3071.0.1 INTERAGENCY ADVISORY ON ACCOUNTING AND REPORTING FOR COMMITMENTS TO ORIGINATE AND SELL MORTGAGE LOANS

On May 3, 2005, the Federal Reserve and the other federal financial institution regulatory agencies[1] (the agencies) issued an Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans.[2] (See SR-05-10.)

The advisory provides guidance on the appropriate accounting and reporting for commitments to—

- originate mortgage loans that will be *held for resale,* and
- sell mortgage loans under mandatory-delivery and best-efforts contracts.

Commitments to originate mortgage loans that will be held for resale are derivatives and must be accounted for at fair value on the balance sheet by the issuer. All loan-sales agreements, including both mandatory-delivery and best-efforts contracts, must be evaluated to determine whether the agreements meet the definition of a derivative under Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by Statement of Financial Accounting Standards No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" (collectively, FAS 133). A financial institution should also account for loan-sales agreements that meet the definition of a derivative at fair value on the balance sheet.

The advisory discusses the characteristics that should be considered in determining whether mandatory-delivery and best-efforts contracts are derivatives and the accounting and regulatory reporting treatment for both commitments to originate mortgage loans that will be held for resale and those loan-sales agreements that meet the definition of a derivative. The advisory also addresses the guidance that should be considered in determining the fair value of derivatives.

The advisory provides additional guidance on the application of FAS 133. Financial institutions, including those that are *not* required to file reports with the Securities and Exchange Commission (SEC), are expected to follow the guidance in SEC Staff Accounting Bulletin No. 105, "Application of Accounting Principles to Loan Commitments" (SAB 105).[3]

A financial institution is expected to account for and report derivative loan commitments and forward loan-sales commitments as derivatives in accordance with generally accepted accounting principles (GAAP), which include the use of valuation techniques that are reasonable and supportable in the determination of fair value. An institution's failure to account for and report derivative loan commitments and forward loan-sales commitments in regulatory reports in accordance with GAAP may be an unsafe and unsound practice.

3071.0.1.1 Accounting and Reporting

3071.0.1.1.1 Accounting Policies

Well-managed financial institutions have written and consistently applied accounting policies for commitments to originate mortgage loans that will be held for resale and to sell mortgage loans under mandatory-delivery and best-efforts contracts, including approved valuation methodologies and procedures to formally approve changes to those methodologies. The methodologies should be reasonable, objectively supported, and fully documented. Procedural discipline and consistency are key concepts in any valuation-measurement technique. Institutions should ensure that internal controls, including effective independent review or audit, are in place to provide integrity to the valuation process. Institutions' practices should, therefore, reflect these concepts to ensure the reliability of their valuations of derivative loan commitments and forward loan-sales commitments.

3071.0.1.1.2 Derivative Loan Commitments

A financial institution should account for deriva-

1. The agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.
2. The guidance in the interagency advisory is also intended to apply to financial-statement reporting by bank holding companies.
3. Staff accounting bulletins (SABs) summarize the views of the SEC's staff regarding the application of generally accepted accounting principles.

tive loan commitments at fair value on the balance sheet, regardless of the manner in which the intended sale of the mortgage loans will be executed (e.g., under a best-efforts contract, a mandatory-delivery contract, or the institution's own securitization). An institution should report each fixed, adjustable, and floating derivative loan commitment as an "other asset" or an "other liability" in their regulatory reports based upon whether the individual commitment has a positive (asset) or negative (liability) fair value.[4]

With respect to floating derivative loan commitments, because the interest rate on such a commitment "floats" on a daily basis with market interest rates, the fair value of a floating derivative loan commitment approximates zero as long as the creditworthiness of the borrower has not changed. However, as with other derivative loan commitments, an institution must report the entire gross notional amount of floating derivative loan commitments in its regulatory reports.

Commitments to originate mortgage loans that will be held for investment purposes and commitments to originate other types of loans are not within the scope of FAS 133 and, therefore, are not accounted for as derivatives.[5] An institution should report the unused portion of these types of commitments, which are *not* considered derivatives, as "unused commitments" in its regulatory reports.

3071.0.1.1.3 Forward Loan-Sales Commitments

A financial institution should account for forward loan-sales commitments for mortgage loans as derivatives at fair value on the balance sheet. Each forward loan-sales commitment should be reported as an "other asset" or an "other liability" based upon whether the individual commitment has a positive (asset) or negative (liability) fair value.[6]

3071.0.1.1.4 Netting of Contracts

For balance-sheet-presentation purposes, FAS 133 does not provide specific guidance on financial-statement presentation.[7] A financial institution may not offset derivatives with negative fair values (liabilities) against those with positive fair values (assets), unless the criteria for "netting" under GAAP have been satisfied.[8] In addition, an institution may not offset the fair value of forward loan-sales commitments against the fair value of derivative loan commitments (the pipeline) or mortgage loans held for sale (warehouse loans). Rather, forward loan-sales commitments must be accounted for separately at fair value, and warehouse loans must be accounted for at the lower of cost or fair value (commonly referred to as "LOCOM")[9] with certain adjustments to the cost basis of the loans if hedge accounting is applied.

3071.0.1.1.5 Hedge Accounting

A financial institution should follow the guidance in FAS 133 when applying hedge accounting to its mortgage banking activities. If the FAS 133 qualifying criteria are met, an institution may apply—

- fair-value hedge accounting in a hedging relationship between forward loan-sales commitments (the hedging instrument) and fixed-rate warehouse loans (the hedged item), or
- cash-flow hedge accounting in a hedging relationship between forward loan-sales com-

4. When preparing Reports of Condition and Income (Call Reports) and the Consolidated Financial Statements for Bank Holding Companies (BHC reports), fixed, adjustable, and floating derivative loan commitments should not be reported as unused commitments in Schedule RC-L, Derivatives and Off-Balance Sheet Items (Schedule HC-1 for bank holding companies), because such commitments are to be reported as derivatives in this schedule.

5. See FAS 133, paragraph 10(i).

6. Regardless of whether the underlying mortgage loans will be held for investment or for resale, commitments to purchase mortgage loans from third parties under either mandatory-delivery contracts or best-efforts contracts are derivatives if, upon evaluation, the contracts meet the definition of a derivative under FAS 133. An institution should report its loan-purchase commitments that meet the definition of a derivative at fair value on the balance sheet.

7. That is, FAS 133 does not provide specific guidance where, in the financial statements, the fair value of derivatives or the changes in the fair value of derivatives should be classified and presented on the financial statement.

8. When an institution has two (or more) derivatives with the same counterparty, contracts with positive fair values and negative fair values may be netted if the conditions set forth in FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts" (FIN 39), are met. Those conditions are as follows: (1) each of the parties owes the other determinable amounts; (2) the reporting party has the right to set off the amount owed with the amount owed by the other party; (3) the reporting party intends to set off; and (4) the right of setoff is enforceable at law. In addition, without regard to the third condition, fair-value amounts recognized for derivative contracts executed with the same counterparty under a master netting arrangement may be offset.

9. See Statement of Financial Accounting Standards No. 65, "Accounting for Certain Mortgage Banking Activities" (FAS 65), paragraph 4.

mitments (the hedging instrument) and the forecasted sale of the warehouse loans and/or the loans to be originated under derivative loan commitments (the forecasted transaction).[10]

If a financial institution does not apply hedge accounting, either because the FAS 133 hedge criteria are not met or the institution chooses not to apply hedge accounting, forward loan-sales commitments should be treated as nonhedging derivatives. If hedge accounting is not applied, an institution will account for its warehouse loans at the lower of cost or fair value. Because nonhedging forward loan-sales commitments are accounted for at fair value through earnings, such an approach causes volatility in reported earnings if the fair value of the warehouse loans increases above their cost basis. In this situation, the volatility is a result of recognizing the full amount of any decline in the fair value of the forward loan-sales commitments in earnings while not adjusting the carrying amount of the warehouse loans above their cost basis.

3071.0.1.1.6 Income-Statement Effect

Unless cash-flow hedge accounting is applied, a financial institution should include the periodic changes in the fair value of derivative loan commitments and forward loan-sales commitments in current-period earnings. An institution should report these changes in fair value in either "other non-interest income" or "other non-interest expense," but not as trading revenue, in their regulatory reports. However, an institution's decision as to whether to report the changes in fair value in its regulatory reports in an income or expense line item should be consistent with its presentation of these changes in its general-purpose external financial statements (including audited financial statements)[11] and should be consistent from period to period.

3071.0.1.2 Valuation

3071.0.1.2.1 Fair Value

FAS 133 indicates that the guidance in Statement of Financial Accounting Standards No. 107, "Disclosures About Fair Value of Financial Instruments" (FAS 107), should be followed in determining the fair value of derivatives.[12] That guidance provides that quoted market prices are the best evidence of the fair value of financial instruments. However, when quoted market prices are not available, which is typically the case for derivative loan commitments and forward loan-sales commitments, estimates of fair value should be based on the best information available in the circumstances (e.g., valuation techniques based on estimated expected future cash flows). When expected future cash flows are used, they should be the institution's best estimate based on reasonable and supportable assumptions and projections.

Estimates of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. In the absence of (1) quoted market prices in an active market, (2) observable prices of other current market transactions, or (3) other observable data supporting a valuation technique, the transaction price represents the best information available with which to estimate fair value at the inception of an arrangement.

A financial institution should not recognize an unrealized gain or loss at inception of a derivative instrument unless the fair value of that instrument is obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique incorporating observable market data.[13] Based on this guidance, derivative loan commitments generally would have a zero fair value at inception.[14] However, subsequent changes in the fair value of a derivative loan commitment must be recognized in financial statements and regulatory reports (e.g., changes in fair value attributable to changes in market interest rates).

When estimating the fair value of derivative loan commitments and those best-efforts contracts that meet the definition of a derivative, a

10. See FAS 133, paragraphs 20–21, and related FAS 133 guidance for hedging instruments, hedged items, and forecasted transactions that qualify for fair-value and cash-flow hedge accounting.

11. See footnote 7.

12. See FAS 133, paragraph 17.

13. See footnote 3 in Emerging Issues Task Force Issue No. 02-3 (EITF 02-3), "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities."

14. If a potential borrower pays the lender a fee upon entering into a derivative loan commitment (e.g., a rate-lock fee), there is a transaction price, and the lender should recognize the derivative loan commitment as a liability at inception using an amount equal to the fee charged to the potential borrower.

financial institution should consider predicted "pull-through" (or, conversely, "fallout") rates. A pull-through rate is the probability that a derivative loan commitment will ultimately result in an originated loan. Some factors that may be considered in arriving at appropriate pull-through rates include (but are not limited to) the origination channel (which may be either internal [retail] or external [wholesale or correspondent, to the extent the institution rather than the correspondent closes the loan]),[15] current mortgage interest rates in the market versus the interest rate incorporated in the derivative loan commitment, the purpose of the mortgage (purchase versus refinancing), the stage of completion of the underlying application and underwriting process, and the time remaining until the expiration of the derivative loan commitment. Estimates of pull-through rates should be based on historical information for each type of loan product adjusted for potential changes in market interest rates that may affect the percentage of loans that will close. An institution should not consider the pull-through rate when reporting the notional amount of derivative loan commitments in regulatory reports but, rather, must report the entire gross notional amount.

3071.0.1.2.2 SAB 105

In March 2004, the SEC issued SAB 105 to provide guidance on the proper accounting and disclosures for derivative loan commitments. SAB 105 is effective for derivative loan commitments entered into after March 31, 2004. SAB 105 indicates that the expected future cash flows related to the associated servicing of loans should not be considered in recognizing derivative loan commitments. Incorporating expected future cash flows related to the associated servicing of the loan essentially results in the immediate recognition of a servicing asset. Servicing assets should only be recognized when the servicing asset has been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained.[16] Further, no other internally developed intangible assets (such as customer-relationship intangible assets) should be recognized as part of derivative loan commitments. Recognition of such assets would only be appropriate in a third-party transaction (for example, the purchase of a derivative loan commitment either individually, in a portfolio, or in a business combination).

15. If an institution commits to purchase a loan that will be closed by a correspondent in the correspondent's name, the institution would have a loan-purchase commitment rather than a derivative loan commitment. See footnote 6.

16. See Statement of Financial Accounting Standards No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," paragraph 61.

3071.0.1.3 Standard-Setter Activities

Financial institutions should be aware that the SEC or the Financial Accounting Standards Board (FASB) may issue additional fair-value, measurement, or recognition guidance in the future (e.g., a fair-value measurement statement). To the extent that additional guidance is issued, institutions must also consider the guidance in developing fair-value-estimate methodologies for derivative loan commitments and forward loan-sales commitments as well as measuring and recognizing such derivatives.

3071.0.1.4 Changes in Accounting for Derivative Loan Commitments and Loan-Sales Agreements

Financial institutions should follow Accounting Principles Board Opinion No. 20 (APB 20), "Accounting Changes,"[17] if a change in their accounting for derivative loan commitments, best-efforts contracts, or mandatory-delivery contracts is necessary. APB 20 defines various types of accounting changes and addresses the reporting of corrections of errors in previously issued financial statements. APB 20 states, "Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared."

For regulatory reporting purposes, a financial institution must determine whether the reason for a change in its accounting meets the APB 20 definition of an accounting error. If the reason for the change meets this definition, the error should be reported as a prior-period adjustment if the amount is material. Otherwise, the effect of the correction of the error should be reported in current earnings.

If the effect of the correction of the error is

17. Effective December 15, 2005, APB 20 will be replaced by FASB Statement No. 154, "Accounting Changes and Error Corrections—A Replacement of APB Opinion No. 20 and FASB Statement No. 3."

material, a financial institution should also consult with its primary federal regulatory agency to determine whether any of its prior regulatory reports should be amended. If amended regulatory reports are not required, the institution should report the effect of the correction of the error on prior years' earnings, net of applicable taxes, as an adjustment to the previously reported beginning balance of equity capital. For the Call Report, the institution should report the amount of the adjustment in Schedule RI-A, item 2, "Restatements due to corrections of material accounting errors and changes in accounting principles," with an explanation in Schedule RI-E, item 4.

The effect of the correction of the error on income and expenses since the beginning of the year in which the error is corrected should be reflected in each affected income and expense account on a year-to-date basis beginning in the next quarterly income statement (Call Report) to be filed and not as a direct adjustment to retained earnings.

3071.0.1.5 Definitions of Terms Used in the Advisory

3071.0.1.5.1 Derivative Loan Commitment

The term *derivative loan commitment* refers to a lender's commitment to originate a mortgage loan that will be held for resale. Notwithstanding the characteristics of a derivative set forth in FAS 133, these commitments to originate mortgage loans *must* be accounted for as derivatives by the issuer under FAS 133 and include, but are not limited to, those commonly referred to as *interest-rate-lock commitments.*

In a derivative loan commitment, the lender agrees to extend credit to a borrower under certain specified terms and conditions in which the interest rate and the maximum amount of the loan[18] are set prior to or at funding. Under the agreement, the lender commits to lend funds to a potential borrower (subject to the lender's approval of the loan) on a fixed- or adjustable-rate basis, regardless of whether interest rates change in the market, or on a floating-rate basis. In a typical derivative loan commitment, the borrower can choose to—

- "lock in" the current market rate for a fixed-rate loan (i.e., a fixed derivative loan commitment),
- "lock in" the current market rate for an adjustable-rate loan that has a specified formula for determining when and how the interest rate will adjust (i.e., an adjustable derivative loan commitment), or
- wait until a future date to set the interest rate and allow the interest rate to "float" with market interest rates until the rate is set (i.e., a floating derivative loan commitment).

Derivative loan commitments vary in term and expire after a specified time period (e.g., 60 days after the commitment date). Additionally, derivative loan commitments generally do not bind the potential borrower to obtain the loan, nor do they guarantee that the lender will approve the loan once the creditworthiness of the potential borrower has been determined.

3071.0.1.5.2 Forward Loan-Sales Commitment

The term *forward loan-sales commitment* refers to either (1) a mandatory-delivery contract or (2) a best-efforts contract that, upon evaluation under FAS 133, meets the definition of a derivative.

3071.0.1.5.3 Mandatory-Delivery Contract

A *mandatory-delivery contract* is a loan-sales agreement in which a financial institution commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If the institution fails to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, it is obligated to pay a "pair-off" fee, based on then-current market prices, to the investor to compensate the investor for the shortfall. Variance from the originally committed principal amount is usually permitted, but typically may not exceed 10 percent of the committed amount.

All loan-sales agreements must be evaluated to determine whether they meet the definition of a derivative under FAS 133.[19] A mandatory-

18. In accordance with the "Background Information and Basis for Conclusions" in Statement of Financial Accounting Standards No. 149 (FAS 149), the notional amount of a derivative loan commitment is the maximum amount of the borrowing. See FAS 149, paragraph A27.

19. See FAS 133, paragraph 6, for the characteristics of a financial instrument or other contract that meets the definition of a derivative.

delivery contract has a specified underlying (the contractually specified price for the loans) and notional amount (the committed loan-principal amount), and requires little or no initial net investment. Additionally, a mandatory-delivery contract requires or permits net settlement or the equivalent thereof as the institution is obligated under the contract to either deliver mortgage loans or pay a pair-off fee (based on the then-current market prices) on any shortfall on the delivery of the committed loan-principal amount. Since the option to pay a pair-off fee accomplishes net settlement, it is irrelevant as to whether the mortgage loans to be delivered are considered readily convertible to cash.[20] Based on these characteristics, a mandatory-delivery contract meets the definition of a derivative at the time an institution enters into the commitment.

3071.0.1.5.4 Best-Efforts Contract

The term *best-efforts contract* refers to a loan-sales agreement in which a financial institution commits to deliver an individual mortgage loan of a specified principal amount and quality to an investor if the loan to the underlying borrower closes. Generally, the price the investor will pay the seller for an individual loan is specified prior to the loan being funded (e.g., on the same day the lender commits to lend funds to a potential borrower). A best-efforts contract that has all of the following characteristics would meet the definition of a derivative:

- an underlying (e.g., the price the investor will pay the seller for an individual loan is specified in the contract)
- a notional amount (e.g., the contract specifies the principal amount of the loan as an exact dollar amount or as a principal range with a determinable maximum amount)[21]
- requires little or no initial net investment (e.g., no fees are exchanged between the seller and investor upon entering into the agreement, or a fee that is similar to a premium on other option-type contracts is exchanged)
- requires or permits net settlement or the equivalent thereof (for example, the seller is contractually obligated to either (1) deliver the loan to the investor if the loan closes or (2) pay a pair-off fee, based on then-current market prices, to the investor to compensate the investor if the loan closes and is not delivered. Since the option to pay a pair-off fee accomplishes net settlement, it is irrelevant as to whether the loan to be delivered is considered readily convertible to cash.).

3071.0.1.5.5 Master Agreement

A financial institution may enter into one of several types of arrangements with an investor to govern the relationship between the institution and the investor and set the parameters under which the institution will deliver individual mortgage loans through separate best-efforts contracts. Such an arrangement might include, for example, a *master agreement* or an *umbrella contract.* These arrangements may specify an overall maximum principal amount of mortgage loans that the institution may deliver to the investor during a specified time period, but generally they do not specify the price the investor will pay for individual loans. Further, while these arrangements may include pair-off-fee provisions for loans to be sold under individual best-efforts contracts covered by the arrangements, the seller is neither contractually obligated to deliver the amount of mortgages necessary to fulfill the maximum principal amount specified in the arrangement nor required to pay a pair-off fee on any shortfall. Because these arrangements generally either do not have a specified underlying or determinable notional amount or do not require or permit net settlement or the equivalent thereof, the arrangements typically do not meet the definition of a derivative. As discussed above, an individual best-efforts contract governed by one of these arrangements may, however, meet the definition of a derivative.

As the terms of individual best-efforts contracts and master agreements or umbrella contracts vary, a financial institution must carefully evaluate such contracts to determine whether the contracts meet the definition of a derivative in FAS 133.

20. See FAS 133, paragraph 57(c)(1), for a description of contracts that have terms that implicitly or explicitly require or permit net settlement.

21. The use of a maximum amount as the notional amount of a best-efforts contract is consistent with the loan-commitment discussion in the "Background Information and Basis for Conclusions" in FAS 149. See FAS 149, paragraph A27.

3071.0.1.6 Example of the Accounting for Commitments to Originate and Sell Mortgage Loans[22]

3071.0.1.6.1 ABC Mortgage Financial Institution (Best-Efforts Contracts and No Application of Fair-Value Hedge Accounting)

The following simplified example was developed to provide a financial institution that has a limited number of derivative loan commitments general guidance on one approach that may be used to value such commitments.[23] This example also illustrates the regulatory reporting requirements for derivative loan commitments and forward loan-sales commitments.

The guidance in this example is for illustrative purposes only, as there are several ways that a financial institution might estimate the fair value of its derivative loan commitments. A second approach to valuing derivative loan commitments is described in *Derivative Loan Commitments Task Force Illustrative Disclosures on Derivative Loan Commitments,* a practice aid developed by staff of the American Institute of Certified Public Accountants (AICPA) and a task force comprising representatives from the financial services, mortgage banking, and public accounting communities.[24] As indicated in the body of the interagency advisory, a financial institution must consider the guidance in FAS 133, FAS 107, EITF 02-3, and SAB 105 in measuring and recognizing derivative loan commitments and forward loan-sales commitments. In addition, an institution should be aware that the SEC or FASB may issue additional guidance in the future that may alter certain aspects of this example.

3071.0.1.6.1.1 Background

ABC Mortgage Financial Institution (ABC) enters into fixed, adjustable, and floating derivative loan commitments to originate mortgage loans that it intends to sell. The institution accounts for the commitments as derivative financial instruments as required under FAS 133.

ABC enters into best-efforts contracts with a mortgage investor under which it commits to deliver certain loans that it expects to originate under derivative loan commitments (i.e., the pipeline) and loans that it has already originated and currently holds for sale (i.e., warehouse loans). ABC and the mortgage investor agree on the price that the investor will pay ABC for an individual loan with a specified principal amount prior to the loan being funded. Once the price that the mortgage investor will pay ABC for an individual loan and the notional amount of the loan are specified, and ABC is obligated to deliver the loan to the investor if the loan closes, the contract represents a forward loan-sales commitment. Under FAS 133, ABC accounts for these forward loan-sales commitments as derivative financial instruments.

On December 31 of a given year, the notional amounts of ABC's mortgage banking derivative loan commitments and forward loan-sales commitments are as follows:

Table 1—Notional Amounts of Derivative Loan Commitments and Forward Loan-Sales Commitments

	Notional amount
Derivative loan commitments	
Fixed-rate commitments	$ 8,500,000
Adjustable-rate commitments	1,500,000
Floating-rate commitments	2,000,000
Total derivative loan commitments	$12,000,000 [A][25]

22. This example uses the definitions and concepts presented in the body of the Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans (the interagency advisory). Refer to the interagency advisory for clarification of the terms and concepts used in this example.

