongoing monitoring, and serve as a consistent point of contact for institution management. While dedicated and/or designated examiners are the primary point(s) of contact for most institutions subject to continuous examinations, FT, RO, and WO staff also participate in continuous examinations. Participation by FT examiners can be on a short-term basis (e.g., assigned to one or more TRs) or on a longer-term basis (e.g., assigned as a designated Examiner-in-Charge (EIC)). RO and WO Specialists provide subject matter expertise for complex issues and may provide both on and offsite support to the dedicated or designated examiners.

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SUPERVISORY PLANNING TIMELINE

Supervisory Planning Timeline (Dates Approximate)

May 15	Projected Staffing Changes due to WO
By May 31	Supervisory Planning Kickoff
August 1	Draft Supervisory Plans due to WO
August 15	First WO feedback due to RO
August 31	Final WO feedback due to RO
September 15	Final Supervisory Plans due to WO

Due to the relative complexity, annual time period covered, and the larger resource needs for continuous examinations compared to point-in-time examinations, the planning process is more extensive, with planning beginning approximately 8 months in advance of the examination cycle and lasting four months from start to finish. This timeline aligns with the FDIC's annual staffing evaluation, as projections from Plans support continuous examination resource needs for the following calendar year.

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CONTINUOUS SUPERVISORY PLANNING

Supervisory planning for a continuous examination is not a static, once-a-year exercise. The Plan outlines the expected examination strategy; however, one of the primary benefits of a continuous examination is the ability to use information obtained during OGM and TRs to adjust the supervisory strategy, when needed. Examiners should use OGM to shape future supervisory activities including the expansion, reduction, or postponement of planned TRs. While flexibility exists to adjust to evolving circumstances, material changes made after the Plan's approval must be discussed with FT and RO management, other agencies, and any other applicable stakeholders. Written concurrence from the RO Assistant Regional Director is required prior to implementation of material changes to the examination scope. In addition, actual targeted review activities compared to planned activities are to be reviewed throughout the examination cycle with deviations noted and explained in the SP Tool.

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COMMUNICATION

Effective communication is key to developing and executing a strong supervisory planning program. The dedicated or designated EIC[3] is responsible for drafting the

[3] If a Dedicated or Designated Examiner in Charge is not in place, Regional Office management should designate a preparer.

Plan and submitting it to the Case Manager for review; in addition, other personnel are involved in developing the supervisory strategy and coordinating resource needs. From the beginning of the Plan's development, preparers must work collaboratively with dedicated team members, specialty examiners, State Agencies, FT management, RO management, Division of Depositor and Consumer Protection (DCP) staff, Consumer Financial Protection Bureau (CFPB) points of contact (if applicable)[4], and Federal Reserve Bank (FRB) staff (if applicable), among others. Preparers should discuss the following topics with relevant stakeholders to come to a consensus on goals, objectives, and their respective roles:

- Current and emerging risks;
- Strategic and growth plans;
- Institution-prepared risk assessments;
- Scope and findings from prior reviews;
- Examination priorities;
- Potential opportunities to collaborate;
- Staffing needs and availability; and
- Other matters as appropriate.

FDIC staff should be aware of other regulators' examination planning timelines and strategies to ensure communication is sufficient to address changes to the supervisory strategy (such as changing the timing or scope of a TR) throughout the examination cycle. Coordination with Federal and State regulators is expected in order to achieve effective and efficient supervision, as well as to lessen burden on the institution to the extent possible. If the institution is owned by a bank holding company (BHC), the FRB should be given the opportunity to participate in examination activities in those areas that are part of the FRB's supervisory process for BHCs. Likewise, the FDIC should actively participate in the FRB's supervisory activities of the parent, if they significantly impact the state nonmember institution. Similar coordination should occur with regulators of industrial bank parent companies.

For Anti-Money Laundering/Countering the Financing of Terrorism[5] (AML/CFT), OFAC Compliance, and specialty reviews (i.e., Information Technology (IT), Trust, Municipal Securities Dealer (MSD), Government Securities Dealer (GSD), and Registered Transfer Agent (RTA)), the EIC or Case Manager should coordinate with their respective FT and RO management to identify designated specialty leads, subject matter experts (SME) and/or Specialists to draft or assist with Plan development and specialty examination strategies. This coordination should occur well in advance of the Plan's due date to ensure availability of needed experts for Plan preparation. In addition, EICs should consult with these specialists to evaluate opportunities for collaboration on selected reviews such as corporate governance, vendor management, or internal audit.

EICs and FT management should coordinate schedules of continuous examination activities and other FT responsibilities to plan for appropriate resource availability. Furthermore, RO management should design a process to coordinate Regional resources among their continuous examinations, as needed.

Collaboration between the Division of Risk Management Supervision (RMS) and DCP staff should be a routine part of a continuous examination, including supervisory planning meetings or consideration of activities that may be conducted jointly. DCP's input and involvement will vary depending on the institution's consumer risk profile. Draft Plans should be shared with the appropriate DCP point of contact for comment no later than the date they are submitted to LBS for review (August 1). Once Plans have been approved, preparers should share a summary of planned supervisory activities with institution management.

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[4] A Memorandum of Understanding dated May 16, 2012, establishes requirements for coordination between the CFPB and the Prudential Regulators, which includes the FDIC.

[5] The *Anti-Money Laundering Act of 2020* (the AML Act), amended subchapter II of chapter 53 of title 31 United States Code (the legislative framework commonly referred to as the "Bank Secrecy Act" or "BSA"). The AML Act requires the Financial Crimes Enforcement Network (FinCEN), in consultation with Federal functional regulators, to promulgate AML/CFT regulations. Due to the addition of the CFT, and for consistency with FinCEN, the FDIC will use the term AML/CFT (which includes BSA/AML) instead of BSA/AML when referring to, issuing, or amending regulations to address the requirements of the AML Act.