23. Estimating fair values when quoted market prices are unavailable requires considerable judgment. Valuation techniques using simplified assumptions may sometimes be used (with appropriate disclosure in the financial statements) to provide a reliable estimate of fair value at a reasonable cost. See FAS 107, paragraphs 60–61.

24. The practice aid is available at www.aicpa.org/download/members/div/acctstd/Illustrative_Disclosure_on_Derivative_Loan_Commitments.pdf.

25. Alpha references in table 1 and the text of this example refer to the "Reference" column in table 3.

Table 1—continued

	Notional amount	
Forward loan-sales commitments		
Pipeline loan commitments	$12,000,000	
Warehouse loan commitments	8,000,000	
Total forward loan-sales commitments	$20,000,000	[B]

Market interest rates have changed throughout the time period that ABC's derivative loan commitments and forward loan-sales commitments have been outstanding. Some of the fixed-rate commitments are at rates above current market rates while others are at rates at or below current market rates. All of ABC's adjustable-rate commitments are at rates below current market rates.

Based on its past experience, ABC estimates a pull-through rate of 70 percent on its fixed-rate commitments for which the locked-in rate is above current market rates (i.e., 70 percent of the commitments will actually result in loan originations) and a pull-through rate of 85 percent for its fixed-rate commitments for which the locked-in rate is at or below current market rates. ABC also estimates a pull-through rate of 85 percent for all of its adjustable-rate commitments that are below market rates.

The pull-through-rate assumptions in this example have been simplified for illustrative purposes. In determining appropriate pull-through rates, a financial institution must consider all factors that affect the probability that derivative loan commitments will ultimately result in originated loans. Therefore, an institution is expected to have more granularity (i.e., stratification) in its application of pull-through-rate assumptions to its derivative loan commitments.

3071.0.1.6.1.2 Discussion of ABC's Approach to Valuing Derivative Loan Commitments and Forward Loan-Sales Commitments

ABC estimates the fair value of its derivative loan commitments using the best information available in the circumstances because quoted market prices are not available. In this case, ABC uses valuation techniques that take into account current secondary-market loan pricing information.[26] ABC had noted the appropriate reference price for the underlying loans on the day that each derivative loan commitment was given to a borrower, and assigned an initial fair value of zero to each loan commitment consistent with the guidance in SAB 105 and EITF 02-3. At the end of the month, ABC compares the current reference price of each underlying loan with its initial reference price and calculates the price difference. ABC then calculates the fair value of these derivatives by multiplying the price difference by the estimated pull-through rate. This approach is illustrated in table 2.

As illustrated in table 2, ABC excludes time value from its fair-value-estimate methodology due to the short-term nature of the derivative loan commitments. As the exclusion of time value is not appropriate for all fair-value estimates, an institution must consider the terms of its specific agreements in determining an appropriate estimation methodology.

In the example in table 2, ABC estimated the initial reference price of the underlying loan to be originated under the commitment, excluding the value of the associated servicing rights, to be $100,000. That is, at the date it entered into the fixed derivative loan commitment with the borrower, ABC estimated it would receive $100,000, excluding the value of the associated servicing rights, if the underlying loan was funded and sold in the secondary market on that day. Because this amount is equal to the notional amount of the loan, ABC would not experience a gain or loss on the sale of the underlying loan (before considering the effect of the loan-origination fees and costs associated with the loan). As such, the fair value of this derivative loan commitment would be zero, and there would not be any unrealized gain or loss at the inception of the derivative loan commitment. This may not be true for all derivative loan commitments.

ABC defers all unrealized gains and losses at the inception of its derivative loan commitments until the underlying loans are sold. ABC's policy is based on the short-term nature of its

26. In general, source data for secondary-market loan-pricing information may include, for example, quotations from rate sheets; brokers; or electronic systems such as those provided by third-party vendors, market makers, or mortgage loan investors. When secondary-market loan-pricing information that includes the value of servicing rights is used, the fair value of the derivative loan commitments ultimately must exclude any value attributable to servicing rights.

Table 2—ABC's Calculation of the Fair Value of Derivative Loan Commitments: An Example of a Fixed Derivative Loan Commitment for Which the Locked-In Rate Is Above the Current Market Rate*

Notional amount of loan	*Initial reference price of loan to be originated under commitment—excluding servicing rights*	*Current reference price of loan to be originated under commitment—excluding servicing rights*	*Price difference*	*Pull-through rate*	*Fair value of derivative loan commitment*
(1)	(2)	(3)	[(3) - (2)]	(4)	[(3) - (2)] × (4)
$100,000	$100,000	$100,500	$500	70%	$350

* The example in this table presents the fair-value calculation for one derivative loan commitment. The fair value of this derivative, which is positive, would be added to all the other derivative loan commitments with positive fair values. Netting derivatives with positive fair values (assets) against derivatives with negative fair values (liabilities) is not permitted unless the conditions stipulated in FIN 39 are met. Refer to footnote 8.

derivative loan commitments and was adopted in order to not accelerate the timing of gain recognition. As this practice may not be appropriate for all derivative loan commitments or other derivatives initially accounted for under EITF 02-3, and due to the lack of authoritative guidance in this area, an institution should consult with its accounting advisers concerning the appropriate accounting for its specific agreements.

After applying the methodology described above to individual derivative loan commitments, ABC aggregates the fair values of the derivative loan commitments by type (i.e., fixed, adjustable, and floating) and by whether the commitments have above-, at-, or below-market rates. The fair values of the fixed derivative loan commitments with above-market rates, adjusted for the appropriate pull-through rate, total $21,000 [C], which represents an asset. The aggregate fair value of the fixed derivative loan commitments that have at- or below-market rates, adjusted for the appropriate pull-through rate, sums to ($31,000) [D], which represents a liability. For the adjustable derivative loan commitments, the aggregate fair value, adjusted for the pull-through rate, is approximately ($2,000) [E], which is also a liability. The fair value of the floating derivative loan commitments approximates zero.

ABC also estimates the fair value of its forward loan-sales commitments outstanding at the end of the month using a similar methodology as that described above. Based upon this information, ABC determines that the estimated fair value of the forward loan-sales commitments related to its derivative loan commitments and warehouse loans with above-market rates is approximately ($45,000) [F], which represents a liability, because current market interest rates for comparable mortgage loans are lower than the rates in effect when the derivative loan commitments were initiated. (Consequently, current offered delivery prices for similar commitments are greater than the delivery prices of ABC's existing forward loan-sales commitments. Therefore, the change in the fair value of ABC's forward loan-sales commitments since they were entered into represents a loss.) The fair value of ABC's forward loan-sales commitments related to its derivative loan commitments and warehouse loans with at- or below-market rates is estimated to be $50,000, which is an asset.[27]

3071.0.1.6.1.3 Regulatory Reporting

The following table illustrates the regulatory reporting requirements for the derivative-related dollar amounts cited in the example.

As illustrated in table 3, depending upon particular market circumstances, individual derivative loan commitments and forward loan-sales

27. The absolute value of the fair value of the forward loan-sales commitments is greater than the absolute value of the fair value of the related derivative loan commitments because the forward loan-sales commitments also apply to, and act as an economic hedge of, ABC's warehouse loans. ABC accounts for its warehouse loans at the lower of cost or fair value in accordance with FAS 65. In this example, ABC does not apply hedge accounting to its warehouse loans.

Table 3—Regulatory Reporting Implications for Derivative Loan Commitments and Forward Loan-Sales Commitments

	Amount	Reference
Derivative loan commitments		
Notional amount of "over-the-counter written options"[28]	$12,000,000	[A]
Derivatives with a *positive* fair value held for purposes other than trading (asset)	$21,000	[C]
Derivatives with a *negative* fair value held for purposes other than trading (liability)	$33,000	[D + E]
Forward loan-sales commitments		
Notional amount of "forward contracts"	$20,000,000	[B]
Derivatives with a *positive* fair value held for purposes other than trading (asset)	$50,000	[G]
Derivatives with a *negative* fair value held for purposes other than trading (liability)	$45,000	[F]
Derivative loan commitments and forward loan-sales commitments		
Total notional amount of derivative contracts held for purposes other than trading	$32,000,000	[A + B]

commitments may have either positive or negative fair values, which ABC properly reports gross as assets or liabilities on its balance sheet. In addition, for regulatory reporting purposes, ABC consistently reports the periodic *changes* in the fair value of its derivative contracts in "other non-interest expense" in its income statement. Alternatively, ABC could have chosen to consistently report these fair-value changes in "other non-interest income" in its regulatory reports.

3071.0.2 INSPECTION OBJECTIVE

1. To find out if the bank holding company accounted for and reported the following transactions at their fair value: (1) its commitments to originate mortgage loans that were held for resale (derivatives) and (2) its loan-sales agreements that are derivatives. If so, ascertain if these transactions were accounted for and reported—
   a. in accordance with the instructions for the BHC reports (for example, the FR Y-9C); GAAP; and SR-05-10 and its attached May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans and
   b. based on reasonable and supportable valuation techniques as prescribed by the May 3, 2005, interagency advisory.

3071.0.3 INSPECTION PROCEDURES

1. Determine whether the bank holding company has written and consistently applied accounting policies to its commitments to (1) originate mortgage loans that were held for resale and (2) sell mortgage loans under mandatory-delivery and best-efforts contracts.
2. Find out if the bank holding company has developed and uses approved valuation methodologies and procedures to obtain formal approval for changes to those methodologies.
   a. Ascertain whether the valuation methodologies are reasonable, objectively supported, and fully documented.

28. Because derivative loan commitments are in certain respects similar to options, they are reported with "over-the-counter written options" for regulatory reporting purposes.

   b. Determine if the bank holding company has internal controls, including an effective independent review or audit, in place that give integrity to the valuation process.
3. If the bank holding company issues fixed-, adjustable-, and floating-rate derivative loan commitments or forward loan-sales commitments, review an adequate sample that evidences the full coverage of these types of transactions.
   a. Ascertain if these transactions were properly reported on the balance sheet as an ‘‘other asset’’ or an ‘‘other liability,’’ based on whether the individual commitment has a positive (asset) or negative (liability) fair value in accordance with the instructions for the BHC reports.
   b. Determine if the floating-rate derivative loan commitments and other derivative loan commitments were reported at their entire gross notional amount in the BHC's reports (such as the FR Y-9C).
   c. Find out if the balance sheet correctly presents accounts for all such transactions, including the netting of contracts, the application of hedge accounting to mortgage banking activities, the valuation of derivatives, and any material or other accounting changes for derivative loan commitments and loan-sales agreements. Also determine if the bank holding company complies with the May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans and with GAAP.
   d. Ascertain if periodic changes in the fair value of derivative loan commitments and forward loan-sales commitments are reported in current-period earnings as either ‘‘other non-interest income or ‘‘non-interest expense, as appropriate.
4. Report to the central point of contact or examiner-in-charge any failure by the bank holding company's management to follow (1) the bank holding company's accounting and valuation policies for its commitments to originate mortgage loans that are held for resale and its commitments to sell mortgage loans, (2) the instructions for the Consolidated Financial Statement for Bank Holding Companies, (3) the May 3, 2005, interagency advisory, or (4) GAAP.
5. When additional inspection scrutiny is needed—based on the examination's findings; the supervisory concerns discussed in section 3071.0; the February 23, 2003, Interagency Advisory on Mortgage Banking (see SR-03-4 and its attachment); and the May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans (see SR-05-10 and its attachment)—consider using the comprehensive mortgage banking examination procedures in the appendix section A.2040.3 of the *Commercial Bank Examination Manual.*

Section 4(c)(8) of the BHC Act (Activities Related to Extending Credit) Section 3072.0

In 1997, the Board amended Regulation Y to include ''activities related to extending credit'' in section 225.28(b)(2), which includes the following permissible nonbanking activities:

	Section No.
1. real estate and personal property appraising	3270.0
2. arranging commercial real estate equity financing	3220.0
3. check-guaranty services	3320.0
4. collection agency services	3330.0
5. credit bureau services	3340.0
6. asset-management, servicing, and collection activities	3084.0
7. acquiring debt in default	3104.0
8. real estate settlement services[1]	3072.8

1. Real estate settlement services do not include providing title insurance as principal, agent, or broker.

In 1997, the Board incorporated real estate servicing into section 225.28(b)(2) as one of the activities related to extending credit. (See 12 C.F.R. 225.28(b)(2)(viii).) Real estate settlement services do not include providing title insurance as principal, agent, or broker. Previously, the Board had approved the activity by Board order. In the order, the Board found that real estate settlement services consist of—

1. reviewing the status of the title in the title commitment, resolving any exceptions to the title, and reviewing the purchase agreement to identify any requirements that need to be complied with;
2. verifying payoffs on existing loans secured by the real estate and verifying the amount of and then calculating the prorating of special assessments and taxes on the property;
3. obtaining an updated title insurance commitment to the date of closing; preparing the required checks, deeds, and affidavits; and obtaining any authorization letters needed;
4. establishing a time and place for the closing, conducting the closing, and ensuring that all parties properly execute all appropriate documents and meet all commitments;
5. collecting and disbursing funds for the parties, holding funds in escrow pending satisfaction of certain commitments, and preparing the HUD settlement statement, the deed of trust, mortgage notes, the Truth-in-Lending statement, and purchaser's affidavits; and
6. recording all of the documents required under law. (See 1990 FRB 1058.)

3072.8.1 REAL PROPERTY EXCHANGE TRANSACTIONS UNDER SECTION 1031 OF THE INTERNAL REVENUE CODE

A request submitted to the Board on behalf of a bank holding company (BHC) requested an advisory opinion pursuant to section 225.27 of Regulation Y (12 C.F.R. 225.27). The BHC was proposing the acquisition of a subsidiary (the 1031 exchange subsidiary) that provided services to customers seeking to make exchanges of real property pursuant to section 1031 of the Internal Revenue Code (1031 exchange transactions).

Section 1031 of the Internal Revenue Code provides a U.S. taxpayer with deferral of gain when the taxpayer exchanges his or her property for another property of a "like kind." In a "forward" 1031 exchange transaction, the taxpayer first sells his or her existing property and later purchases a replacement property.[1] In order to complete a forward 1031 exchange transaction successfully, a taxpayer must satisfy certain conditions in section 1031 of the Internal Revenue Code and the U.S. Treasury regulations that implement section 1031. For example, in a forward 1031 exchange transaction, at the closing of the sale of the initial property, the proceeds of the sale must be held by an individual or entity otherwise unrelated to the transaction (the qualified intermediary). In addition, the taxpayer engaging in the forward 1031 exchange transaction may not receive the sale proceeds during the period in which a replacement property is identified (up to 45 days) and acquired (up to 180 days). In this request, the BHC was proposing to acquire a subsidiary that would act as a qualified intermediary in forward 1031 exchange transactions involving real property.

The 1031 exchange subsidiary would engage in several activities in order to facilitate forward 1031 exchange transactions. First, the subsidiary would provide its customer with documents related to the exchange to ensure that the exchange qualified as a valid forward 1031 exchange transaction. Specifically, the subsidiary would provide an exchange agreement, an assignment agreement, and a notice. The exchange agreement is a contract between the customer and the subsidiary that, among other features, notes the requirements for the successful completion of the transaction. The assignment agreement transfers from the customer to the subsidiary certain responsibilities for the sale of the initial property and the receipt of sales proceeds in order to ensure that the customer does not "constructively receive" the proceeds of the initial property sale for tax purposes. These responsibilities may include taking the transitory title to the initial property and replacement property as they are transferred from seller to buyer. The notice informs the purchaser of the initial property that the transaction is part of a forward 1031 exchange transaction; it helps establish that the mecha-

1. In a "reverse" 1031 exchange transaction, the taxpayer first purchases a replacement property and later sells his or her property. The proposal did not include the provision of services to customers seeking to make reverse 1031 exchange transactions.

nism for the forward 1031 exchange transaction is in place at the time of the sale.

Second, the 1031 exchange subsidiary would invest the proceeds of the sale of the initial property on behalf of the customer until the customer acquired the replacement property. The proceeds would be invested at the discretion of the subsidiary but would typically be deposited into deposit accounts at the BHC's subsidiary state-chartered commercial bank.[2] The subsidiary would also transfer the necessary funds to the appropriate party to effect the customer's purchase of the replacement property. If the customer does not identify a replacement property or purchase the replacement property within the required time periods set forth in section 1031 of the Internal Revenue Code or U.S. Treasury regulations implementing section 1031, the proceeds of the sale of the initial property would be transferred to the customer. It was represented that the subsidiary would act in a fiduciary capacity in holding, investing, and disbursing the customer's funds and that a state-chartered nondepository trust company would be allowed to engage in the activities of the subsidiary.

The 1031 exchange subsidiary (1) would not participate in negotiating the terms of the real property sale and purchase transactions that constitute the forward 1031 exchange transaction and (2) would not assist the customer in locating a buyer of the initial property or a seller of the replacement property. The requestor also asserted that the proposed services are permissible nonbanking activities for BHCs under section 225.28(b) of Regulation Y (12 C.F.R. 225.28(b)).

In view of all the facts of the record, Board staff opined that the proposed activities of the 1031 exchange subsidiary would be permissible real estate settlement services under section 225.28(b)(2)(viii) of Regulation Y (12 C.F.R. 225.28(b)(2)(viii)); would be trust company functions under section 225.28(b)(5) of Regulation Y (12 C.F.R. 225.28(b)(5)); and would be financial advisory services, including tax-planning and tax-preparation services, under section 225.28(b)(6) of Regulation Y (12 C.F.R. 225.28(b)(6)).[3]

The opinion is limited to the activities relating to the 1031 exchange transaction described in the opinion and in the correspondence exchanged between the requestor and Board staff. See the Board staff's February 9, 2006, legal interpretation.

2. The BHC's commercial bank subsidiary also may be a lender with respect to real properties involved in the 1031 exchange transaction. Any lending relationship between the bank and the customer would depend on the ability of the customer and the loan transaction to meet the bank's standard underwriting terms and conditions.

3. The Office of the Comptroller of the Currency (OCC) authorized national banks to provide a wide range of services to facilitate their customers' 1031 exchange transactions. See OCC Interpretive Letter No. 880 (December 16, 1999) and OCC Corporate Decision No. 2001–30 (October 10, 2001).

3073.0.1 EXPANDED STUDENT-LOAN-SERVICING ACTIVITIES

A bank holding company applied for the Board's approval under section 4(c)(8) of the Bank Holding Company Act (BHC Act) and section 225.23 of Regulation Y to expand the student-loan-servicing activities of its nonbank subsidiary. The activities would consist of—

1. providing student-loan authorities (the authority) with regular reports that include information in the aggregate and by individual lenders concerning the volume of loans being serviced for the authority and the volume of loans outstanding;
2. preparing projections for approval by the authority of student loans to be purchased and commitments to be issued in the future, based on the volume of loans being serviced and commitments outstanding, consistent with the amount of funds available to the authority as the result of its sale of bonds;
3. advising eligible lenders, borrowers, and other interested parties of the authority's student-loan-purchase program, including the criteria used by the authority in purchasing student loans and the extent to which the authority will be purchasing loans in the future based on the availability of funds; and
4. meeting regularly with the authority to advise it of the nonbank subsidiary's efforts in connection with the student-loan activities.

Under no circumstances would the nonbank subsidiary be authorized to bind the authority or its bank trustee to commit to purchase or actually to purchase student loans from eligible lenders.

The proposed activities were regarded as being equivalent to the activities of a mortgage banking subsidiary of a bank holding company, authorized under section 225.28(b)(1) of Regulation Y, with respect to acquiring and servicing mortgage loans for institutional investors or in connection with the secondary-mortgage market. The activities proposed and currently conducted by the applicant, to the extent that they were different from the services performed by any institution that services loans for others, were perceived as being different only in that they related to servicing student loans for a governmental authority. Banks and their nonbank subsidiaries generally provide comprehensive loan-acquisition and -servicing "packages" for investors in mortgage and other loans. The bank holding company's nonbank subsidiary was the nation's largest servicer of student loans, and was thus particularly well equipped to perform the proposed expanded services.

In addition to determining that the proposed activities were closely related to banking to approve the application, the Board had to conclude that the proposed activities would produce benefits to the public that would outweigh any possible adverse effects, such as unsound banking practices, unfair competition, conflicts of interests, or undue concentration of resources. The Board made that conclusion in addition to determining that the balance of public interest factors that it is required to consider under section 4(c)(8) of the BHC Act was favorable. Accordingly, the application was approved on July 1, 1985 (1985 FRB 725).

A bank holding company or its subsidiary may engage in the activity of servicing loans or other extensions of credit for either affiliated companies or for persons or institutions not affiliated with the holding company. The service will often be carried on as an additional activity of a credit-extending subsidiary, such as a mortgage company, where the loan serviced was originated by the subsidiary and subsequently sold to an investor. A servicing company provides the collection vehicle through receipt and disbursement of funds for investors who may not possess the resources to accomplish the activity. The purpose of servicing is to keep a sound loan in good standing for a passive investor. The servicing company's remuneration is usually based upon a percentage of the outstanding balance of the loan.

The traditional servicing arrangement arises from the normal business of a mortgage company. The company grants extensions of credit to qualified borrowers and subsequently packages and sells these loans, normally without recourse, to individuals or institutional investors who contract the collection of the credit to the mortgage company. The company may also purchase mortgages or other extensions of credit in the open market with the intention of reselling the credit and retaining the servicing or can simply purchase servicing portfolios (12 C.F.R. 225.132). The collection itself is basically a bookkeeping function.

Servicing loans for others is relatively risk-free to the company when the credits are sold without recourse to investors. A credit which has been sold with recourse represents an unusual circumstance and should, therefore, be reviewed in detail. The serviced loans will generally be high quality mortgages which are in turn purchased from the company by passive investors desiring a fixed rate of return on their funds. The risk to a servicing company lies in its portfolio of unsold loans, or its "warehouse." The risk is two-fold: (1) the loan may not be of high enough quality to attract an investor so that the servicing company will have to continue to carry the credit for its own account, and (2) the loan was made at an interest rate which is below current market rates. In the latter case, the servicing company must either sell the loan at a discount or continue to hold the credit for its own account. In either case, the loan is treated as an asset of the company and involves credit risk.

The inspection of a servicing company, or a servicing department of a credit-extending subsidiary, should focus on adequacy of documentation and controls, and on the quality and marketability of the warehoused loans. The examiner should obtain a past due report for the portfolio and note in the inspection report significant credits which are past due together with the period of delinquency, the type of loan, and the asset classification, if any. The nature of the servicing business is such that the number of past dues should be small because loans are only warehoused for a short period of time until they can be sold to an investor. As a rule, a past due loan or a current loan which has been warehoused for more than several months is indicative of some problem with the credit. Each loan should be evaluated to determine the reason it has not been sold.

During periods of rising long-term interest rates, the warehouse portfolio becomes subject to the risk that a loan may not be marketable, except at a discount, because of its relatively low yield. This affects both the servicer's income and liquidity.

In the case of the parent company acting as a servicer, the inspection should also determine whether the activity is being carried on under the proper exemption. A bank holding company may act as a servicer under section 4(c)(8) of the Act or under the provisions of sections 4(a)(2) and/or 4(c)(1) of the Act. If carried on under Section 4(a)(2) of the BHC Act, the holding company is limited to servicing loans only for its own account or its banking and nonbanking subsidiaries. If carried under Section 4(c)(1)(C) of the BHC Act, the bank holding company is limited to servicing loans only for its own account or its banking subsidiaries.

Finally, the income of the company should be subject to scrutiny. A servicing company should be a profitable business. The servicer receives a fee based upon a percentage of the outstanding balance of the loan. In the early years of the payback period, the fee should significantly exceed the cost of the service, and because much of the portfolio will be refinanced either prior to its maturity or prepaid, the fee income should be sufficient to cover the servicer's cost plus profit. The reason for poor earnings in this activity is generally either inefficiency in the collection area, failure to attain the breakeven point of servicing volume, or the inability to turnover the warehouse portfolio often enough to maintain new fee generation. In the event that the servicer is unprofitable, the examiner should determine the reasons and clearly set them forth in the inspection report.

The servicing arrangement is of a fiduciary nature and as such it gives rise to certain contingent liabilities. In the situation where the servicer is not fully and properly discharging its servicing responsibilities in accordance with the servicing agreement, the holder of the serviced notes might bring legal claims against the servicer. The inspection process should direct attention to this area including a review of the servicing agreement and verification that the servicer is fulfilling its obligations. Management should be reminded of the significant loss exposure which can result from improper attention to its fiduciary responsibilities.

3080.0.1 INSPECTION OBJECTIVES

1. To determine that internal controls are adequate to administer effectively the servicing of the loan portfolio.

2. To determine the level of exposure to credit risk of loans held for the firm's own account.

3. To determine if the firm's earnings are sufficient so as not to be a burden on the parent or subsidiary bank.

3080.0.2 INSPECTION PROCEDURES

1. Review the balance sheet to determine the volume of credits held for the firm's own account and evaluate their asset quality.

2. Review internal controls and evaluate their adequacy.

3. Review earnings and appraise the impact on the parent and bank subsidiaries.

4. Review servicing agreements and evaluate the potential or contingent risks to which the firm is exposed in the event of failure by a borrower to service its loan properly.

5. Determine whether mortgage servicing rights are recorded as an asset and whether they are being amortized over the average life of the loans being serviced.

A bank holding company may engage under contract with a third party in the management, servicing, and collection[1] of the types of assets that an insured depository institution may originate and own. The company cannot engage in real property management or real estate brokerage services as part of these services. See Regulation Y, section 225.28(b)(2)(vi). Provided below are some initial historical examples of Board orders that involve asset-management services related to this nonbanking activity. The commitments and conditions provided for within the Board orders should not be considered to be currently applicable.

3084.0.1 ASSET-MANAGEMENT SERVICES TO CERTAIN GOVERNMENTAL AGENCIES AND UNAFFILIATED FINANCIAL INSTITUTIONS WITH TROUBLED ASSETS

Three bank holding companies (the applicants) applied for the Board's approval under section 4(c)(8) of the BHC Act to engage de novo in providing asset-management services to the Resolution Trust Corporation and the Federal Deposit Insurance Corporation, and generally to unaffiliated financial institutions with troubled assets. The applicants committed to conduct these activities under the same terms and conditions as set out in 1988 FRB 771.

The commitments and conditions of this order required that (1) the asset-management activities would be provided to the banks and savings associations, (2) the applicant would obtain the Board's approval before providing asset-management services for pools of assets that were not originated or held by financial institutions and their affiliates, (3) the applicant would cause its asset-management subsidiary to establish procedures to preserve the confidentiality of information obtained in the course of providing asset-management services, and (4) neither the applicant nor its management subsidiary would take title to the assets managed by the asset-management subsidiary.

The applications of these holding companies were approved by a Board order on December 24, 1990 (1991 FRB 124). Two additional orders about providing asset-management services were approved on March 25, 1991 (1991 FRB 331 and 334).

1. Asset-management services include acting as agent in the liquidation or sale of loans and collateral for loans, including real estate and other assets acquired through foreclosure or in satisfaction of debts previously contracted.

3084.0.2 ASSET-MANAGEMENT SERVICES FOR ASSETS ORIGINATED BY NONFINANCIAL INSTITUTIONS

Two bank holding companies (the applicants) applied jointly for the Board's approval under section 4(c)(8) of the BHC Act to engage de novo in collection-agency activities pursuant to Regulation Y through a joint venture. The Board concluded that the collection activities were permissible.

The bank holding companies also applied for the Board's approval to engage in asset-management, asset-servicing, and collection activities through a nonbank of the joint venture located in New Jersey. The subsidiary would provide asset-management services to the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC). It would also provide these services to unaffiliated third-party investors that purchase pools of assets assembled by the RTC or the FDIC. Under the proposal, neither the applicants nor this nonbank subsidiary would acquire an ownership interest in the assets that they manage or in the institutions for which they provide the asset-management services. The applicants further committed that they would not provide real property management or real estate brokerage services as part of the proposed activities.

The Board previously determined that, within certain parameters, providing asset-management services for assets originated by financial institutions (banks, savings associations, and credit unions) and their bank holding company affiliates is an activity closely related to banking (see 1991 FRB 331, 334 and section 3600.15.3). The applicants proposed to conduct all asset-management activities subject to the same conditions as in the Board orders previously cited.

The applicants proposed to engage in asset-management activities for assets originated by nonfinancial institutions as well as by financial institutions. These assets include real estate, consumer, and other loans; equipment leases; and extensions of credit. Assets of nonfinancial institutions include pension funds, leasing companies, finance companies, and investment companies formed to engage in asset-management activities. The managed assets would be limited to the types of assets that financial institutions have the authority to originate. The Board concluded that the applicants would have the expertise to engage in managing these types of assets, regardless of the originating entity. The Board also determined that the proposal was consistent with the asset-management proposals approved in its prior orders. The Board concluded that the applicants' proposed activities are closely related to banking and approved the order on December 21, 1992. (1993 FRB 131)

Section 4(c)(8) of the BHC Act (Receivables)

Section 3090.0

Two nonbanking activities authorized under section 4(c)(8) of the BHC Act, per Regulation Y in section 225.28(b)(1), are the discount purchasing of a client's accounts receivables (factoring) and the establishment of a revolving credit facility secured by an assignment of accounts receivable (accounts receivable financing). These activities date back to Board orders issued in 1951. See sections 3090.1 and 3090.2.

3090.1.1 INTRODUCTION

Factoring is the discount purchasing of the client's accounts receivable invoices for goods that have been manufactured and shipped. Factoring differs from accounts receivable financing in that the factor assumes the credit risk of collecting payment from the recipient of the goods. The principal advantage of factoring is that the client is assured of the collection of the proceeds of its sales, regardless of whether the factor is paid.

A factor generally offers four basic services: (1) credit investigation and approval; (2) buying the client's accounts receivable at a discount (generally between .75 and 1.5 percent) after shipment of the goods to which there is no subsequent claim, just a claim against the invoices; (3) bookkeeping in the form of posting accounts; and (4) advancing funds in the form of an ''open account'' when there could be 30 days between shipment and payment. The later allows the client to replenish inventory loans for working capital or expansion.

Maturity factoring and advance factoring are the basic techniques of the industry. In maturity factoring, an average maturity due date is computed for the receivables purchased during a period and the client receives payment on that date. Advance factoring uses the same computations, however, the client has the option of taking advance payments equal to a percentage of the balance due at any time *prior* to the computed average maturity due date. The unadvanced balance, sometimes called the ''client's equity,'' is payable on demand at the due date.

The factor's balance sheet reflects the purchases as ''factored receivables'' and the liabilities as ''due to clients.'' Usually the due to clients balance will be significantly less than the factored receivables balance because of payments and advances to the clients. The income statement will show factoring commissions, which represent the discount on the receivables purchased. Interest income for advances on the due to client balances may or may not be a separate line item.

The factor is a pivoting point between the buyer and the seller. The buyer must pay or all parties lose. Also the seller must have a reputation for delivering quality merchandise. The factor must know the business well enough to account for sudden increases in returns for out-of-specification merchandise or for merchandise of low quality. If the seller does not perform adequately, payment for the goods may not be forthcoming, and if bankruptcy threatens the seller, buyers may hold back their future purchases.

3090.1.2 FUNDING

Since factors traditionally provide financing to industries with seasonal borrowing requirements, such as textiles, shoes, clothing, and other consumer goods, their own funding programs will usually reflect this volatility. It may be expected that factors generally will have greater access to short-term unsecured credit facilities than would be expected for other nonbank activities. This would hold true for factors funded solely from internal sources as well as external sources.

Because of a factor's inherent funding volatility, a major portion of a factor's liabilities will be short-term debt. For the internally funded company, this source will be predominantly commercial paper proceeds from the parent company, with perhaps some bank line proceeds intermixed. The externally funded company will probably rely on bank lines for its short-term needs, usually with the parent company's guaranty of the debt.

Longer term funding may be provided through bank term loans and subordinated debt, although the volume of this type of debt appears to be low relative to other financing industries. The terms and covenants of long-term debt appear to allow for relatively more flexibility in operations and more highly leveraged positions than similar debt for other financing industries in recognition of the volatility of factoring operations and the liquidity of factoring assets.

The principal suppliers of senior and subordinated funds to factors and accounts receivable financers appear to be limited to a few insurance companies that specialize in this field, although a few banks also provide senior term funding. These lenders have incorporated their perceptions of acceptable balance sheet ratios and earnings performance into their debt agreements as restrictive covenants. Since comparative industry data is limited, these restrictive covenants may be the examiner's primary means of evaluating leverage, loss reserves, and capital adequacy. The ''due to clients'' account is another significant measure of a factor's liabilities. As noted before, the account represents the accumulation of the amounts payable to the clients upon the maturity of their factored receivables. This liability is, to a large extent, self-liquidating through the collection of those receivables.

An analysis of the changes in the relative proportions of the "due to clients" account should provide valuable input into the analysis of a factor's earnings. Since factoring is a highly competitive industry, price cutting has reduced factoring commissions to a point where they provide minimal support to earnings; therefore, the interest margins on factoring advances have a significant impact on net income. The implication of the analysis of proportional changes is that as more clients take advances (reducing "due to clients"), profit margins should widen, and conversely, as the "due to clients" proportion of total liabilities rises, profit margins may be expected to narrow.

3090.1.3 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the Act and Regulation Y.
2. To determine whether transactions with affiliates, including banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolios, and whether lending, monitoring and collection policies are adequate to maintain sound asset conditions.
4. To determine the adequacy of the reserve for loan losses and whether the asset charge-off policy is appropriate.
5. To determine the viability of the company as a going-concern, and whether its affiliate status represents a potential or actual adverse influence upon the condition of the consolidated corporation.

3090.1.4 INSPECTION PROCEDURES

The inspection procedures for a factor have been divided into two phases, preliminary and on-site, when considered necessary.

The preliminary phase entails the gathering and analysis of information at the parent company in order to determine the scope of the field work to be performed on-site. The on-site segment of the procedures expresses some of the typical practices and considerations in this form of financing.

During the preliminary phase, the following information should be reviewed:

1. System approvals for offices and activities, including stipulated public benefits;
2. Financial statements, both interim and fiscal, for a sufficient period to determine trends and operating patterns;
3. All management reports which should indicate problem loans, loan volume, new accounts and other reports regarding loan portfolio and company status;
4. External debt instruments to determine material restrictive covenants;
5. Internal audit reports and workpapers;
6. Minutes of the board of directors, executive committee and loan committee, if available at the parent company;
7. The results of a parent company loan review, if any.
8. To be requested:
   a. Schedules of past due loans, intercompany participations, and large loans;
   b. Schedules of problem accounts, liquidating accounts, and repossessed assets;
   c. General ledger trial balance;
   d. Loan trial balance, including overadvances;
   e. Statements of company lending, accrual, and other policies;
   f. Reconcilement of the loan loss reserve for the period between inspections;
   g. Listing of common borrowers between affiliates.

3090.1.4.1 On-Site Procedures

After reviewing the material available at the parent company, including the audit review, a decision whether to go on-site is in order. Some of the determinants of this decision are relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by internal loan review reports and problem loan reports, and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in apparently sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected which would require a visit, even though a satisfactory condition had been determined during the previous inspection. Subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected.

The following comments provide a general outline of the factor's basic operation. This outline will provide a background for the comments in the inspection procedures.

While the typical factoring agreement stipulates that all accounts receivable of a client are assigned to the factor, not all are purchased without recourse. The agreement between the factor and the client will usually state that receivables subject to shipping disputes and errors, returns, and adjustments are chargeable to the client because they do not represent bona fide sales. In addition, sales made without the factor's approval are considered *client risk* receivables, with full recourse to the client if the customer fails to pay.

The usual approval process requires the client to contact the factor's credit department before filling a sales order on credit terms. The credit department will research its files, determine the credit worthiness of the customer, and approve or reject the sale. As stated before, if the credit department rejects the sale, the client may complete the sale, but at its own risk. The most common reasons for rejection are sales to affiliates, sales to known bad risks, sales to customers whose credit cannot be verified, and sales to customers whose outstanding payables exceed the factor's credit line.

Once a sale has been made and the receivable assigned to the factor, approved or not, the client's account will be credited for the net invoice amount of the sale. That is, any trade or volume discounts, early payment terms, and other adjustments are deducted from the invoice amount. The receivable then becomes part of the client's "availability" to be paid in advance or at the computed due date, depending upon the basis of the factoring arrangement.

Each month the client will receive an "accounts current" statement from the factor which details the transactions on a daily basis. This statement will reflect the daily assignments of receivables, remittances made, deductions for term loans, and interest charges and factoring commissions. Credit memos, client risk, charge backs, and other adjustments will also be shown. Client risk charge backs are the amounts deducted from the balance due to the client upon the failure of customers to pay receivables factored at client risk.

The accounts current statement and the availability sheets will be necessary for the asset analysis process. Considering the volume of transactions, the accounting system that develops this data will probably be automated, which may allow the factor to obtain comparison and monitoring data on the client. If a monitoring system is in place, the data provided will be valuable in the asset analysis process.

The evaluation of a factor includes a review of its systems and controls as well as an analysis of the quality of its assets, both of which may be accomplished by a two segment analytical approach. A major portion of a factor's assets will be factored receivables, for which the credit department has the responsibility for credit quality and collection. The other major portion of the assets will be the client loans and credit accommodations, for which the account officers are responsible. The procedures for each area will be dealt with separately.

3090.1.4.2 Credit Department

Because of its integral function in the credit and collection process, the credit department is the heart of a factor. The department maintains credit files, which are continually updated as purchases are made and paid for by the customers. These files will include financial statements, credit bureau reports, and details of purchasing volume and paying habits. Usually, each customer will have an assigned credit line, which is the credit department's estimate of the customer's credit capacity.

The evaluation of this department should take the form of a review of a sample of the customer files. The sample may be drawn from lists of large volume customers and closely monitored customers, or it may be a random sample. The examiner should have either a copy of departmental policies and procedures or a verbal understanding of them prior to the review. It should be kept in mind that the objective of the review is to critique the credit and collection process and to verify departmental effectiveness, and not to obtain classifications.

3090.1.4.3 Asset Evaluation

Prior to the review of asset quality, the examiner should receive the lists of problem clients, client over-advances, term loans, and credit accommodations; as well as the aging schedule of factored receivables including client risk receivables. These will be used as the basis for selecting the clients to be reviewed. It is recommended that the selection be made from the list of clients with term loans, largest first, in addition to the acknowledged problems. Clients with high dilution rates and those with client risk receivables equal to 20 percent or more of factored volume may also be included.

It should be noted that a factor usually collects principal and interest payments directly from the client's availability, which means that the expected delinquency rate is minimal. Past due factored volume is not an effective measure of client quality.

A maturity client's availability is the sum of all factored receivables, less trade and other discounts, factoring commissions, credit memos, and client risk charge-backs. There may also be other deductions for letters of credit and other credit accommodations. An advance client's availability would be further reduced by advances on the factored receivables, interest charges, and the reciprocal of the contractually agreed upon ''advance'' percentage. This reciprocal, 20 percent in the case of an 80 percent advance client, is sometimes referred to as the client's ''equity'' in the factored receivables. Availability may be increased by liens on additional collateral such as inventory, machinery and equipment, real estate, and other marketable assets.

The review and analysis of asset quality will be procedurally similar to that used in accounts receivable financing. However, certain aspects of the financial statements may need elaboration. The client's balance sheet will have a ''due from factor'' account instead of accounts receivable. The account balance may be somewhat lower than a normal receivables balance, which would affect turnover ratios and other short-term ratios. The difference relates to the client's ability to convert sales to cash faster with a factor than if the receivables were to be collected normally. In addition, the analysis of the statements should incorporate an assessment of the client's ability to absorb normal dilution and the potential losses associated with client risk receivables, particularly when these factors are higher than usual for the portfolio.

As a factor's systems and controls for client loans are somewhat similar to those for accounts receivable financing, the evaluation of asset quality must consider these factors before the classification of a client is made. While the typical client may have less than satisfactory financial statements, the factor's working knowledge of the client's operations and industry tends to mitigate the risk factors present.

For classification purposes, ''client risk receivables'' is the only portion of factored volume that is appropriate for use in the amount classified. Because of the recourse aspect the balance is considered as an indirect obligation rather than a direct obligation.

As a further step in the evaluation of the lending area and its controls, the evaluation of the steps taken and the results of at least one recent client liquidation should be made. By reviewing the chronology of events along with the loan and collateral balances, the effectiveness of systems and controls under extended circumstances may be assessed. The type of liquidation will have a bearing on the losses taken. Losses tend to be higher when client fraud is involved.

In the process of evaluating a factor's condition, the adequacy of systems and controls and the capability of management are considered significant measures. Asset quality, as measured by classifications, may be influenced by seasonal aspects and should be carefully analyzed to allow for such influences. Because of a lack of regular and consistent comparative data for the industry, earnings and capital adequacy are evaluated in terms of the company's own performance.

The review of the company's internal systems and controls should be continuous during the inspection. Considering the large volume of daily transactions that flows through a factor, any internal control that can be easily negated represents a potential problem and should be brought to management's attention. In the broad context, this review would include the credit controls for both clients and customers. Since credit problems can develop rapidly in factoring, credit controls and systems must be responsive to the identification of these problems. Deficiencies noted should be discussed with management and, if significant, cited in the report. The company's earnings trends may be evaluated by using a comparative yield on assets approach. By analyzing yields on asset categories from period to period the examiner will be able to make a judgment as to the efficiency of the systems. Factors are subject to the same price competition in the commercial finance market as accounts receivable financers. Declining portfolio yields may reflect the inroads made by competition and may indicate a decline in future profitability.

The subject of capital adequacy is influenced by the aforementioned seasonal characteristics. Over the period of a year, the comparisons of equity to assets and equity to liabilities will vary significantly. It is suggested that an average balance sheet be used to stabilize the variations.

In addition to balance-sheet ratio analysis, the effects of dividends and fees paid to the parent company on the capital accounts may be analyzed to determine the rate of internal capital generation. If the company is in a growth profile, or attempting to gain market share, the comparisons between fiscal periods may reflect a declining trend. Such a trend should be discussed with parent company management.

The report comments should summarize these considerations in a clear, concise presentation.

3090.1.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Loans to affiliates	23A FRA 371c			
Purchase of affiliate's notes from a third party	23A FRA 371c		3–1131	1951 FRB 960
Activities not closely related to banking	4(c)(8) BHC Act 1843(c)(8)	225.126	4–184	
Acquisition of assets	4(c)(8) BHC Act 1843(c)(8)	225.132	4–175.1	1974 FRB 725 1984 FRB 370
Real estate mortgages as eligible collateral under section 23A	23A FRA 371c			1933 FRB 566
Indebtedness of affiliate on assets acquired from member bank	23A FRA 371c		3–1125	1936 FRB 324
Marketability of collateral under section 23A	23A FRA 371c		3–1121	1935 FRB 395
Activities closely related to banking	4(c)(8) BHC Act 1843(c)(8)	225.123 225.28(b)(1)	4–176	1971 FRB 514 1975 FRB 245 1984 FRB 50 1984 FRB 370 1984 FRB 376 1984 FRB 452 1984 FRB 736 1986 FRB 143 1988 FRB 177 1988 FRB 330 1989 FRB 79 1992 FRB 74
Community development activities	4(c)(8) BHC Act 1843(c)(8)	225.127 225.28(b)(12)	4–178	1972 FRB 572

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3090.2.1 INTRODUCTION

Accounts receivable financing is a revolving credit facility secured by an assignment of accounts receivable. As a financing technique, it allows the client (the financed company) to obtain working capital without waiting for customer payments. This form of financing is frequently used by companies with working-capital shortages, companies in seasonal industries, and companies with weak financial conditions. Typically, the funding requirements of these companies are in excess of any amounts that would be available through unsecured bank financing.

The financing process begins with a bona fide credit sale by the client and the assignment of the resulting receivable to the financer. Upon assignment, the financer advances a specific percentage of the receivable to the client. The loan is repaid by customers' direct payments or, in the case of a lockbox, by the remittance of the customer's payment to the financer, who returns the amount in excess of the loan to the client. While a simple concept for a single transaction, the operations of an accounts receivable financer become a complex process when many clients and perhaps thousands of receivables are involved.

Companies engaged in accounts receivable financing usually incorporate the full range of commercial financing activities into their operation. These activities would include inventory financing, loans secured by machinery and equipment, some forms of real estate loans, and loans secured by other assets. As a general statement, these companies will provide working-capital financing using almost any form of viable collateral to secure the loans. These additional activities are facilitated by the financer's in-depth knowledge of the borrowers' financial conditions and cash flows. This knowledge comes from the controls placed on the borrowers, such as periodic field audits, the flow of the borrower's cash through the company, and an internal staff that specializes in the financed industries.

3090.2.2 FUNDING

Accounts receivable financing companies, like factors, traditionally provide working-capital financing to seasonal industries. Consequently, the funding programs of these financing companies will reflect these variations in their increased use of short-term funds relative to other nonbanking activities.

Since many accounts receivable clients have seasonal businesses, a large portion of the financer's liabilities will be short-term debt. For internally funded financers, this debt will be predominantly commercial paper proceeds from the parent company, with perhaps some bank lines intermixed. The externally funded company will probably rely on bank lines for its short-term needs, usually with the parent company's guaranty of the debt.

Longer term funding may be provided through bank term loans and subordinated debt, although the volume of this type of debt appears to be low relative to other financing industries, another parallel to factoring. The terms and covenants of long-term debt appear to allow for more flexibility in operations and somewhat more highly leveraged positions than similar debt for other financing industries. This practice is apparently in recognition of the volatility of this form of financing and the liquidity of the assets supporting the financer's loans.

The principal suppliers of senior and subordinated funds to collateral lenders (factors and accounts receivable financers) appear to be limited to a few insurance companies that specialize in this field, although a few banks also provide senior term funding. These lenders have incorporated their perceptions of acceptable balance-sheet ratios and earnings performance into their debt agreements as restrictive covenants. Since comparative industry data are limited, these restrictive covenants may be the examiner's primary means of evaluating leverage, loss reserves, and capital adequacy.

3090.2.3 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the act and Regulation Y.
2. To determine whether transactions with affiliates, including banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolios and whether lending, monitoring, and collection policies are adequate to maintain sound asset conditions.
4. To determine the adequacy of the reserve for loan losses and whether the asset charge-off policy is appropriate.
5. To determine the viability of the company as a going concern, and whether its affiliate

status represents a potential or actual adverse influence upon the condition of the consolidated corporation.

3090.2.4 INSPECTION PROCEDURES

The inspection procedures for an accounts receivable company have been divided into two phases, preliminary and on-site.

The preliminary phase entails the gathering and analysis of information at the parent company in order to determine the scope of the field work to be performed on-site, if required. The on-site segment of the procedures expresses some of the typical practices and considerations in this form of financing.

During the preliminary phase, the following information should be reviewed:

1. system approvals for offices and activities, including stipulated public benefits
2. financial statements, both interim and fiscal, for a sufficient period to determine trends and operating patterns
3. all management reports which should indicate problem loans, loan volume, new accounts and other reports regarding loan portfolio and company status
4. external debt instruments to determine material restrictive covenants
5. internal audit reports and workpapers—
   a. internal control exception report to determine weaknesses and corrective actions,
   b. flow charts in the workpapers which will enable the examiner to become familiar with company systems, and
   c. additional internal reports may be identified which may assist the inspection on-site
6. minutes of the board of directors, executive committee and loan committee, if available at the parent company
7. the results of a parent company loan review, if completed
8. To be requested:
   a. schedules of past-due loans, intercompany participations, and large loans
   b. schedules of problem accounts, liquidating accounts, and repossessed assets
   c. general ledger trial balance
   d. loan trial balance
   e. statements of company lending, accrual, and other policies
   f. reconcilement of the loan-loss reserve for the period between inspections
   g. listing of common borrowers between affiliates

3090.2.4.1 On-Site Procedures

After reviewing the material available at the parent company level, including the audit review, a decision whether to go on-site is in order. Some of the determinants of this decision would include relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by internal loan review reports and problem loan reports, and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in apparently sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected which would require a visit, even though a satisfactory condition had been determined during the previous inspection. Subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected.

The on-site inspection procedure will be similar to that used in a commercial department of a bank. Selection and evaluation of the assets, review of internal controls, identification of lending policies, and credit review procedures are all familiar areas to the examiner and do not need further explanation. However, the accounting and reporting systems are somewhat different and will require the examiner to become familiar with systems and policies before proceeding with the asset evaluation process.

3090.2.4.2 Accounting and Controls

There are two basic systems within the accounting and control environment of an accounts receivable company. The first system provides accounting and control for client loans and collateral balances and is frequently automated to handle the large flows of data generated in the operation. It is also common to find lockbox arrangements with banks that tie into the client system for the receipt of customer remittances. Such lockbox arrangements provide a greater degree of control over remittances.

The mechanics of the client system will be detailed in the internal audit file, which should also indicate the adequacy and efficiency of the system's controls. The audit file may also indicate the accounting techniques used and the client-monitoring reports that are generated by the system, such as dilution rates and trends, and year-to-year volume and operating comparisons. The client system provides the basic data for the company's accounting and control system. While the basic accounting considerations are outlined in the AICPA *Industry Audit Guide: Audits of Finance Companies*, there are certain accounting aspects which deserve additional treatment. In some cases where a group of related companies are clients, the financing arrangements may include cross-guarantees and cross-collateralization agreements. In these cases, the financer might utilize excess availability for some of the related entities to offset the over-advance of another entity. Another treatment that may be applied is the use of a "reserve for liquidating accounts," which in some instances is a specific reserve for a problem account that reverses at least current period earnings for the account. This reserve is in addition to the allowance for bad debts and may not be an explicit balance sheet account, but an offset to gross loans outstanding.

3090.2.4.3 Definitions

While many of the following comments define certain routine accounting and control considerations for accounts receivable financing, certain of the concepts are necessary for proper evaluation of client quality (i.e., availability, dilution, over-advances, and advances on other collateral). These definitions are general in nature as is the terminology, however, the processes will be similar in almost every company.

Loans to the client are based upon a contractual percentage of the client's eligible receivables against which the financer has agreed to advance funds. Eligible receivables include all assigned receivables, less trade discounts, early payment discounts, contra-accounts (reciprocal sales between the client and customers), receivables past due beyond the eligibility period specified in the contract, and other adjustments. The advance percentage is determined by a number of factors which include the expected average dilution rate (disputed invoices, misshipped goods, returns and allowances, etc.) and the client's expected gross profit margin. As a general rule, lenders in this field try to finance only the cost of sales and not the client's profits.

Because this form of financing involves rapidly changing collateral balances, a high volume of customer payments, and frequent loan requests, the financer has to determine the client's "availability" (loanable funds) before advancing the loan. Availability is the total of eligible receivables times the advance percentage less credit memos and the current loan balance. Credit memos are adjustments to the customer's account for errors in the client's shipments (i.e., the quantity shipped was less than that ordered). It is the client's responsibility to provide this information to the financer on a daily basis. If there is sufficient availability, the requested amount is usually advanced. On occasion, the availability computation will show the client to be "over-advanced," that is the loan balance exceeds the agreed percentage advance against collateral. This situation may have occurred because some receivables have become past due, or the financer may have authorized additional funds to meet some valid client requirement. As a rule, over- advance positions are usually subject to a quick paydown to reduce the loan balance to the original contractual terms.

At times, the availability computation will reflect additional collateral value in the form of inventories, machinery and equipment, and other assets, shown net of an advance percentage. These categories usually indicate term loans, secured by liens against the respective assets, which expand the collateral base and provide additional support to the client's working capital requirements. These term loans should not be confused with loans for the acquisition of such assets which might appear only in the client's monthly statement.

The accounts receivable financer charges interest on the daily cash borrowings of the client and accumulates these charges on the client's monthly statement. The total interest charge for advances on receivables and other loans is deducted directly from remittances received by the financer. Accordingly, the expected delinquency rate for an accounts receivable operation is low except for the rare loan which is paid directly by the client and other assets which formerly belonged to a defunct client.

3090.2.4.4 Over-Advances and Other Loans

It was indicated earlier that an over-advance represented funds advanced in excess of available loanable funds and that there are two basic causes for over-advances. Some over-advances occur because a portion of eligible receivables becomes past due and ineligible for advances. This condition is usually corrected by the assignment of additional receivables or receipt of customer payments, and therefore may exist only for a few days.

The other basic over-advance occurs when a client requires additional funds for valid business purposes, such as an inventory buildup at the beginning of a season. In such cases, the over-advance is set up as a very short-term loan and paid down rapidly out of the client's availability. While the policy for over-advances varies between financers, when they are permitted they are usually carefully analyzed by the internal credit committee and closely monitored until paid off.

If a client is involved only in receivables financing and has made an over-advance request, the financer generally will prefer to take a lien against inventory rather than make an unsecured over-advance. Regardless of the purpose of the inventory loan, the financer will advance only a small percentage of the inventory value (40 to 50 percent) to allow for shrinkage, spoilage and obsolescence of the collateral. While inventory liens are in effect, the field audit staff will partially verify the inventory during each audit.

While machinery and equipment may be pledged as additional collateral to support working capital loans during the business period, most client companies will also finance equipment purchases on a secured basis. In either case, the financer usually advances a percentage of the quick sale or auction value of the equipment as determined by an appraisal. During field audits, the presence of the equipment and appropriate lien tagging are verified by the field auditors.

On occasion, a lien on real estate is part of the pledged collateral. The real estate may be operating premises, land, or the property of the principal of the client. Such liens may occur when the client is acquiring new, or expanding old, operating facilities and is using the financing relationship to fund the project. However, in many cases the lien was taken to provide additional collateral for working capital loans. In either case, appropriate documentation and appraisals should be on file.

It should be noted that loans on real estate collateral are limited to those providing support to the primary business of the client. Loans to finance speculative real estate acquisitions, and unrelated commercial property are not considered to be the usual practice of this industry, and would be considered as not complying with the general activities of a commercial finance company, unless specifically approved.

3090.2.4.5 Asset Evaluation

In selecting the loans to be reviewed, the first group to be considered is the acknowledged problem accounts. The next sample should be drawn from accounts with high dilution rates, those with frequent or large over-advances, and those which constantly take down all of their availability. Participations, purchased or sold, between affiliates should also be included in the examiner's sample. While this approach may exclude some of the larger accounts, it is intended to include those accounts which are potential problems in the primary review group. Should the company have a monitoring system for potential problem accounts, the system should be used for drawing the review sample.

The principal tools for the review process should include: the credit file, the field audit file, the monthly statement for the inspection date, the availability sheet for the inspection date, and updated information for the interim period ending with the on-site inspection date. Within the credit file, the copies of the financing agreements will indicate the specific terms of the borrowing relationship: the pledged collateral; advance percentage; interest rate; guarantees; appraisals; and the required communications, such as monthly receivables agings, inventory and machinery and equipment certification, etc. The usual file information will also include management's analysis of the client's operations.

The field audit file will contain the audit reports originated by the financer's field audit staff. These reports are usually quite comprehensive, with a primary focus upon critical financial areas. As a minimum, the auditors will analyze trade payables, State and federal taxes, cash flows, inventories, and receivables. Particular attention is paid to the client's sales and shipping procedures in order to ascertain that valid invoices are being assigned to the financer. The client's accounting procedures are also analyzed to determine their effectiveness and accuracy. These reports represent a primary source of information regarding the general financial condition of the client.

The client's monthly statement and availability sheets represent spot information on the client's activity. Many clients operate in seasonal industries such as clothing and textiles. In such industries, a client will tend to use all of its availability, as well as seasonal over-advances, during its inventory buildup period, and will pay off the over-advances and may have excess availability during the sales and collection period. The examiner will have to analyze the client's current position with regard to its particular operating cycle. Over-advances granted to a client for valid reasons do not necessarily represent undue exposure or a substandard asset for the financer.

The financial statements of a client quite frequently reflect a “relatively unsatisfactory or weak” financial condition, with minimal working capital, high leverage, and uncertain earnings as prime ingredients. There have been cases where both deficit working capital and deficit net worth were in evidence, however, the financing relationship has continued to function properly. The financer can continue these relationships if the short-term factors (sales volume, receivables and inventory turnover, and current liabilities) are appropriate and the character of the principals warrants the exposure. Analysis of a financed client should emphasize the short-term analytical factors and the related trends in the evaluation of asset quality.

Such factors as the success of the selling season, availability of materials, and fad merchandising will have direct impact on the client’s financial condition. While the loan may be adequately protected by pledged collateral, the ability of the client to continue operations may be affected by these short-term factors.

For classification purposes, the financer’s controls will have to be considered in addition to weighing the degree and quality of collateral protection, short-term factors, and the client’s ability to withstand any financial reverses that are evident. Clients with deficit net worth, past-due trade obligations, and delinquent taxes should be considered to be problems and appropriately classified. The ability of the financer to control the risk exposure in the portfolio will be an important consideration in determining whether to classify a specific loan.

3090.2.4.6 DPC Assets

In some companies, assets acquired from defunct clients remain in the loan account instead of being reclassified to another balance-sheet category. Usually, these assets are uncollected accounts receivable, inventory, and machinery and equipment which have not been liquidated. However, these assets may include securities, as well as business and personal real estate, which had been pledged as collateral. By retaining these assets in the loan category, effective liquidation of the respective assets may be delayed because they usually represent small dollar amounts. Apart from this consideration, classification as loans may disguise the fact that certain of the assets may be subject to provisions of Regulation Y and the act, such as control and retention considerations. Separate control of these assets is recommended.

It is common practice in the accounts receivable and factoring industry for the lender to require a pledge of client company stock by the principals, particularly in overextended situations. Additional pledges of securities owned by the principals may also provide added collateral. While such pledges are not precluded by Regulation Y and the act, once they become company assets they should be reviewed for control and retention purposes.

3090.2.4.7 Financial Condition

Secured lending relies upon the four C’s of credit: the traditional Capital, Character, Capacity, and Collateral. Pragmatically, these lenders practice a fifth C, Control. In this context, control implies the continuous monitoring of the client’s financial condition, continued evaluation of the collateral, constant contact with the client, and the adjusting of the credit accommodation to conform to the client’s current situation. This control is the reason that the secured lender can maintain a proper and mutually profitable financing arrangement with the client.

It is to be expected that the typical portfolio may include clients with less than satisfactory financial conditions. Considering the controls imposed upon the borrowing relationships, the secured lender has compensated for some of the additional risk in the loans. The combination of field audits, collateral controls, and account officer contact can be expected to reduce the exposure to unsatisfactory clients to a minimum. However, clients do fail and losses may be taken in liquidating the account. The incidence rate of liquidations and the extent of losses taken may be an indicator of the effectiveness of company controls.

The earnings of an accounts receivable company are based upon loans carrying interest rates above prime, which means that loan volume is a major determinant of revenues. Because this industry is very competitive, loan pricing is frequently used to obtain new clients from other lenders in order to promote growth in loan volume. Increases in loan volume combined with declining interest margins may be an indicator of price competition that is yielding negative results. Analysis of client turnover may verify this possibility.

In summary, management’s ability to control risk and achieve profitability is essential to the soundness of an accounts receivable operation.

The effectiveness of company policies, the expertise of the lending staff and field audit staff, and the adequacy of systems and controls are the expressions of this ability to control risk. Company profitability is a measure of management's ability to obtain satisfactory client quality and terms in a price-competitive environment. The examiner will have to balance these factors in assessing the condition of the company.

3090.2.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Loans to affiliates	23A FR Act 371c			
Purchase of affiliate's notes from a third party			3–1131	1951 FRB 960
Acquisition of assets		225.132	4–175.1	1974 FRB 725 1984 FRB 370
Activities closely related to banking		225.123	4–176	1971 FRB 514 1975 FRB 245
Investments in community welfare projects		225.127	4–178	1972 FRB 572

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3100.0.1 INTRODUCTION

The basic activity of a consumer finance company is making installment loans to individuals and is permissible pursuant to section 225.28(b)(1) of Regulation Y and section 4(c)(8) of the BHC Act (the act). In most areas, a company may make these loans under one or more of the following licenses: consumer discount, small loan, sales finance, or second mortgage. Most of a company's activity will probably be direct cash lending, in which the borrower and the lender come into direct contact with one another in the credit-extension process. However, a significant volume of lending is done through third-party contact. This is sales finance lending in which the company purchases, or discounts, the loans originated by a durable goods dealer in daily retail sales activity. Second mortgage lending may be originated from either direct contact or through home-improvement contractors.

Most consumer finance companies offer credit-related insurance as part of their services, and may have a captive insurance subsidiary if they are large enough. Inspection considerations and procedures for reviewing credit-related insurance activities are covered in section 3170.0.

3100.0.2 FUNDING

In some holding companies, management has elected to use a conventional industry funding pattern to support its consumer finance company operations. This pattern makes use of long-term subordinated debt in a specific proportion to equity capital. The further addition of senior long-term and short-term debt is then limited by restrictive covenants incorporated into the subordinated debt agreements. These covenants also provide operating limits for management in such areas as the proportions of specific classes of assets, minimum levels of net worth to be maintained, and the maximum dividend payout allowable. Since the wording and limits of these covenants are negotiated between the borrower and the subordinated debt holder, generalizations regarding the usual terms are not practicable.

It appears that certain life insurance companies supply most of this subordinated debt to the consumer finance industry. Along with their general knowledge of the industry, these insurance companies police their loans by requiring periodic reports from the borrower and by sending teams of their people to review the borrower's operations. In a sense, this approach to funding represents regulation and control by market forces rather than by governmental intervention.

In other holding companies, management has elected to support these operations using holding company funding sources such as commercial paper and lines of credit. In using this approach, operating management is generally free from market restrictions on operations.

It is likely that most affiliated consumer finance companies will have a funding plan that falls somewhere between these two extremes. Since commercial paper generally carries a lower total cost than bank lines of credit, the examiner may find that the senior short-term debt component is almost completely supplied by the parent company. On the other hand, long-term debt may have been obtained directly, or with the parent company's guaranty, or it may have been borrowed from the parent company's sources—that is, the parent borrows from a third party and re-lends the proceeds to the subsidiary.

Since a large volume of consumer installment paper carries maturities of three years or more, the use of commercial paper proceeds with maximum maturities of 270 days warrants some comment. Securities Act Release No. 401 specifically recognizes this use of commercial paper as appropriate. Further information may be found in the Code of Federal Regulations, 17 C.F.R. 231.4412. Also see sections 2080.1 and 5010.16 for information on commercial paper.

3100.0.3 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the act and Regulation Y.
2. To determine whether transactions with affiliates, including banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolio, and whether lending, monitoring, and collection policies are adequate to maintain sound asset conditions.
4. To determine the adequacy of the reserve for loan losses and whether the asset charge-off policy is appropriate.
5. To determine the viability of the company as a going concern, and whether its affiliate

status represents a potential or actual adverse influence on the condition of the consolidated corporation or the subsidiary bank(s).

3100.0.4 INSPECTION PROCEDURES

After reviewing the material available at the parent company level, including the audit review, a decision whether or not to go on-site is in order. Some of the determinants of this decision would include relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by delinquency reports and industry comparisons (detailed later in this section), and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in apparently sound condition. In such a case, an on-site inspection may not be warranted, providing that a fairly recent on-site inspection had been conducted. Conversely, a deteriorating condition might be detected which would require a visit, even though a satisfactory condition had been determined during the previous inspection. Subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected.

The inspection procedures for a consumer finance company have been divided into two phases: preliminary and on-site. The preliminary phase entails the gathering and analysis of information at the parent company to determine the scope of the field work to be performed on-site. The on-site phase establishes a minimum scope of the inspection at the main office, and includes considerations to be incorporated into a visit to field offices if the inspection scope is expanded to that degree.

During the preliminary phase, the following information should be reviewed:

1. system approvals for offices and activities, including stipulated public benefits
2. financial statements, both interim and fiscal, for a sufficient period to determine trends and operating patterns
3. all management reports which should indicate problem loans, loan volume, delinquencies, and other reports regarding loan portfolio and company status including the Robert Morris Associates' *Direct Cash Lending Questionnaire* and similar reports
4. external debt instruments to determine material restrictive covenants
5. internal audit reports and workpapers:
   a. internal control exception reports to determine weaknesses and corrective actions
   b. flow charts in the workpapers to become familiar with company systems
   c. additional internal reports may be identified which may assist the inspection on-site
6. examination reports of any state regulatory agencies having jurisdiction over the company's offices
7. minutes of the board of directors, executive committee, and any other such committee, if available at the parent company
8. the results of a parent company loan review or operations review, if conducted and available
9. the following items to be requested from management:
   a. detailed past-due schedules and intercompany participations
   b. schedule of problem accounts, liquidating accounts, and repossessed assets
   c. general-ledger trial balance
   d. loan trial balance
   e. policy statements on lending, accrual, and charge-offs
   f. reconcilement of the loan-loss reserve for the period between inspections
   g. organization chart
   h. listing of company offices with addresses and operating licenses

3100.0.4.1 On-Site Phase

The procedures of the on-site inspection are intended to evaluate management and its supervisory efforts, to determine the soundness and compliance with the company's operating policies, and to analyze the impact of these policies on the company's financial condition using ratio analysis. A thorough understanding of the policies and systems of the company is necessary for the examiner to accurately determine the company's condition.

During the initial period on-site, the examiner may obtain an overview of the company's systems by interviewing the key staff officers. These individuals can provide the examiner with the detailed reports, policy manuals, and other information necessary for the inspection.

3100.0.4.2 Policy Evaluation

Because of its large volume of transactions and the number of offices involved, the typical consumer company will maintain an extensive set of policy and procedure manuals which are intended to guide company personnel in their daily activities. During the review of these manuals, the examiner should bear in mind that liberal policies and procedures may allow the company to mask portfolio problems and reflect other than an accurate condition in its financial statements.

The principal policies to be considered cover such areas as:

1. extensions of credit;
2. treatment of delinquent accounts and partial payments;
3. loan renewals;
4. loan charge-offs;
5. provisions for loan losses;
6. bulk purchases of loans, for both credit and account purposes; and
7. treatment of deferred income.

After assessing the soundness of company policies, the next step is to test their implementation through a review of the company's supervisory structure.

3100.0.4.3 Evaluation of the Supervisory Structure

The effectiveness of the supervisory structure is a key element in the condition of a consumer finance operation. This system serves two functions: it communicates the policies to the field personnel, and it enforces those policies. Assuming that management's policies are valid, the effectiveness of this system will be partially reflected in the ratio analysis of the company. However, it may take close analysis to determine whether any poor ratios are due to inadequate policies or ineffective enforcement.

In order to evaluate the supervisory effort, the examiner may review a sample of the various supervisor's reports which are prepared after visits to the loan offices. The sample should represent a cross-section of the offices and supervisors in order to obtain a balanced view of the company.

A further evaluative step may be undertaken if there are sufficient resources available to the examiner. The on-site visits to selected loan offices may provide considerable input to the examiner in assessing supervisory effort. In selecting the offices to be visited, well-performing as well as poor-performing offices should be selected. Concentration on poor offices will result in a biased assessment of the supervisory effort and may result in an invalid evaluation of company policies. The selection of the offices may be made by using the number of policy exceptions cited, poor performance records, or local economic conditions as criteria.

3100.0.4.4 Detailed Procedures for an Office Visit

The following steps outline a general procedure for determining field compliance with company policies and assessing the effectiveness of the supervisory effort. The examiner may modify, eliminate, or expand any of these steps or may devise any procedure deemed appropriate under the circumstances present.

The review of loans on-site should be oriented toward confirming the implementation of company policies for delinquency, balance renewals, charge-offs, extensions, partial payments, collection, and loan approvals. This review is intended to be a test of compliance and not a review of specific assets for classification purposes.

1. Review the detailed delinquency report for the selected office for a short period before the inspection date, generally two or three months. Trace the well overdue loans through to resolution, pay-off, charge-off, or reinstatement. Check these loans against the loan register to determine whether new loans have been granted to these customers and if so, determine if they are in accordance with company policy.
2. Review the controls for charging off loans and determine the effectiveness of the collection and recovery effort.
3. Review the loans to present borrowers. While renewals are usually granted to the better customers, the examiner will find a volume of renewals ("under 10 percent new money advanced" loans). In some companies, these "under 10 percent new money" loans represent efforts to rehabilitate borrowers with poor payment records due to ill health, unemployment, etc. However, the examiner may find that management is using this approach to adjust and control delinquency and loss rates. There should be sufficient internal controls present to prevent the continuous renewal of such loans to poor borrowers.

The examiner may find that some office personnel are circumventing these controls, for example, by advancing 11 percent new money to the borrower. If found, such circumvention raises serious questions regarding portfolio quality, the adequacy of internal controls, and the effectiveness of the supervisory effort. A high volume of "under 10 percent" loans or evidence of circumvention of controls may warrant separate treatment in the report.

4. Review partial-payment, interest-only, and extension accounts. Significant numbers of these accounts may indicate potential problems for the loan portfolio and the office.
5. Review credit-extension and loan documentation procedures, especially if the office's portfolio has a high level of losses or frequent litigation. Proper credit controls and documentation are essential for sound operations. If the office extends second mortgage financing, appraisals and lien searches should be included with the documentation.
6. Test the office's delinquency reporting. There are two methods for computing delinquencies, a contractual basis and the recency basis. On a contractual basis, principal reductions are applied to the most overdue payment under the contract and the loan is considered past due from the date of the oldest unsatisfied payment. On a recency basis, delinquency is computed from the date of last payment regardless of contract terms.

   As an example, assume a loan was granted with payments beginning the first of March. The borrower makes the first payment on time and the second payment on the first of June. On the first of April, the loan is a 30-day recency account and current contractually. On the first of May, the loan is a 60-day recency account and a 30-day contractual account. Upon receipt of payment in June, the loan is current on a recency basis and a 60-day (two-payment) contractual account. Notice the difference in computations between the banking industry and the consumer finance industry.

   The consumer finance industry has begun to institute contractual delinquency reporting standards. As these standards are developed and refined, changes in the computation of delinquent accounts may be expected.
7. Review the collection effort. The past-due accounts will be under the control of the collection manager, whose objective is to return these accounts to current status. The manager's collection efforts must begin early in the delinquency pattern if the loans are to be salvaged from charge-off. Consistent, persistent, frequent effort is expected.

The foregoing steps should provide the examiner opportunity to evaluate the company's policies, procedures, and supervisory systems.

3100.0.4.5 Additional Procedures

While field visits are a desirable aspect of the inspection procedure, the examiner may have to rely on other procedures to be satisfied with certain aspects of company operations, particularly when the company reports past-due receivables on a recency rather than a contractual basis. The additional procedures may be necessary when the examiner has other reasons to question portfolio quality or the adequacy of internal controls.

The examiner may perform an extensive review of the most recent audit of the company, including the workpapers and programs of the internal and independent auditors, when available. In this review, the examiner should be able to determine whether internal controls are adequate, and portfolio characteristics are properly reported.

3100.0.4.6 Compliance

Certain aspects of the company are subject to review for compliance with the requirements of the act and Regulation Y. These include public benefits, office activities and locations, and bulk purchases of assets.

1. Public benefits stipulated in approval orders frequently require continuing reduced interest rates or insurance charges as part of the approval to operate. It is expected that these relative public benefits continue in effect despite changes in state-mandated rates.
2. Office locations and activities are subject to approval by the Board before opening for business. The operating licenses and activities of the offices should also be reviewed for compliance with the respective approvals.
3. On occasion, a consumer finance company may make a bulk purchase of loans or other assets of another finance company. Under certain circumstances, these purchases require the prior approval of the Board (12 C.F.R. 225.132). These bulk purchases should not be confused with the bulk purchase of sales finance contracts from a retailer recently signed to a dealer agreement.

4. While most consumer finance activity relates to consumer installment loans, some companies also extend credit under the "large loan" provisions of the consumer lending statutes of certain states. While the limitations vary from state to state, these provisions allow loans of many times the size of normal consumer loans. A review of these large loans may indicate that there are extensions of credit to local businesses which may constitute commercial installment lending. Unless specifically approved by the System, this activity may not be permissible for the company being inspected. Review for compliance with various consumer regulations is the responsibility of the Federal Trade Commission.

3100.0.4.7 Asset Classification Policy

As previously discussed, companies use one of two different methods of delinquency computation. In general, classifications should be based on the *contractual* reporting basis whenever possible. Since much of the industry utilizes *recency* reporting, which tends to reduce classifications comparatively, the classification approach enumerated above may unduly penalize an affiliated company using the contractual basis. This is particularly true when such important measures of portfolio quality as the liquidation ratios are in line with industry averages. Therefore, formula classification may result in more severe classifications for companies using the contractual method than those reporting on a recency basis. Examiners should indicate the reporting method used when calculating classifications.

Classification information is used to evaluate the adequacy of the loss reserve. In assessing the adequacy of the loss reserves, the examiner should take into consideration the charge-off frequency, the period of delinquency which would require charge-off under company policy, and the controls regarding renewal of severely past-due accounts. A shorter charge-off cycle prevents the accumulation of poor-quality assets; in this respect, monthly charge-offs are preferable to annual charge-offs. An unlimited "when deemed uncollectible" charge-off policy is considered lax and inadequate. The delinquency period to required charge-offs refers to the period of time a loan is past due before it is charged to the reserve; a six-month period is understandably preferred to a nine-month or one-year period. Management should have sufficient controls in place to prevent the continued renewal of loans to avoid charge-off. Adequate controls might include special coding of such loans, with supervisory review of the renewals. Inadequate controls over these assets represent poor management practices deserving special comment.

Most subordinated debt agreements provide for an adjustment (reduction) to net worth when calculating compliance with leverage limits for any loans past due 60 days on a recency basis that exceed loss reserves. As there are some seasonal characteristics to the loan portfolio, it may be of benefit to compare the delinquency statistics on inspection date to the company's seasonal pattern as revealed in both the subordinated debt calculations and monthly past-due reports. It is possible that a currently adverse portfolio condition may be due to local economic conditions which correct themselves over a period of time. Such conditions may relate to a tourist economy, an agricultural community, or a strike at a major local employer's plant. Consumer finance companies are very sensitive to these local factors; therefore, these factors may temper the examiner's evaluation of the loss reserves.

3100.0.4.8 Ratio Analysis

In order to assess the condition of a company using ratio analysis, the examiner will have to be familiar with the company's accounting policies and systems. It will become obvious from the data used in the ratios that, under certain accounting treatments, the data can be misinterpreted. The following analysis has been structured around the *Direct Cash Lending Questionnaire,* published by the Robert Morris Associates and endorsed by the National Consumer Finance Association, in an effort to provide both a format for developing the information and a means of minimizing the possibility of misinterpretation. While some consumer companies do not prepare the questionnaire, much of the information is required for management purposes and should be available from company systems.

The analytical factors presented have been derived from two principal sources: *A Lender's Approach to a Realistic Analysis of Consumer Finance Companies* by Richard E. Edwards (Philadelphia: The Philadelphia National Bank, 1970) and the *Industry Audit Guide: Audits of Finance Companies* by the Committee on Finance Companies (New York: American Institute of

Certified Public Accountants, 1988). These sources provide basic information on certain accounting and management policies and are recommended as references for the examiner. While the Federal Reserve System stipulates no specific accounting policies, the examiner may choose to criticize those policies which result in a misleading presentation of the company's financial condition.

Each year the *Annual Statement Studies,* published by Robert Morris Associates, includes sets of consumer finance company operating ratios. This information will provide a background against which the performance of the company under inspection can be measured. Such compiled ratios should be used only as background as they represent the ''average company'' in the respective sample. Attention should be directed toward the company's trends as they compare to the industry's trends and the changes in the company that are indicated by those trends.

3100.0.4.9 Delinquency

As shown in the *Annual Statement Studies,* the delinquency rates are on a recency-of-payment basis. *While past-due statistics based on contractual payments are preferred,* companies continue to report on a recency basis. It is important to have full knowledge of the company's reporting, lending, and renewal policies in order to fully understand the implications of this data. The trends for ''interest-only'' accounts and ''partial-payment'' accounts will provide some measure of the adherence of the operating personnel to company policy regarding these loan categories.

3100.0.4.10 Liquidation

Liquidation ratios provide two types of information. First, they indicate the amount of principal cash flowing back to the company for liquidity purposes. Secondly, they indicate the amount required to pay senior debt and the period of time required to do so. Several ratios follow:

1. Average monthly cash principal collection to average net monthly outstanding.

   The higher this percentage, the more liquid the portfolio. A company following conservative policies such as requiring full payments and a contractual aging of receivables will tend to show a higher principal collection percentage and, accordingly, a higher liquidity. This ratio can be used to estimate near term collections as compared to current outstandings.

   Monthly cash collections should not include loan renewals or rebates during the period. On an industry-wide basis, there appears to be a pattern of increased loan renewals during November and December, which would be reflected in a seasonal decrease in principal cash collections. Lower than expected collections may be indications of changes in local economic patterns or of increased market effort by a competitor which has resulted in loan payoff. In any event, adverse change in the collection pattern should be reviewed for the underlying causes.
2. The ratio of unsubordinated liabilities less cash and near cash to estimated monthly principal collections results in the number of months it would take to pay senior debt.
3. The ratio of senior debt to gross receivables reflects the proportion of gross receivables which would have to be liquidated to repay senior debt. The higher the percentage, the more senior lenders are relying on the assets for protection.

3100.0.4.11 Loss Reserves

Analysis of the loss reserve for a specific entity has to include company policy regarding loan charge-offs, delinquencies, payments, and charge-off frequency. In addition, if charge-offs are made gross of deferred income, the reserve account may be slightly larger than if charge-offs were net of deferred income. Ratios used to evaluate loss reserves include—

1. Reserve for loan losses to total receivables, net of deferred income,
2. Loans charged off less recoveries to average outstandings (net or gross of deferred income, depending on policy).

   Unless the company's charge-off and delinquency policies are realistic, this ratio will not depict true losses over the periods, and
3. Recoveries to loans charged off tends to be higher in companies with conservative charge-off policies than those with liberal policies. This ratio is indicative of the effectiveness of a company's collection and follow-up policy.

3100.0.4.12 Volume

Analyzing aspects of a company's loan volume can provide the examiner with some information regarding the company's renewal and credit policies.

Lengthening of loan maturities during the current period will be reflected in the future average monthly principal collections and in the company's liquidity. While loans of longer maturity are not necessarily indicative of an adverse trend, the reasons behind a longer maturity portfolio should be analyzed. Ratios used to evaluate loan volume include:

1. *New money advanced to present borrowers to total loan volume.*

   This ratio is somewhat indicative of whether the company's renewal policy is conservative or liberal. A high percentage may indicate that a volume of new money is being advanced along with the renewal of the previous balance.

2. *Loans to present borrowers with less than 10 percent new money advanced to loan volume.*

   A high ratio can indicate the possibility of disguised delinquencies and potential charge-offs. The examiner may take a random sample of loans in the new money advanced to present borrowers category and review them to determine whether or not the company's "balance renewal" policy is being followed.

The preceding ratios were presented because they represent a means of measuring the effect of certain company policies. The analysis of company operations may be expanded to include other ratios such as return on equity, return on assets, interest margins, and other conventional measurements. The particular format utilized will, of course, vary to some degree between companies, however, the analysis should be broad enough in scope to determine the company's trends and the causes of those trends.

3100.0.4.13 Evaluation of the Company's Condition

Ratio analysis of a consumer finance company is a feasible technique for evaluating its condition because of the "portfolio effect" of its assets. However, the examiner must look beyond the ratios and analyze the effects of company policies on the elements of the ratios. As an example, if a company only charges off loans once a year, the losses determined by a formula classification would be less just after the charge-off date than just before.

In comparing classifications from one inspection to another, there might be a difference in the loss classifications which may be interpreted as an apparent improvement or decline in asset quality should the inspections bracket the charge-off date. Similar misinterpretations can occur from a change in charge-off frequency, a change to an automatic charge-off policy, or a shortening in the past-due period required for charge-off.

Certain accounting and reporting techniques may also be misleading in ratio analysis. For example, an artificial improvement in earnings would be reported when a company changes from a collection basis to an accrual basis of income recognition, if the collection and follow-up policy had been poor or deteriorating. Only a thorough review of the accounting policies and an understanding of their interplay with operating policies will prevent this type of misinterpretation. In some cases, the company's accounting system may yield results that inadvertently distort the ratios. A company recognizing income on a straight-line basis would, during a period of low loan volume, reflect improving gross interest income as a percentage of loans outstanding. While the importance of realistic accounting policies cannot be overstated, neither can the proper interpretation of reported results be overstressed.

One of the key elements in the evaluation of the company's performance is reflected in the ratios, but not quantified by the analysis. The company's internal controls and management information systems are the primary means of controlling asset quality and communicating management's policies. The supervisory effort is not only reflected by the ratios, but also in such areas as personnel turnover, citations in state supervisory reports, audit exceptions, and litigation. The systems relied on by management should be responsive not only to the changing needs of the company, but also to the changing climate of consumer regulations.

In the inspection report commentary, the examiner should maintain an objective view of the company under inspection. Management's corrective actions for exceptions and plans to reverse adverse trends are a necessary ingredient in the commentary. Report comments should give the reader an accurate picture of the condition of the company and its relationship with, and impact on, the financial condition of the consolidated corporation and the subsidiary bank(s).

3100.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Activities not closely related to banking		225.126	4–184	
Marketability of collateral under section 23A			3–1121	1935 FRB 395
Activities closely related to banking		225.123	4–176	1971 FRB 514 1975 FRB 245
Expansion of activities of a trust company, or acquisition of a de novo bank, to include consumer lending		225.28(b)(1)		1984 FRB 371 1985 FRB 51 1985 FRB 55 1985 FRB 61 1985 FRB 253

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

The Board amended Regulation Y, effective April 21, 1997, to include the acquiring of debt in default as an authorized nonbanking activity for bank holding companies (see Regulation Y, section 225.28(b)(2)(vii)). A bank holding may acquire debt that is in default at the time of acquisition if the company—

1. divests shares or assets securing debt in default that are not permissible investments for bank holding companies, within the time period required for divestiture of property acquired in satisfaction of a debt previously contracted under section 225.12(b) of Regulation Y;
2. stands only in the position of a creditor and does not purchase equity of obligors of debt in default (other than equity that may be collateral for such debt); and
3. does not acquire debt in default secured by shares of a bank or bank holding company.

The Board held that these restrictions were necessary to define the scope of the activity and to ensure that the activity remains the acquisition of debt instead of an impermissible nonbanking activity involving the acquisition of securities or other assets. As for calculating the time period for disposing of the underlying shares or assets, the time period is the same as that applied under the BHC Act to disposing of shares or assets acquired in satisfaction of a debt previously contracted. During this period, a bank holding company can divest the property or, in the case of any debt that has been previously contracted, restructure the debt.

The initial Board order that was issued to permit the acquisition of defaulted debt is summarized here as a historical example of the nonbanking activity. Provisions or commitments made in the Board order should not be relied upon. The current requirements are found in section 225.28(b)(2)(vii) of Regulation Y.

3104.0.1 ACQUISITION OF DEFAULTED DEBT—BOARD ORDER

A bank holding company (the applicant) within the meaning of the BHC Act gave notice under section 4(c)(8) of the BHC Act (12 U.S.C. 1843(c)(8)) and the Board's Regulation Y that it proposed to acquire a company (the company) and engage nationwide in asset-based commercial lending and management of assets.

The applicant proposed to engage through the company in managing certain assets as the corporate general partner in two limited partnerships (the partnerships).[1] The applicant committed to conduct the activities, which the Board previously determined to be permissible, through the partnerships, subject to the limitations previously established by the Board.[2]

One nonbanking activity proposed by the partnerships, acquisition of defaulted debt, was an activity that the Board had not previously approved. The partnerships are engaged primarily in making, servicing, and investing in discounted bank loans and other debt securities.[3] The partnerships acquire debt that has been or is in the process of being restructured, including secured and unsecured debt in the form of bank loans, privately placed and publicly traded debt instruments, bonds, notes, debentures, and discounted receivables.[4] The applicant stated that the partnerships will take an active role in the restructuring of the defaulted debt they acquire, including participating on creditors' committees. The applicant indicates that such discounted debt would be acquired for the purpose of restructuring the debt to achieve a higher yield and greater collateral protection.

Some of the debt the partnerships would acquire may be in default at the time of acquisition and may be secured by voting shares or

1. The first partnership group (in which the company owned more than a 50 percent interest) was to terminate by December 31, 1995. The company owned less than 50 percent of the second partnership group, which would terminate by December 31, 1999.

2. See 1994 FRB 736. The partnerships, together with the applicant and its affiliates, would hold not more than 5 percent of any class of voting securities of any issuer and not more than 25 percent of the total equity, including subordinated debt, of any issuer. In addition, the applicant committed that no directors, officers, or employees of the applicant or its affiliates will serve as directors, officers, or employees of any issuer of which the applicant and its affiliates hold more than 10 percent of the total equity. The applicant also committed that future limited partnerships would be structured in the same manner as the current partnerships.

3. The partnerships are not leveraged, and the applicant stated that the partnerships will not be leveraged. The applicant has committed that neither the applicant nor any of its subsidiaries would be permitted to make loans to the partnerships.

4. The debt investments may include investments in companies that may be contemplating, be involved in, or recently have completed a negotiated restructuring of their outstanding debt or a reorganization under chapter 11 of the Federal Bankruptcy Code.

other assets that would be impermissible for a bank holding company to hold without Board approval.[5] Because the partnerships would have the right in some cases to take title immediately to shares or assets securing defaulted debt that they acquire, the applicant committed that the partnerships would treat this collateral, as well as any other assets acquired in renegotiating this debt, as assets acquired in satisfaction of a debt previously contracted (DPC). Under the BHC Act, a bank holding company must divest any shares or assets acquired as DPC within two years from the date the asset is acquired. For this purpose, the applicant has committed that it will consider shares or assets acquired in satisfaction of defaulted debt to have been acquired on the date the defaulted debt is acquired.[6]

The Board stated that the acquisition of defaulted debt under the circumstances and conditions proposed by the applicant is an activity that is closely related to banking. The applicant stated that it will only purchase debt, not equity, and will stand in the position of a creditor.

Based on all the facts of record, the Board concluded that the proposed activities are closely related to banking. The Board approved the notice on October 17, 1995 (see 1995 FRB 1128). Approval was specifically conditioned on the applicant's compliance with the commitments made in connection with the notice.

5. The applicant has committed that the partnerships will not acquire debt in default that is secured by shares of banks or bank holding companies.

6. The applicant could apply for up to a three-year extension. See 12 C.F.R. 225.22(d)(1). The Board notes that the divestiture requirement would be satisfied if, during the divestiture period, the partnerships renegotiate the debt into a performing obligation and release the collateral to the borrower as part of the renegotiation. To the extent that defaulted debt acquired by the partnerships is secured by assets or shares that would be permissible investments for a bank holding company, this divestiture commitment would not apply.

A bank holding company applied for the Board's approval, pursuant to section 4(c)(8) of the BHC Act, to engage de novo, through its existing nonbank subsidiary, in credit card authorization services and lost/stolen credit card reporting services. The credit card authorization activity would consist of providing, for a fee, a service to issuers of credit cards that would enable merchants to determine the validity and credit limits of cards tendered to them. In addition, the applicant was to provide, for a fee, a reporting service to credit card holders, that would enable them to report the loss or theft of any of their credit cards via a single toll-free telephone call to the nonbank subsidiary.

A number of banks indirectly offer the service of reporting lost cards that are issued by other institutions by arranging with independent companies to provide the service under a trade name associated with the bank. With respect to credit card authorization services, banks have a financial interest in the security of the credit cards and the availability of credit. Based on the foregoing, the Board believed that banks generally have, in fact, provided the services proposed by the applicant and are particularly well suited to provide the proposed services. On that basis, the Board concluded that the proposed services were closely related to banking.

Since the proposed credit card reporting service would create more competition and provide greater conveniences by allowing an individual who loses more than one card to report all lost cards at once to one source rather than having to make separate notifications to each card issuer, and there was no evidence of adverse effects as a result of the proposal, the application was approved by the Board on January 5, 1985 (1985 FRB 648). See Regulation Y, section 225.28(b)(2).

Section 4(c)(8) of the BHC Act (Stand-Alone Inventory-Inspection Services) Section 3107.0

A domestic bank holding company (the applicant) applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23(a)(3) of the Board's Regulation Y to engage de novo, through a wholly owned subsidiary, in the following services to customers who make loans secured by inventory:

1. identifying inventory and deciding its general condition, level of protection, and amount of use, as appropriate
2. identifying inventory subject to a purchase-money security interest under the Uniform Commercial Code
3. identifying missing inventory and any credit exposure that could result
4. supporting the proper allocation of loan payments that are related to the aging or sale of inventory[1]

The applicant would provide the above inventory-inspection services only in connection with an extension of credit either by the BHC (applicant) or a third pary. The service would be provided throughout the United States, but only in connection with inventory pledged as collateral for a loan.

Bank holding companies currently inspect and survey collateral for loans made or services provided by them. Banks inspect collateral for loans originated in direct lending activities. The applicant suggested that its proposed collateral-inspection services to third-party lenders are identical to the collateral-inspection services performed for its own extensions of credit.

In accordance with section 225.28(b)(1) of Regulation Y, the Board authorized bank holding companies to make, acquire, and service loans for the company's own account or for the account of others. The Board believes that these activities include collateral-inspection services provided to third parties in connection with third-party extensions of credit. The Board also believes that bank holding companies have the necessary expertise to provide this service for other lenders (on a stand-alone basis).

The Board found that public benefits would result from a potential increase in the availability of inventory financing. It noted that there was no evidence suggesting that the proposal would result in significant adverse effects. The financial and managerial resources of the applicant were believed to be consistent with previous approvals. The Board, based on the facts of record, and the commitments and conditions made by the applicant, approved the request on September 13, 1993 (1993 FRB 1053).

1. For example, a loan may be secured by a pool of inventory collateral, but there may be an agreement to apply loan proceeds to specific items of collateral in a specified order. Equipment used beyond a stated number of hours might be of limited value, and the lender might agree to release its security interest in such items. The inspection of inventory collateral would verify the equipment's proceeds to pay off the oldest (or the youngest) items of collateral first (or last), rather than applying the proceeds pro rata to all items.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2015, this section was revised to amend the beginning discussion and to include statutory and regulatory citations and a current Board order reference within section 3110.0.4.

A bank holding company may acquire or retain an industrial bank to the extent authorized by state law, under section 225.28(b)(4) of Regulation Y only if the industrial bank acquired by the holding company is not a "bank" within the meaning of the Bank Holding Company Act. Industrial loan companies, industrial banks, and Morris Plan banks are state-chartered financial institutions that engage primarily in the business of furnishing consumer loans and small- business loans. The distinction between these institution and consumer finance companies lies in the ability of the industrial loan company to generate funds through the acceptance of deposits or issuance of certificates of indebtedness (thrift notes). Although some of these institutions have the same charters as banks (in some states), they traditionally have not been considered to be banks for purposes of the Bank Holding Company Act as they cannot both make commercial loans and accept demand deposits, although in some states they have been empowered to offer NOW accounts. Under a decision of the Supreme Court, NOW accounts are not demand deposits for the purposes of defining what a bank is. Thus, industrial loan companies and similar institutions may offer NOW accounts and make commercial loans without being treated as banks for purposes of the Bank Holding Company Act. These institutions may be insured by the Federal Deposit Insurance Corporation and are eligible for membership in the Federal Reserve System.

3110.0.1 NONBANKING ACQUISITIONS NOT REQUIRING PRIOR BOARD APPROVAL

In accordance with 12 C.F.R. 225.22(d)(8) of Regulation Y, the Board's prior approval is not required for certain asset acquisitions by a lending company or industrial bank. This refers to the assets of an office(s) of a company of which all, or substantially all, the assets relate to making, acquiring, or servicing loans for personal, family, or household purposes, if—

- the acquiring company has previously received Board approval to engage in lending or industrial banking activities under Regulation Y;
- the assets acquired during any 12-month period do not represent more than 50 percent of the risk-weighted assets (on a consolidated basis) of the acquiring lending company or industrial bank, or more than $100 million, whichever amount is less;
- the assets acquired do not represent more than 50 percent of the selling company's consolidated assets that are devoted to lending activities or industrial banking business;
- the acquiring company notifies the Reserve Bank of the acquisition within 30 days after the acquisition; and
- the acquiring company, after giving effect to the transaction, meets the Board's capital adequacy guidelines and the Board has not previously notified the acquiring company that it may not acquire the assets under the exemption.

3110.0.2 INSPECTION OBJECTIVES

1. To determine the quality of the loan portfolio and the overall condition of the company.
2. To determine what exposure the subsidiary presents to the holding company and subsidiary bank(s).
3. To determine compliance with applicable laws and regulations.

3110.0.3 INSPECTION PROCEDURES

1. Contact the applicable state regulatory agency to determine the legal parameters within which the company operates and to assess the degree to which the company is supervised. Each of the institutional structures under this exemption is state chartered, and the laws and regulations vary widely from state to state. The company may be directly supervised by its state department of banking or may be subject to virtually no supervision or regulation. If the company is insured by the Federal Deposit Insurance Corporation or is a member of the Federal Reserve System, the company is primarily subject to the primary supervision and regulation of that agency. In cases in which the

company is supervised by a banking agency, that agency's report of examination will generally suffice. However, when the company is not supervised or examined, or when the Reserve Bank finds the supervising agency's report inadequate, an on-site inspection is necessary.

2. Focus on an evaluation of the loan portfolio and securities account, a determination of the volatility of the deposits, an appraisal of the adequacy of the audit program, and a review of the company's internal policies.
3. Review the receivables representing lending activities. The company should provide a schedule of the aging of the consumer receivables. It is preferable that the aging be done on a contractual method. Classification of the consumer paper may be done on a formula basis. The larger credits must be given a complete evaluation.
4. Review the adequacy of the allowance for loan and lease losses in conjunction with the asset evaluation.
5. Price the securities portfolio, with particular emphasis placed upon determining its liquidity. Since the deposits of these institutions are not always insured, they are more susceptible to a deposit run off; therefore, the requirement of adequate liquidity is of paramount importance.

   The deposits may be insured by a guaranty corporation up to a certain limit in some states. These guaranty corporations have provided some stability to the industry. The guaranty corporations are independent of any government agency or municipality and therefore are limited in the amount of protection which can be offered depositors.
6. Review back-up lines of credit available to ensure secondary liquidity to the company.
7. Review the deposit accounts of the company. The deposits are evidenced by certificates of indebtedness, or thrift notes. Information regarding the number of deposits, the size of accounts, and maturity distribution should be obtained to assess the stability of the funding base.
8. Determine that the institution makes proper disclosure to the public as to the type of instrument the certificate represents. Some states require that a disclosure statement, or a prospectus, be filed with the public yearly, which sets forth the uses to which the funds are being put and states that the funds are not insured. This prospectus should be reviewed for proper disclosure of the required information to ensure against possible suits.
9. Check the company's policy concerning withdrawals, giving recognition to state law requirements, to ascertain whether funds are generally not allowed to be withdrawn without prior notice.
10. Review the scope of the internal or external audits.

3110.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Reference for authorized nonbanking activity—activity closely related to banking	4(c)(8) 4j(2)(A)	225.28(b)(4)		1982 FRB 253 1983 FRB 921 1984 FRB 231 1984 FRB 234 1984 FRB 371 1984 FRB 469 1984 FRB 741 1985 FRB 476
BHC indirect acquisition of an industrial bank	4(c)(8) 4j(2)(A)	225.24 225.28(b)(1) and (3)		2014 FRB 59, Q2
Nonbanking acquisition not requiring Board approval (conditions specified)		225.22 (d)(8)		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2016, this section was revised to include in subsection 3111.03 additional Board orders that have authorized the acquisition of savings and loan holding companies.

3111.0.1 ACQUISITION OF A SAVINGS ASSOCIATION

Prior to 1989, the Board had determined that the operation of a savings association was closely related to banking but concluded, as a general rule, that the operation of a savings and loan association was not a proper incident to banking because the potential adverse effects, of allowing the affiliations of banks and thrift institutions outweighed the potential public benefits (1977 FRB 280). Upon consideration of some individual cases, the Board found that the adverse effects of the affiliation would be outweighed by the public benefits of preserving the failing thrift institution as a competitor in its market and of ensuring public confidence. (See 1985 FRB 462.) The 1982 Garn–St Germain Act recognized the Board's authority under section 4(c)(8) of the BHC Act to approve such acquisitions by authorizing the Board to dispense with the necessary notice and hearing requirements of this section under appropriate emergency circumstances.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) amended section 4 of the Bank Holding Company Act (BHC Act) to authorize, effective August 9, 1989, bank holding companies (BHCs) to acquire any savings association. The legislation lifted the previously existing "tandem operations" restrictions as they applied to savings associations owned by BHCs. (See 1989 FRB 716, appendix I.) These restrictions (1) provided that savings associations acquired by a BHC could not be operated in tandem with any other subsidiary of the BHC and (2) required approval by the appropriate Federal Reserve Bank before the savings association engaged in any transactions with the BHC or its other subsidiaries. The Board may not impose these restrictions on such transactions in the future, except for those restrictions required by sections 23A and 23B of the Federal Reserve Act.

With respect to previous Board approvals of the acquisition of problem thrifts by BHCs, FIRREA required the Board to modify those approvals by limiting any restrictions on transactions between the savings association and its holding company affiliates to those required under sections 23A and 23B of the Federal Reserve Act. In 1989, the Board removed the tandem restrictions imposed on the operations of savings association subsidiaries of a BHC. (See 1989 FRB 71b.)

The Board amended Regulation Y pursuant to FIRREA, effective October 10, 1989 (12 C.F.R. 225.28(b)(4)(ii)). The regulation allows BHCs to acquire healthy and failed or failing savings and loan associations in accordance with FIRREA. The regulation permits BHCs to acquire savings and loan associations in any state, regardless of whether the holding company may operate a bank in that state. It does not impose any operational or branching conditions on the operation of savings and loan associations. The regulation authorizes, as a permissible activity under section 4(c)(8) of the BHC Act, the owning, controlling, or operating of a savings association if the savings association engages only in deposit taking, lending, and other activities that are permissible for BHCs.[1] The Board has permitted a short divestiture period for impermissible investments and other activities. (See 1992 FRB 707.)

The Board requires that when a BHC acquires a savings association, the BHC must conform the acquired institution's direct and indirect activities to those permissible for BHCs under section 4 of the BHC Act.

In 2002, a foreign banking organization subject to the provisions of the BHC Act, and its wholly owned subsidiary, requested the Board's approval under section 4(c)(8) and section 4(j) of the BHC Act to acquire a savings association and thereby engage in operating a savings association, and to conduct certain nonbanking activities as a result of that acquisition. The foreign banking organization committed that it would conform all the activities of the acquired savings association to those permissible under

1. Section 225.2(m) of Regulation Y defines a savings association as (1) any federal savings association or federal savings bank; (2) any building and loan association, savings and loan association, homestead association, or cooperative bank if such association or cooperative bank is a member of the Savings Association Insurance Fund; and (3) any savings bank or cooperative deemed by the director of the Office of Thrift Supervision to be a savings association under section 10(*l*) of the Home Owners' Loan Act.

section 4(c)(8) of the BHC Act and Regulation Y. (See section 225.28(b)(4)(ii). See also 2002 FRB 385, 2002 FRB 485, 2003 FRB 439, 2004 FRB 503, and 2005 FRB 91.) The foreign banking organization was also treated as a financial holding company. Any other activities of the acquired savings association were, therefore, required to conform to those permissible for a financial holding company under section 4(k) of the BHC Act.

3111.0.2 APPROVAL TO BECOME A BHC BY ACQUIRING ANOTHER BHC

A savings and loan holding company (SLHC) requested the Board's approval, under section 3 of the BHC Act, to become a bank holding company (BHC), by merging with HN Corporation (a bank holding company) and thereby acquire HNB, a national bank. The SLHC requested the Board's approval to continue to operate SB, a subsidiary federal savings bank, until its conversion to a national bank. After the merger, SLHC would convert SB to a national bank and merge its subsidiary commercial bank (SCB) and HNB into SB, the survivor being SB.

SLHC also requested the Board's approval under section 3 of the BHC Act to acquire HN's minority interest in another BHC, BBI and its subsidiary bank, B Bank.

3111.0.2.1 Financial, Managerial, and Other Supervisory Considerations

Sections 3 and 4 of the BHC Act require the Board to consider the financial and managerial resources and future prospects of the companies, banks, and savings associations involved in a proposal and certain other supervisory factors.[2] These factors include supervisory and examination information received from the relevant federal and state supervisors of the organizations involved in the proposal, and other available financial information, including information provided by the SLHC. The Board is required to consider the managerial resources of the organizations involved and the proposed combined organization.[3]

3111.0.2.2 Nonbanking Activities

The SLHC filed a notice pursuant to sections 4(c)(8) and 4(j) of the BHC Act to (1) retain its ownership interest in SB and thereby operate a savings association and (2) engage in activities that are permissible for BHCs through its nonbanking subsidiaries, including lending, loans servicing and related activities, leasing, and selling credit-related insurance. The Board previously has determined by regulation that the operating of a savings association by a BHC and the other nonbanking activities for which SLHC has requested approval, are closely related to banking for the purposes of section 4(c)(8) of the BHC Act.[4]

With respect to the public interest factors under section 4(j) of the act, the Board must determine whether the operation of SB as a savings association by a BHC can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices. The record indicated that consummation of the proposal would create a stronger and more diversified financial services organization and would provide current and future customers of HNB with expanded financial products and services.

2. 12 U.S.C. 1842(c)(2) and (3).

3. A comment received from the public expressed concern that SLHC acquired control over HN before obtaining the Board's approval of the application as the result of an extension of credit the SLHC made to HN. The extension of credit was made after the SLHC had filed its application with the Board to acquire HN. The SLHC loaned HN $50 million, secured by the shares of HNB. HN invested the loan proceeds in HNB to increase the bank's capital.

The Board noted its concern about a banking organization seeking to acquire another banking organization and making a loan to the acquiree in advance of the Board's approval of the acquisition. Such types of loans raise concern that the transactions would be, in substance, the acquisition of a controlling interest or would provide the acquirer with the ability to exercise a controlling influence over the management and policies of the BHC before receiving approval. The Board carefully reviewed the loan transaction, its supporting documentation, and the relationships of the organizations after the loan transaction. Based on all the facts of record, the Board concluded that the loan did not result in SLHC acquiring voting securities of, or a controlling equity interest in, HN, or in SLHC exercising, or having the ability to exercise, a controlling influence over HN. The Board noted that it continues to believe that when a loan is made by an acquirer to a target organization before it receives agency approval of its acquisition proposal, it raises important issues, and that it will review these arrangements critically and carefully.

4. See 12 C.F.R. 225.28(b)(1), (2), (3), (4), (8), and (11).

3111.0.2.3 Noncontrolling Investment

The SLHC proposed to acquire 17.5 percent of BBI's voting shares that HN currently owned and to increase up to 19.9 percent its total ownership of BBI's voting shares. The Board previously had approved HN's investment in BBI as a passive investment, and HN complied with certain commitments that were previously relied on by the Board in determining that an investing BHC would not exercise a controlling influence over another BHC or bank for the purposes of the BHC Act ("Passivity Commitments").[5] The SLHC indicated that it did not propose to control or exercise a controlling influence over BBI and that its indirect investment in B Bank also would be a passive investment. The SLHC provided the passivity commitments to the Board (see appendix A). Based on those commitments, the Board concluded that the SLHC would not acquire control of, or have the ability to exercise a controlling influence over, BBI or B Bank through the proposed acquisition of BBI's voting shares.

3111.0.2.4 Appendix A Passivity Commitments

The SLHC will not, without the prior approval of the Federal Reserve Board or its staff, directly or indirectly:

1. Exercise or attempt to exercise a controlling influence over the management or policies of BBI or any of its subsidiaries;
2. Have or seek to have a representative of SLHC serve on the board of directors of BBI or any of its subsidiaries;
3. Have or seek to have any employee or representative of SLHC serve as an officer, agent, or employee of BBI or any of its subsidiaries;
4. Take any action that would cause BBI or any of its subsidiaries to become a subsidiary of SLHC;
5. Acquire or retain shares that would cause the combined interests of SLHC and its officers, directors, and affiliates to equal or exceed 19.9 percent of the outstanding voting shares of BBI or any of its subsidiaries;
6. Propose a director or slate of directors in opposition to a nominee or slate of nominees proposed by the management or board of directors of BBI or any of its subsidiaries;
7. Solicit or participate in soliciting proxies with respect to any matter presented to the shareholders of BBI or any of its subsidiaries;
8. Attempt to influence the dividend policies; loan, credit, or investment decisions or policies; pricing of services; personnel decisions; operations activities, including the location of any offices or branches or their hours of operation, etc.; or any similar activities or decisions of BBI or any of its subsidiaries;
9. Dispose or threaten to dispose (explicitly or implicitly) of shares of BBI in any manner as a condition or inducement of specific action or non-action by BBI or any of its subsidiaries;
10. Enter into any other banking or nonbanking transactions with BBI or any of its subsidiaries, except that SLHC may establish and maintain deposit accounts with BBI, provided that the aggregate balance of all such deposit accounts does not exceed $500,000 and that the accounts are maintained on substantially the same terms as those prevailing for comparable accounts of persons unaffiliated with BBI.
11. Acquire or seek to acquire any nonpublic financial information of BBI or any of its subsidiaries, beyond the information already available to it as a shareholder of BBI. SLHC also confirms that there are no legal, contractual, or statutory provisions that would allow it or its subsidiaries to have any access to financial information of BBI or its subsidiaries beyond the information available to shareholders.

3111.0.2.5 Interstate Acquisition

Under the Dodd-Frank Act, the Board of Governors of the Federal Reserve System may not approve the acquisition of an insured depository institution (including a savings association) if the home state of the insured depository institution is a state other than the home state of the

5. The Board previously determined that the acquisition of less than a controlling interest in a bank or BHC is not a normal acquisition for a BHC. The requirement in section 3(a)(3) of the BHC Act that the Board's approval be obtained before a BHC acquires more than 5 percent of the voting shares of a bank seems to suggest, however, that Congress contemplated the acquisition by BHCs of between 5 and 25 percent of the voting shares of banks. See 12 U.S.C. 1843(a)(3). On this basis, the Board has previously approved the acquisition of a BHC of less than a controlling interest in a bank or BHC. See 2006 FRB C37 (acquisition of up to 24.89 percent of the voting shares of a BHC); 2005 FRB 74 (acquisition of 24.9 percent of the shares of a BHC); and 2000 FRB 52 (acquisition of up to 9.9 percent of the voting shares of a BHC).

bank holding company and the applicant controls, upon consummation, more than 10 percent of the total amount of insured deposits in the United States. (For the Dodd-Frank cite, see 12 USC 1843(c)(8). Pub. L. 111-203 124 stat 1547, 1634)

3111.0.3 LAWS, REGULATIONS, INTERPRETATIONS, ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Activity approval	1843(4)(i)	225.28(b)(4)(ii)		1997 FRB 275
Determination that the operation of a thrift institution is closely related to banking and a proper incident thereto		225.28(b)(1), (2), (3), (4), (8), and (11)		2010 FRB B7 1989 FRB 86 1986 FRB 724 1986 FRB 342 1985 FRB 340 1983 FRB 812 1982 FRB 660 1982 FRB 316 1977 FRB 280 1974 FRB 868
Bank holding companies acquiring savings associations must conform their direct and indirect nonbank activities to those permissible for bank holding companies		225.28(b)(4)(ii)		2014 FRB 13, Q3 (FRB Order No. 2014-16) 2010 FRB B7 2005 FRB 91 2004 FRB 503 2003 FRB 439 2002 FRB 485 2002 FRB 385
Acquisition of stock savings and loan associations				1985 FRB 462
Removal of tandem restrictions				1989 FRB 716
Establishing branches on an interstate basis after acquisition				1993 FRB 890
BHC's joint acquisition of a savings association, merged subsequently into a subsidiary bank		225.28(b)(4)(ii)		2014 FRB 23, Q4 (FRB Order No. 2014-22)
Minority investment (interest) in a savings bank				1995 FRB 509
Acquisition of a BHC of less than a controlling interest in a bank or BHC				2006 FRB C37 2005 FRB 74 2000 FRB 52

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Acquisition of a savings and loan holding company	1843(c)(8) and (j)	225.28(b)(4)(ii)		2015 FRB 61 (Board Order No. 2015-27 2015 FRB 37 (Board Order No. 2015-34

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Section 4(c)(8) of the BHC Act (Trust Services) Section 3120.0

The performance of trust services by a trust company subsidiary that is neither a ''bank'' nor a nonbank bank encompasses virtually any kind of fiduciary, agency, or custodial service commonly performed by a trust company so long as the subsidiary does not accept demand deposits or make loans, except as expressly permitted by section 225.28(b)(5) of Regulation Y. Generally, under Regulation Y, a trust company may only accept deposits arising out of trust funds not currently invested; perform escrow services, such as receiving, holding, and disbursing downpayments and other funds deposited by purchasers in real estate transactions; and act as an agent for an issuer of, or broker or dealer in, securities in a capacity of a paying agent, dividend-disbursing agent, or securities clearing agent, so long as the funds are not used by the customer as a general-purpose checking account and do not bear interest. The subsidiary's lending activities are restricted to making call loans to securities dealers and to purchasing money market instruments; however, such loans may not be used to provide funding for nonbank subsidiaries of the holding company.

Trust companies may be either state chartered or nationally chartered. Some nationally chartered trust companies have national bank charters but have agreed through limitations in their bylaws to engage only in those activities permitted for trust departments of national banks. To prevent the use of a trust company as a vehicle for evasion of section 3(d) of the Bank Holding Company Act, the Board has conditioned its approval of certain interstate acquisitions by requiring that (1) the trust company's demand deposit–taking activities not be operated in tandem with any other subsidiary, (2) demand deposit and commercial lending services of affiliates will not be linked in any way, and (3) the trust company will not engage in any transactions with affiliates, other than the payment of dividends or the infusion of capital, without the Board's approval (for example, see U.S. Trust Corporation, 1984 FRB 371). The scope of these conditions may be reviewed by the Board in connection with nonbank bank applications.

As part of normal administration of its trust accounts, a trust company will from time to time engage in an activity, such as property management or land development, that has been determined to be *not* closely related to banking by the Board. Any such service may only be performed incidentally to fiduciary-account administration and may not be offered or marketed as a separate service.

The board of directors and senior management of financial holding companies (FHCs) and bank holding companies (BHCs) are responsible for overseeing the operations of their fiduciary activities in a safe and sound manner. Such oversight (particularly for those BHCs and FHCs engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with financial activities as well as fiduciary activities can cut across legal entities and business lines. Federal Reserve examiners review and assess the internal policies, reports, and procedures and effectiveness of the BHC/FHC consolidated risk-management process.

The appropriate regulator of trust activities (including activities of a fiduciary, agency, or custodial nature) has the primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for any subsidiary or subsidiaries that the regulator supervises. Federal Reserve examiners should seek to use the examination findings of the appropriate regulators. (See SR-00-13.)

To determine the complete scope of fiduciary assets within an FHC/BHC, examiners should reference the Uniform Bank Performance Report (UBPR), which reflects the information gathered on Schedule RC-T. To further understand the scope of fiduciary assets within an FHC/BHC, an examiner should also look at information reported on Schedules Y-11 and Y-9C with respect to income derived from trust, fiduciary, and asset-management activities. (See also page 4 of the Bank Holding Company Performance Report (BHCPR) for the amount and percentages of income from fiduciary activities to adjusted operating income (tax-equivalent), including the BHC's corresponding peer-group ratios.)

Peer analysis is also available at the bank level. Examiners should refer to pages Trust 1 and Trust 1A of the UBPR. General comparison information is also available on a lagged basis in the FFIEC's electronic report ''Trust Assets of Financial Institutions'' (www2.fdic.gov/structur/trust/index.asp). Aggregate data are listed by year back to 1996.

3120.0.1 ON-SITE INSPECTIONS

Trust companies are normally engaged in activities such as management of funds for individuals. These activities are significant to the integrity of the banking system and involve significant potential liability to the bank holding company if not properly conducted. Therefore, periodic on-site inspections should be performed. If the trust company is examined by a state banking department, then alternate-year examination procedures may apply. If nationally chartered, a review of the periodic on-site examinations of the Comptroller of the Currency will generally suffice. If the trust company is not subject to a regular examination by another federal banking agency (i.e., if it is an uninsured, state-chartered nonmember trust company), the Reserve Bank should perform regular on-site inspections to include, at a minimum, full-scope reviews of the trust activity. The inspections would use procedures such as those used in the examinations of trust activities of state member banks. This portion of the inspection should be performed by examiners specially trained in trust examinations. Holding company inspectors should specifically review trust activities for compliance with any conditions imposed by the Board in connection with the approval of an application.

The main sections that follow (sections 3130.1 through 3130.9) address all financial and investment advisory activities under section 4(c)(8) of the BHC Act and section 225.28(b)(6) of Regulation Y that have been authorized by the Board. This section provides general inspection objectives and procedures that relate to such financial and investment advisory activities. These objectives and procedures can be applied to the BHC inspection of every advisory activity when advisory activities are not listed separately in any of this manual's individual advisory sections.

Any commitments that were made by the bank holding company or its nonbank subsidiaries to the Federal Reserve System pertaining to its financial and investment advisory nonbanking activities should be reviewed by the examiner for compliance and applicability, in accordance with the current statutory and regulatory provisions. Any existing commitments or conditions that relate to the financial resources of a bank holding company or its subsidiaries or to commitments or conditions that relate to the risk-management policies of the organization should remain intact and should be reviewed by an examiner for compliance during each inspection.

The Board's Regulation Y, effective April 1997, resulted in a structural reorganization of financial and investment advisory nonbanking activities. The provision of discretionary investment advice is no longer limited to institutional customers. Bank holding companies and their subsidiaries may engage in financial and investment advisory activities without restriction. Bank holding companies can manage retail customer accounts outside of the trust department of an affiliated bank (to the extent permitted by law). Further, bank holding companies may engage in any combination of permissible nonbanking activities listed in Regulation Y. Accordingly, bank holding companies may provide financial and investment advice jointly with permissible agency transactional service, investment or trading transactions as principal, or any other listed nonbanking activity.

The rules in Regulation Y provide examples of financial and investment advisory activities that are illustrative rather than exclusive. With regard to the examples, a bank holding company may act as an investment or financial adviser without restriction to any person, including

1. serving as an investment adviser (as defined in section 2(a)(20) of the Investment Company Act of 1940) to an investment company registered under that act, including sponsoring, organizing, and managing a closed-end investment company;
2. furnishing general economic information and advice, general economical statistical forecasting services, and industry studies;
3. providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, capital structurings, financing transactions and similar instruments, and conducting financial-feasibility studies;
4. providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instrument;
5. providing educational courses and instructional materials to consumers on individual financial-management matters; and
6. providing tax-planning and tax-preparation services to any person.

Sections 3130.1 through 3130.9 include many historical examples of various financial and investment advisory activities that have been approved by the Board. These examples are to be viewed as historical references. They should be considered as to their applicability to current statutory and regulatory provisions. Some examples include, but are not limited to, providing financial advice in rendering fairness opinions and providing valuation services in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, and capital structurings. Other examples include providing advice on financing and similar transactions with respect to private and public financings and loan syndications; conducting financial-feasibility studies; and providing financial advice to state and local governments with respect to the issuance of their securities.

3130.0.1 INSPECTION OBJECTIVES

1. To review the adviser's organizational structure and the qualifications of its management to conduct business, and to determine whether they are satisfactory.

2. To determine the status of the adviser's financial condition and the adequacy of internal controls, general accounting policies, and reporting procedures, and to determine if they reflect the guidelines established by management.
3. To determine whether fee income is accurately computed and reported on a consistent basis.
4. To determine what financial effect the activity has on the parent holding company and the bank subsidiaries.
5. To review and evaluate investment practices considering the adviser's investment responsibilities for the selection and allocation of investments for various types of accounts to determine whether they are appropriate.
6. To evaluate funding sources, including indebtedness, and their management with respect to maturities and interest rates.
7. To determine the adequacy of internal and external audits.
8. To determine whether the adviser company has adequate policies and procedures to prevent self-dealing and similar improper conflicts.
9. To determine whether operating practices provide for adequate legal documents and agreements such that the account activities, in general, are consistent with the contractual responsibilities and authorities.
10. To determine if any litigation is pending against the company and the possible impact of an unfavorable court decision.
11. To evaluate compliance with applicable bank holding company laws, regulations, and interpretations, including compliance with the standards of care and conduct applicable to fiduciaries as required by Regulation Y.

3130.0.2 INSPECTION PROCEDURES

1. Review System approval and activities for conformance with any limitations. Determine if the activity is conducted through a separately incorporated subsidiary of the bank holding company that—
   a. refrains from taking positions for its own account;
   b. observes the standards of care and conduct applicable to fiduciaries with respect to its advisory and transactional services; and
   c. avoids executing customer transactions when acting in an advisory capacity.
2. Prepare financial statements for the last two fiscal years, plus interim if appropriate. Analyze for adverse trends and evaluate for negative effects on affiliates.
3. Evaluate asset quality when warranted, documenting the scope and detailing asset review. Compile classification data, write up classifications if appropriate, and evaluate reserve adequacy.
4. Obtain documentation for all indebtedness. Evaluate funding sources for maturity mismatch, dependence on affiliates' concentrations, and dependability. Review borrowings from affiliate banks for compliance with section 23A of the Federal Reserve Act.
5. Review income and expense accounts and transactions with affiliates for compliance with section 23B of the Federal Reserve Act.
6. Review the company's revenue sources to determine that it has not taken positions and does not, itself, execute transactions when acting in an advisory capacity.
7. Evaluate contracts and service agreements with affiliates. Identify whether the company receives or provides services or products. Determine that the services or products are needed and received or provided, and that the contract or agreement terms represent market rates.
8. Review the company's fee schedule for providing advice and the fees charged by affiliated banks to conduct transactions for the company's customers. Determine whether the bank is being adequately compensated for executing trades, or whether these profits are accruing largely to the benefit of the company.
9. Review checking-account statements for all accounts at affiliate banks for overdrafts since the previous inspection.
10. Evaluate whether the nonbank activities are being performed by affiliate bank personnel or are using bank assets. If so, is the bank adequately compensated?
11. Identify off-balance-sheet activities and contingent liabilities, and assess the risk to the company and any affiliate.
12. Obtain a listing of litigation against the company or any individuals who represent the company from the company's legal counsel, and evaluate potential effects on the financial condition.
13. Obtain and review internal and external audit reports and workpapers.

14. Obtain and review internal and external asset-review reports.
15. Obtain and review copies of the board of directors' and senior management's policies and procedures.
16. Review a sample of recommendations to determine that a reasonable basis exists for the company's recommendations.
17. Review the advisory contracts to determine if there are any conflicts of interests involving the parent company or affiliates, as well as the officers, directors, or principal shareholders and their related interests of the holding company and its affiliates.
18. Evaluate insurance for adequacy.
19. Obtain or verify that workpapers contain the following permanent documentation:
    a. System approval letters
    b. date of incorporation or date acquired
    c. date activity commenced
    d. articles of incorporation and by-laws
    e. commitments
    f. supervisory actions
    g. other pertinent correspondence
20. Obtain and review a listing of shareholders for each class of stock outstanding, and a schedule of officers, directors, and their related interests.

WHAT'S NEW IN THIS REVISED SECTION

This section is revised to amend section 3130.1.6, Laws, Regulations, Interpretations, and Orders. The table references a 2015 Board order that authorizes the merger of two bank holding companies and the acquisition of a bank, which were immediately followed by the acquisition of nonbank subsidiaries authorized to be engaged in financial and investment advisory activities under section 225.28(b)(6) of Regulation Y.

A bank holding company or its nonbank subsidiary that engages in investment or financial adviser activities is subject to section 225.28(b)(6) of Regulation Y. The purpose of an inspection of a company providing investment or financial advice is to determine that it is operating according to applicable laws, regulations, and interpretations, and to determine that the company is subject to an adequate audit program. Regulation Y allows a bank holding company to serve as an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(20)), which defines an "investment adviser" of an investment company as "...any person who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company..."

The Board has issued an interpretive rule regarding the investment adviser activities of bank holding companies under Regulation Y (12 C.F.R. 225.125). The following is a list of some of its provisions:

1. Bank holding companies, including their bank and nonbank subsidiaries, may act as investment advisers to various types of investment companies such as mutual funds and closed-end investment companies. Mutual funds and closed-end investment companies are described in the interpretation.
2. Bank holding company investment adviser activities are limited by the Glass-Steagall Act (Banking Act of 1933 (12 U.S.C. 24, 78, 377, 378)). This act generally prohibits member banks from engaging in the purchase or sale of equity securities other than in an agency capacity.
3. A bank holding company may not sponsor, organize, or control a mutual fund. This does not apply to closed-end investment companies so long as they are not primarily or frequently engaged in the issuance, sale, or distribution of securities.
4. A bank holding company should not act as investment adviser to an investment company which has a name similar to the bank holding company or any of its subsidiary banks, unless the prospectus of the investment company contains certain required disclosures. In no case should a bank holding company act as investment adviser to an investment company that has either the same name as the name of the bank holding company or any of its subsidiary banks, or that has a name that contains the word "bank."
5. Since investment adviser activities may create potential conflicts of interest, the Board determined that a bank holding company and its subsidiaries should not purchase in their sole discretion, in a fiduciary capacity (including as managing agent), securities of any investment company for which the bank holding company acts as investment adviser, unless the purchase is specifically authorized by (1) the terms of the instrument creating the fiduciary relationship, (2) court order, or (3) the law of the jurisdiction under which the trust is administered.
6. A bank holding company may not engage, directly or indirectly, in the underwriting, public sale, or distribution of securities of any investment company for which it or any nonbank subsidiary acts as investment adviser, except in compliance with section 20 of the Glass-Steagall Act. The Board has determined, however, that the conduct of securities brokerage activities by a bank holding company or its nonbank subsidiaries, when conducted individually or in combination with investment advisory activities, is not deemed to be the underwriting, public sale, or distribution of securities prohibited by the Glass-Steagall Act.
7. A bank holding company or any of its nonbank subsidiaries that have been authorized by the Board under the Bank Holding Company Act to conduct securities brokerage activities (either separately or in combination with investment advisory activities) may act as agent, upon the order and for the account of customers of the holding com-

pany or its nonbank subsidiary, to purchase or sell shares of an investment company for which the bank holding company or its subsidiaries act as an investment adviser.
8. A bank holding company or any of its nonbank subsidiaries that have been authorized by the Board under the Bank Holding Company Act to provide investment advice to third parties generally (either separately or in combination with securities brokerage services) may provide investment advice to customers with respect to the purchase or sale of shares of an investment company for which the holding company or any of its subsidiaries acts as an investment adviser.
9. A bank holding company or its subsidiary bank, at the time a service is provided, must caution customers to read the prospectus of the investment company before investing. Customers must be advised in writing that the investment company's shares are not insured by the Federal Deposit Insurance Corporation and are not deposits, obligations, or endorsed or guaranteed in any way by any bank (unless that is the case). The role of the company or affiliate as adviser to the investment company must be disclosed in writing. Such disclosures may be done orally, but the cusotomer must be given such disclosures in writing immediately thereafter.
10. Because of potential conflicts of interest, a bank holding company which acts both as custodian and investment adviser for an investment company should exercise care to maintain at a minimum level demand deposit accounts of the investment company which are placed with a bank affiliate, and should not invest cash funds of the investment company in time deposit accounts (including certificates of deposit) of any bank affiliate.

3130.1.1 REAL ESTATE DEVELOPMENT ADVISERS FOR STATE AND LOCAL GOVERNMENTS

Advising state and local governments about methods available to finance real estate development projects, and evaluating projected income to determine if debt resulting from proposed development projects can be adequately serviced is permissible if the activities are authorized under section 225.28(b)(6) of Regulation Y.

Before this activity was incorporated into Regulation Y, in 1980, the Board had received certain comments noting that certain aspects of these advisory services may be within the scope of the activity of "management consulting." The Board had found that it was not permissible for bank holding companies to offer management consulting services to nonaffiliated companies. Certain management consulting advice could be provided to unaffiliated depository institutions, however. In view of the relationship that had traditionally existed between banks and state and local governments, and the net public benefits that would result from provision of advice to such governments by bank holding companies, the Board indicated that it would be more flexible in determining what particular services constitute "providing financial advice" rather than "management consulting" when the services are solely for state and local governments rather than other nonbank organizations. With the Board's April 1997 revision of Regulation Y, investment and financial advisory activities were grouped together and a bank holding company could act as an investment or financial adviser without restriction.

The Board also allowed the provision of management consulting services regarding any financial, economic, accounting, or audit matter to any company. These financial activities are directly related to the activities and expertise of bank holding companies. Management consulting services are subject to a revenue limitation, however. They may be provided to any customer on any matter, provided that the total annual revenue derived from the management consulting services does not exceed 30 percent of the company's total annual revenue derived from management consulting activities. Thus, any services provided to state and local governments that are deemed management consulting services are subject to this revenue limitation.

3130.1.2 INSPECTION OBJECTIVES

1. To review the adviser's organizational structure and the qualifications of management to conduct business, and to determine whether they are satisfactory.
2. To determine the status of the adviser's financial condition and the adequacy of internal controls, general accounting policies, and reporting procedures, and to determine if they reflect the guidelines established by management.

3. To determine whether fee income is accurately computed and reported on a consistent basis.
4. To determine what financial effect the activity has on the parent holding company and the bank subsidiaries.
5. To review and evaluate investment practices considering the adviser's investment responsibilities for the selection and allocation of investments for various types of accounts, and to determine whether they are appropriate.

6. To evaluate funding sources, including indebtedness, and their management based on maturities and interest rates.
7. To determine the adequacy of internal and external audits.
8. To determine whether the adviser company has adequate policies and procedures to prevent self-dealing and similar improper conflicts.
9. To determine whether operating practices provide for adequate legal documents and agreements such that the account activities, in general, are consistent with the contractual responsibilities and authorities.
10. To determine if any litigation is pending against the company and the possible impact of an unfavorable court decision.
11. To evaluate compliance with applicable bank holding company laws, regulations, and interpretations, including compliance with the standards of care and conduct applicable to fiduciaries as required by Regulation Y.

3130.1.3 INSPECTION PROCEDURES

1. Obtain the company's policy and procedure manuals, and distribute relevant portions to the examiners for review and compliance evaluation.
2. Review the minutes of meetings of the board of directors, audit committees, and any officer-level committees. Ensure that examiners performing other portions of the inspection review relevant minutes or summaries thereof.
3. Obtain, review, and evaluate the adequacy of internal and external audit procedures, reports, and workpapers.
4. Prepare financial statements for the last two fiscal years, plus the interim period, if appropriate. Analyze and evaluate the information for adverse trends and for negative effects on affiliates.
5. Obtain, review, and evaluate internal and external asset-review reports.
6. Evaluate asset quality where warranted, documenting the scope and detailing asset review. Compile classification data, write up classifications if appropriate, and evaluate the adequacy of contra asset allowances.
7. Obtain documentation for all indebtedness. Evaluate funding sources for maturity mismatch, dependence on affiliates, concentrations, and dependability. Review borrowings from affiliate banks for compliance with section 23A of the Federal Reserve Act.
8. Review checking-account statements for all accounts at affiliate banks, checking for overdrafts since the previous inspection.
9. Complete the inspection checklist (see the sections beginning at 3130.1.3.2) based on the guidance provided in section 3130.1.3.1.
10. Identify off-balance-sheet activities and contingent liabilities, and assess the risk to the company and any affiliate.
11. Obtain a listing of litigation against the company or any individuals who represent the company from the company's legal counsel, and summarize the matters in litigation (or in threatened litigation) and any compromise actions. Evaluate the potential effects on the company's financial condition.
12. Evaluate contracts and service agreements with affiliates. Identify whether the company receives or provides services or products. Determine that the services or products are needed and received or provided, and that the contract or agreement terms represent market rates.
13. Review income and expense accounts and transactions with affiliates for compliance with section 23B of the Federal Reserve Act.
14. Evaluate whether the nonbank activities are being performed by affiliate bank personnel or whether bank assets are being used. If so, is the bank adequately compensated?
15. Review FR System approvals, and check conformance with any specified limitations or commitments.
16. Review a sample of recommendations to determine that a reasonable basis exists for the company's recommendations.
17. Review the advisory contracts to determine if there are any conflicts of interests involving the parent company or affiliates, as well as the officers, directors, or principal shareholders and their related interests of the holding company and its affiliates.
18. Evaluate insurance, including bond coverage, for adequacy. Determine the extent of current liability insurance relating to the adviser function, and evaluate the adequacy of such coverage—particularly the extent to which possible significant surcharges would be covered by such insurance.
19. Obtain a listing of shareholders for each class of stock outstanding and a schedule of officers, directors, and their related interests.

20. Obtain or update biographical and experience information for key management personnel, together with overall staffing and salary levels as appropriate for full evaluation.
21. Determine whether operating practices provide for adequate legal documents and agreements such that the account activities, in general, are consistent with contractual responsibilities.
22. Ascertain if senior management is aware, or has adopted the procedures necessary to become aware, of its current and potential responsibilities in connection with any regulatory-reporting and/or regulatory-compliance requirements.
23. Obtain or verify that workpapers contain the following permanent documentation:
    a. System approval letters
    b. date of incorporation or date acquired
    c. date activity commenced
    d. articles of incorporation and by-laws
    e. commitments
    f. supervisory actions
    g. other pertinent correspondence

3130.1.3.1 Scope of Inspection

It is expected that inspections of investment adviser subsidiaries will generally be conducted as part of regularly scheduled bank holding company inspections. If, however, the investment adviser subsidiary provides portfolio management services for a significant portion of trust assets held by a state member bank, the Reserve Bank should inspect the investment adviser subsidiary at the same time it examines the trust operations of the bank subsidiary. The scope of the inspection should be based on a review of the nature and complexity of the financial services provided to customers. An adviser which merely provides investment advice and does not provide any additional financial services, such as portfolio management, safekeeping, recordkeeping, or trading services, may not require an inspection. However, an adviser which provides portfolio management, safekeeping, or other services will require an inspection. To determine the scope of the inspection, it is essential to identify what types of services are being offered to customers and to assess the risks associated with those services.

The examiner needs to understand the adviser's operations, including how it represents itself to clients and whether the adviser has any vested interests in the financial services which it offers. Examiners should use their discretion to schedule inspections based on the size and complexity of the adviser's operations. Most section 4(c)(8) BHC subsidiaries will be subject to SEC registration requirements. (See SR-91-4 (SA).) Appropriate checklist questions should be completed for registered investment advisers which provide investment advice to affiliated banks or trust companies and for investment advisers which engage in activities which could have a significant impact on the bank holding company's financial safety and soundness. The checklist should also be completed for all advisers that manage investment portfolios for their customers. The checklist is only a guideline and some of the sections in the checklist may not be applicable. Conversely, the scope of such examinations is not limited to the items included in this checklist.

3130.1.3.2 Inspection Checklist

The questions in this checklist will assist the examiner in evaluating various areas of supervisory concerns.

3130.1.3.2.1 Review of Fundamental Policies and Procedures

The investment adviser's policies and procedures should be reviewed using the following checklist to ensure that fundamental policies and procedures have been established and implemented.

1. Are adequate minutes of the board and board committee meetings prepared?
2. Is the adviser properly chartered and registered?
3. Does the adviser have sufficient blanket bond or other fidelity or liability coverage in place?
4. Is corporate and regulatory reporting performed on a timely basis?
5. Does the above reporting fairly present the accounting and supplemental data reflected by the corporate records?
6. Are internal accounting controls, provided by a segregation of duties or a need for administrative approvals, adequate?
7. Are duties properly segregated in the receiving, disbursing, and recording of cash and cash transactions?
8. Are fee calculations and billing procedures adequate to ensure accuracy and propriety?

9. Are all security transactions authorized or approved by the appropriate management level, and is there documented evidence of the authorization or approval?

3130.1.3.2.2 Supervision and Organization

Supervision refers to the conduct of an adviser's board of directors and senior management in establishing, communicating, and enforcing a system of policies, procedures, and practices suitable to its business objectives and legal requirements. Organization may be characterized as the framework of committees and the assigned responsibilities through which supervision functions. The examiner should (1) review the structure of the organization for adequacy of management information systems and (2) the organization framework as both relate to meeting the entity's stated responsibilities as well as generally accepted standards of conduct. The examiner should review the supervisory function by first identifying the duties and responsibilities of the board of directors. The directors owe the duty of reasonable supervision, including appropriate attention to areas in which the adviser is assuming sensitive and complex fiduciary responsibilities. The next level of review is the committee and officer positions to which certain authority has been delegated. In reviewing this level of supervision, the examiner should keep in mind that certain functions cannot be delegated; for example, approval of significant new services or lines of business, approval of formal policies designed to ensure that the adviser operates in basic compliance with laws and regulations, and the selection and supervision of senior management cannot ordinarily be delegated. Informal delegations and operating practices represent the last level of review. In reviewing both formal and informal delegations, consideration should be given to the institution's size and complexity. A final determination of the adequacy of supervision and organization must be based on findings of the entire inspection of the bank holding company or its nonbank subsidiaries. While topics that have direct or indirect impact on the adequacy of director supervision and management competence are of particular sensitivity, examiners nevertheless have a responsibility to carefully address and comment upon such issues. During the course of the inspection, the examiner should review the supervisory and organizational structure of the bank holding company, with particular reference to investment-related activities. The examiner should determine whether the board of directors has developed adequate objectives and policies.

3130.1.3.2.2.1 Supervision and Organization Checklist

1. If the board of directors does not directly supervise investment adviser activities—
   a. has a responsible board committee(s) been named to exercise this function?
   b. are any delegations consistent with bylaw provisions and other appropriate principles?
   c. do the board's minutes nevertheless reflect periodic but timely review of the conduct and operating results of the function?
2. Do minutes of the board, or its committee(s), reflect that members—
   a. attend meetings with reasonable frequency?
   b. require and approve, where necessary, appropriate written policies, strategic plans, and management reports relating thereto?
   c. review audit and regulatory reports (and management proposals and corrective measures in response thereto), litigation developments, earnings and expense reports, and changes to fee schedules?
3. Through adoption of formal policies and provisions for auditing, does the board adequately seek to ensure the integrity of the organization's records and operational systems?
4. Are policies and procedures adequately communicated to officers and staff?
5. Does the board or a board committee consider, periodically review, and provide for insurance protection?
6. Does the bank holding company maintain access to competent legal counsel and, where appropriate, obtain written opinions on significant legal questions such as—
   a. pending or threatened litigation?
   b. account agreements whose terms are unclear or ambiguous or raise complicated points of law?
   c. proposed actions or policies involving matters such as conflicts of interest, restricted securities, ERISA, and other matters involving possible legal exposure?
7. If an account's securities are registered in a nominee name(s)—

   a. is the nominee agreement current?
   b. is the nominee registered with the American Society of Corporate Secretaries (to guard against duplication of the nominee name) and state authorities (where required by local law)?
8. Is staffing adequate, in terms of both numbers and qualifications, to handle the current volume of business?
9. Is there adequate provision for management succession, or for continuing operations in case of the loss of key personnel?
10. Is senior management aware of its responsibilities in connection with, and has it established written policies and procedures to ensure compliance with, any applicable regulatory-reporting requirements?
11. Are significant functions of the investment adviser subject to either internal or external audit? If not, ascertain whether an audit program should either be developed or expanded.
12. When appropriate in light of the size and complexity of the adviser's operations, has management had an audit of financial statements performed by certified public accountants?
13. Have all significant exceptions and recommendations in audits or examinations or inspection reports been corrected, implemented, or otherwise satisfactorily resolved?

3130.1.3.2.3 Portfolio Management

Investment selection is the process whereby the adviser evaluates, selects, and reevaluates those securities or other financial assets it will buy or sell for its clients, or for which it will make recommendations. It includes the process of researching and selecting recommended individual stocks and bonds, and setting objectives or strategies for diversifications by types and classes of securities into general or specialized portfolios, as well as the process of communicating and executing overall strategies for particular accounts.

When an adviser holds itself out as a professional, the adviser will be held to a high standard of prudence and expertise in the investment-selection and -review process. Therefore, advisers must carefully consider policies and procedures in this area in accordance with the size and character of the investment-selection responsibilities undertaken. In furnishing portfolio investment advice, particularly to retail clients, an investment adviser should observe the standards of care and conduct applicable to fiduciaries.[1]

3130.1.3.2.3.1 Investment Standards and Research

1. Are the general investment standards and review and selection responsibilities defined and approved by the board of directors?
2. Does management or senior investment personnel review overall investment policy and potential investment problems at least annually?
3. Is portfolio management policy adequately communicated to appropriate personnel (for example, by including it in committee minutes, directives, or memoranda circulated to such personnel)?
4. Does the institution, where appropriate, diversify investments according to—
   a. types of assets, such as common stocks, fixed-income securities, and real estate?
   b. types of securities by characteristics such as income, growth, and size of company?
   c. types of securities by industry and specific companies within industries?
   d. maturities of debt securities?
   e. geographic location of companies of issue, such as utilities?
   f. tax-exempt income?
5. If the institution has a list of securities approved for purchase, retention, and/or sale—
   a. are recommendations for additions to or deletions from such list(s) approved by a committee or group with appropriate authority and expertise?
   b. are periodic reviews made of the lists of securities approved for purchase, retention, or sale to assess the current appropriateness of the investments listed?
6. If the institution uses any research or analysis in its general investment-review and -selection process—
   a. are appropriate factors taken into account?
   b. is appropriate documentation obtained and filed to reflect consideration of such factors?
7. If the size and character of the entity's discretionary investment responsibilities are such that the type of detailed research consider-

1. The term "portfolio investment" is intended to refer generally to the investment of funds in a "security" as defined in section 2(1) of the Securities Act of 1933 (15 U.S.C. 77b) or in real property interests, except when the real property is to be used in the trade or business of the person being advised. In furnishing portfolio investment advice, bank holding companies and their subsidiaries shall observe the standards of care and conduct applicable to fiduciaries.

ations and files envisioned in the previous question are not relied on, does it use ratings by acceptable financial-rating agencies, such as Moody's or Standard and Poor's, together with evaluation of basic relevant factors pertaining to the type of security under consideration?
8. Where appropriate, does the organization differentiate its investment-selection process as to the type of account in question, such as those for which the need for growth or income is paramount, or for taxable versus tax-free trusts or retail versus institutional accounts?
9. Do personnel possess sufficient expertise and experience to properly implement the firm's investment-selection systems and responsibilities?

3130.1.3.2.3.2 Account Administration

Special consideration has to be given to accounts subject to the Employee Retirement Income Security Act of 1974 (ERISA), which imposes fiduciary responsibilities upon any person who has any power of control, management, or disposition over the funds or other property of any employee benefit fund. When an adviser exercises investment discretion over such plans, the extensive fiduciary responsibility and prohibited transaction rules of ERISA will apply.

1. Does the adviser have portfolio management procedures which provide for—
   a. consideration of the needs and objectives of particular types of accounts, such as the need for income versus growth or taxable versus tax-free income?
   b. conformity with investment provisions of governing instruments?
   c. consideration of the liquidity needs of the account for anticipated distributions?
   d. appropriate diversification, including avoidance or elimination of concentrations in individual securities and by type and subclass of securities?
2. When assets in discretionary accounts are considered unsuitable, is a program of prudent and timely sale of such assets followed unless retention is required?
3. In order to determine the advisability of retaining or changing assets, does the adviser have procedures for periodic reviews?
4. Do minute books or other records—
   a. identify reviewed accounts?
   b. report written conclusions on the advisability of retaining or disposing of assets in the accounts?
5. As appropriate to the size and character of business, are account synopses and historical data used in the review of account assets?
6. Does the investment-review information include—
   a. amount and description of investment?
   b. categories of investment, such as bonds and stocks?
   c. types of investments within each category, such as industry groups for stocks?
   d. cost?
   e. market or appraised value at review date?
   f. annual income?
   g. yield at market?
   h. rating of recognized financial service?
7. For accounts in which the adviser makes investments at the direction of the client, does the adviser—
   a. review the account to detect illegal, nonconforming, substandard, or otherwise unsuitable investments?
   b. advise the power holder of any improper investments?
   c. inform parties at interest in the account if any improper investment is not disposed of, and seek legal relief, if necessary?
   d. resign from the account if corrective action is not taken concerning improper investments?
8. Have proxy voting policies and procedures as listed below been established for ERISA accounts that are suitable in relation to assumed responsibilities?
   a. voting of routine proxies?
   b. identification and handling of proxy or tender determinations when sensitive social issues, conflicts of interest, significant increases in management power or perquisites, or merger or buy-out proposals are involved?

      NOTE: For requirements relating to proxy processing and the Shareholder Communications Act of 1985, see Operations and Internal Controls in the *Trust Examination Manual.* For questions relating to the voting of affiliate stock, see Conflicts of Interest in the *Trust Examination Manual.*

   When an adviser invests accounts in options and/or futures, the following checklist questions (numbers 9 through 13) should be completed. For additional information as to appropriate uses of options and futures contracts, see SR-83-2(SA) and SR-83-39(SA).

9. When an adviser uses options and/or futures, has the board of directors or a directors'-level committee approved a policy and strategy for their use? Does the policy address—
   a. the investment objectives to be accomplished by the use of these contracts?
   b. the specific types of contracts to be used?
   c. the types of accounts authorized to use these contracts?
   d. restrictions and/or conditions upon use of contracts, such as selection of brokerage houses, position limits, time frames, leveraging, etc.?
10. Was adequate disclosure made and adequate authorization obtained to execute contract transactions for various types of participating accounts?
11. Are adequate systems and controls in effect to ensure—
    a. proper tax treatment?
    b. proper segregation of securities and/or monies?
    c. conformance with account objectives?
    d. adherence to adopted strategy, position limits, and related program parameters?
    e. periodic management evaluation and reporting systems with respect to—
       - results of contract activities upon overall investment performance?
       - market developments, including current liquidity of relevant futures and options contracts in which positions are taken?
       - financial condition, fee competitiveness, and performance of involved broker-dealers?
12. Does the accounting system accurately reflect contract activities with respect to—
    a. transaction details?
    b. current gains or losses on open contract positions?
    c. necessary tax information?
13. Do operating personnel appear sufficiently knowledgeable relative to the level of contract-transactions activity?

3130.1.3.2.4 Conflicts of Interests

The inspection of an investment adviser subsidiary which provides services to an affiliated trust company or bank with a trust department requires expanded inspection procedures. Often the investment adviser subsidiary was organized for the purpose of providing investment advice and services for the trust accounts held at one or more of its affiliates. These subsidiaries often employ the same individuals who worked in the banks or trust company which they advise.

Conflict-of-interest problems may arise when the adviser exercises any ‘‘discretion’’ when there are mutually opposing interests. The most serious conflict of interest is self-dealing, which could include transactions such as an investment in affiliated banks or the purchase of securities from or through an affiliate. To resolve conflicts of interest, such transactions and the fees associated with them must be fully disclosed and authorized by the appropriate parties.

Potential conflict-of-interest situations are not limited to transactions between affiliates, but can be between the adviser and any of its directors, officers, or employees individually. Due to the complexity, sensitivity, and exposure involved in conflicts of interest, it is particularly important that an adviser develop the awareness and policies and procedures to identify and deal with conflicts situations. Therefore, it is considered highly desirable, even when not specifically required by regulation, that written policies be adopted and periodically revised as necessary.

3130.1.3.2.4.1 Self-Dealing

1. Has the adviser—
   a. acquired any assets from itself or its affiliates?
   b. acquired any assets from directors, officers, or employees of the organization or its affiliates, or from any other individuals with whom a connection exists that might affect their best judgment?
2. Has the adviser sold or transferred any account assets, by loan or otherwise, to—
   a. any affiliates?
   b. directors, officers, or employees of any affiliates?
   c. other individuals or corporations with whom such a connection exists or other organizations in which such an interest exists that might affect the exercise of its best judgment?
3. Has the company purchased any securities for a customer account from any member of an undivided syndicate for which the adviser or any of its affiliates are participating, or from a private placement which the adviser assisted?

4. Does the company have satisfactory policies and procedures, in terms of its size and character of business, to address the preceding situations?
5. If the company directs extra fee-producing business to itself or an affiliate (for example, brokerage services or options-trading services), or if it charges separate fees to accounts for securities transactions or other services commonly provided as part of general account administration (for example, fees for cash management or investments in mutual funds when management or administration fees are received by the company or an affiliate)—
   a. has it identified those accounts which may properly participate in such services in accordance with adopted policy, legal opinion, a Department of Labor ruling, and/or other necessary determinations?
   b. has it made appropriate prior disclosures and obtained adequate specific authorizations for those accounts identified as entitled to the services?
6. Have any assets held by the company in one account been sold to another account? NOTE: The transaction may be permissible if appropriate disclosure is made, authorization is received, and the law or the governing instrument do not prohibit it. However, an interaccount transaction for ERISA accounts may be a prohibited transaction. In addition, difficult problems can arise in establishing or documenting a "fair" price for the transaction, particularly if the asset is a thinly traded security or is a unique asset.
7. Does the company have appropriate policies and procedures to ensure—
   a. its discretionary accounts are not left in uninvested cash positions beyond a minimum period of time?
   b. its accounts are invested in affiliate interest-bearing deposits only for appropriate temporary or other purposes? NOTE: To the extent the company has long-term affiliate deposits or significant aggregate holdings, a special review should be made of the company's documentation evidencing the suitability of such investments in view of available alternate vehicles.
8. Are securities of affiliates only purchased upon proper direction or specific authorization in account instruments?
9. When the adviser purchases securities which are underwritten by an affiliate, does the adviser do so only upon proper direction and specific authorization of the customer?
10. Does the company act as investment adviser to an open-end or closed-end investment company that is registered under the Investment Company Act of 1940? If so, do its activities conform with the Board's interpretation at 12 C.F.R. 225.125, which defines the scope of permissible activities?

3130.1.3.2.4.2 Broker Selection

1. When volume of activity warrants, is allocation of brokerage business controlled through an approved list which is periodically reviewed and approved by the company's board or a senior-officer-level committee?
2. Does management attempt to obtain the best service for customers, including periodic evaluations of broker qualifications such as—
   a. financial condition?
   b. past record of good and timely delivery and payment on trades?
   c. quality of execution and ability to handle specialized transactions?
   d. quality of research received, if applicable?
3. Are there procedures to monitor or periodically survey available negotiated commission prices in order to ascertain reasonable costs for the execution requirements of its accounts?
4. If commissions higher than the "lowest" available negotiated commissions are being paid for executions in order to receive goods and/or services—
   a. have such goods and/or services been determined to reasonably qualify as "brokerage and research services" as defined in section 28(e)(3) of the Securities Exchange Act of 1934?
   b. does an appropriate committee periodically (at least annually) review and determine that the value of the goods and services justifies the payment of the higher brokerage commissions?
5. Does the entity periodically review and maintain records of all goods and/or services received from brokers or third parties in return for brokerage and/or dealer business allocated to particular firms?
6. Do policies and procedures preclude—
   a. selection of broker-dealers on the basis of deposit balances?
   b. agreements or understandings for allocation of specific amounts of business to a

broker-dealer such that the adviser company would not be able to cease allocating business to the firm if it were no longer providing acceptable execution?
7. Are auditing and other monitoring controls and reporting procedures in effect to verify the compliance of traders with policies regarding broker selection and payment of commissions? NOTE: Under section 28(e) of the Securities Exchange Act of 1934, the adviser may also legitimately pay more than the lowest-available commission for reasons of execution, financial soundness, and efficiency of delivery and payment.
8. In addition to advisory services, are brokerage services provided for customers pursuant to section 225.28(b)(7)(i) of Regulation Y? If so, the examiner should refer to the securities brokerage inspection procedures and checklist questions for the inspection of brokerage activities.

3130.1.3.2.4.3 Trading Policies and Practices

1. When trading specialists are employed, are there adequate written or unwritten standards of competence, education, and training for such individuals?
2. When specialists are not employed, are the individuals responsible for trading reasonably trained and informed in relation to the volume and character of trading activity they are required to perform?
3. When transactions are permitted to be crossed between accounts, are procedures adequate to ensure fair pricing of the transactions? If it is not clear the transactions are permitted, has the company determined through counsel that crossing is permissible under applicable law?
4. When specialists are employed and volume of activity permits, are block trades considered in order to obtain more favorable trade prices and execution prices for accounts?
5. If applicable, do procedures, including establishment of time frames in advance of such trading, require special authorization and attention for large or block trades which are to be executed in a number of transactions?
6. If procedures permit the combining of purchase or sale orders of the same security—
   a. are resulting benefits in price and/or execution costs applied on a pro rata or average basis to the participating accounts?
   b. are allocable shares similarly pro-rated to participating accounts when a combined trade is not executed at once, but in a number of transactions over a period of time?
7. Does the adviser maintain policies "reasonably designed to prevent the misuse of material non-public information?"

3130.1.3.2.5 Recordkeeping

Registered investment advisers are subject to extensive recordkeeping requirements. SEC Rule 204-2 imposes recordkeeping standards and requires that registered investment advisers keep accurate records. In addition to this recordkeeping, the adviser is subject to the "brochure rule" (Rule 204-3). This rule requires an investment adviser to deliver a specified disclosure statement with respect to its background and business practices to every client or prospective client. In addition to an initial disclosure, the adviser must offer annually to deliver a current disclosure statement upon request. Those advisers which have custody or possession of securities of any client must maintain certain additional records, including separate ledger accounts for each client, copies of confirmations, and a position record showing the interest of each client and the location of the securities.

1. Does the investment adviser make and keep current appropriate books and records including—
   a. journals or summary journals?
   b. a memorandum of each order given by the firm or instructions received, showing terms and conditions of the orders?
   c. all checkbooks, bank statements, canceled checks, and cash reconciliations?
   d. all bills or statements, paid or unpaid?
   e. trial balances, financial statements, and internal audit papers?
   f. written communications received or sent by the firm?
   g. list of discretionary accounts?
   h. powers of attorney and discretionary powers?
   i. written agreements?
   j. copies of each notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication recommending the purchase or sale of a security?
2. Does the adviser maintain a record of every transaction in which the adviser or any

"advisory representative" has a direct or indirect beneficial interest?
3. Are partnership articles, articles of incorporation, charter, minute books, and stock certificate books maintained at the adviser's principal office?
4. If required books and records are photocopied or microfilmed, or if they are produced or reproduced on computer storage media—
   a. are such media indexed and arranged to permit immediate location of any particular record?
   b. were any copies or printouts of such records promptly provided on request?
   c. is at least one copy of the original records that are now on such media stored in a separate location from the original for the time required?
   d. does the adviser maintain procedures for the maintenance and preservation of, and access to, records so as to reasonably safeguard them from loss, alteration, or destruction?
   e. does the adviser have facilities for the immediate, easily readable projection of microfilmed records and for producing easily readable facsimile enlargements?
5. Do the entries in the general ledger and journals properly reflect payments or receipts of monies or other goods or services?
6. Do the financial statements, canceled checks, deposit slips, and check register properly reflect payments or receipts of monies or other goods or services?
7. When the adviser's financial records indicate that it is capitalized with client funds (through either loans or equity), have adequate disclosures been made to clients about the risks and conflicts of interest involved?

3130.1.3.2.6 Security Storage and Processing

Investment advisers generally do not take possession and control of client funds and securities. However, in those cases in which such responsibilities are assumed, the inspection must evaluate those internal controls which are in place for the safeguarding of client funds and securities. Controls and related processing procedures must be appropriately designed and implemented by the adviser to efficiently and safely facilitate such operations.

1. Does the adviser have custody of client funds or securities?
2. Does the adviser gain effective access to client assets through practices, arrangements, or relationships with clients, such as trustee, executor, or account signator?
3. When the adviser has custody of client funds or securities, does the adviser maintain the following records:
   a. a record reflecting all purchases, sales, receipts, and deliveries of securities, and all debits and credits to such accounts?
   b. a separate ledger account for each client, showing purchases, sales receipts, and deliveries of securities?
   c. copies of confirmations of all transactions for such clients?
   d. a record for each security in which any client has a position, reflecting the name of the client, amount of interest, and location of security?
4. When the adviser renders investment-management services, are the following records maintained:
   a. for each client, a record of securities purchased and sold, containing the date, amount, and price of each transaction?
   b. a record for each security in which any client has a current position, showing the name of each client and current interest or number of shares owned by each client?
5. Are client assets physically segregated from the adviser's own assets?
6. For the vault and other related security-processing areas, are adequate controls/safeguards in effect which include the following:
   a. Are assets maintained under a system of joint custody or dual control?
   b. Is access to these areas restricted to designated/authorized personnel?
   c. As appropriate, are other controls/safeguards systems in place (for example, rotation of assignments, key/lock combinations, or vault or area entrance log(s))?
   d. Is a security-ticket system used as a vault and asset-movement control system?
7. If a security-ticket system is used, are adequate controls/safeguards in effect which include the following:
   a. Are security tickets prenumbered?
   b. Does each copy of the security ticket clearly indicate its destination to ensure prompt and accurate delivery?

c. Does the security ticket provide the necessary information to ensure proper processing and recording of the transaction?
d. Does the security ticket contain sufficient copies to ensure that sound internal control is maintained over the physical security-movement process by providing the following with a copy (or copies):
 - portfolio managers who initiated the transactions?
 - appropriate vault/operations personnel?
 - the audit/asset control function?
e. Are unissued security tickets properly safeguarded and subject to adequate numeric controls?

8. Does the control of security ticket/transaction cancellation and replacement include—
 a. restricting the ability to initiate such action to supervisory personnel?
 b. reporting such activity to the audit/asset control function and other function(s) affected by such action?
 c. procedures to ensure that securities are returned to the vault or that funds charged from an account are redeposited, or that the securities or funds are immediately placed under the control of a new security ticket/transaction?
 d. identifying a replacement security ticket by recording such information on the replacement ticket?
 e. requiring all copies of the replaced security ticket to be forwarded to the audit/asset control function?
9. For assets received, are adequate controls/safeguards in effect which include the following:
 a. Are all assets received promptly placed under joint custody or control?
 b. Is appropriate documentation required and on file for all assets received, and is it compared to actual assets received and posted to control ledgers?
 c. As applicable, are procedures in place for controlling and properly handling assets received by other means, including delivery by mail or messenger?
 d. If assets are not to be physically held or issued (for example, mutual fund shares), is a receipt, statement, or acknowledgment obtained from the issuer or holder and processed by receipt ticket or other means to ensure proper accountability?
 e. If securities received are not properly registered in the company's nominee name, are procedures in place to ensure prompt re-registration, control, and follow-up until re-registration?
10. For the delivery of assets, are adequate control/safeguards in place which include the following:
 a. Are appropriate receipts obtained and on file for securities delivered?
 b. Are procedures in place to ensure that bearer securities are not mailed in amounts in excess of the company's insurance limits?
11. Do vault custodians—
 a. compare securities received/withdrawn to the security ticket?
 b. for withdrawals, verify that the security ticket is signed (initialed) by authorized personnel?
 c. for securities temporarily withdrawn from the vault (for example, for transfer, re-registration, or account/portfolio manager review), is a copy of the security ticket retained by vault personnel pending the return of the security to the vault?
12. For pending security transactions, are adequate controls in effect which include the following:
 a. Are pending items periodically reviewed by operations personnel?
 b. Do procedures provide for prompt follow-up on items which have not been completed within established time periods?
 c. Are exceptions promptly reported and resolved by appropriate personnel (for example, management, supervisors, and/or the audit/asset control function)?
 d. Are current pending security items in compliance with established procedures for reporting exceptions, and are those transactions which have not been completed within established time periods been followed up satisfactorily? NOTE: Examiner judgment should be used in determining the scope of this review. However, at a minimum, the review should include procedures for handling security transactions pending 30 days or more.
13. Does the security-processing system—
 a. contain a sufficient number of controls/safeguards to properly reflect the current status of and limit an individual's control over a security transaction?

   b. contain sufficient information to identify, locate, and trace the movement of each asset?
   c. provide for adequate segregation of duties and responsibilities?
14. Has individual accountability or responsibility been properly assigned for the physical protection of the securities and related cash flow, if applicable, throughout the security-processing system?
15. Do procedures require that orders for trades originate with account or portfolio managers, with the signature or initials of the authorizing party shown on the order form or purchase/sale ticket?
16. Are transactions made on a first-in, first-out basis (that is, executed in order of receipt), except when combined in blocks for execution pursuant to appropriate written procedures?
17. Do operations personnel perform independently of account or portfolio managers to—
   a. reconcile trade tickets to brokers' confirmations?
   b. monitor and promptly follow up on any outstanding transactions, such as confirmations not received within specified time periods or purchases/sales which have not settled on settlement date?
   c. promptly post payments for purchases/sales to the recordkeeping system and promptly record/remove assets?

3130.1.3.2.7 Other Matters

1. Is the adviser or any of its principals involved in litigation or arbitration which will have an impact on its ability to fulfill its contract with clients?
2. Were any matters of a material nature found in the adviser's correspondence, such as significant client complaints?
3. Did a review of customer-complaint files reveal any possible areas for special inspection focus?
4. Did a review of the adviser's current financial condition raise concerns as to the adviser's solvency or its ability to otherwise continue to provide advisory services?
5. Are there any other aspects of the adviser's operations, or the operations of an affiliate, which raise concerns?

3130.1.4 INSPECTION FINDINGS

A written summary of the subsidiary's activities should be presented to the examiner in charge of the bank holding company inspection and should be included in the inspection report or its supporting workpapers. Material exceptions should be noted with management's responses under an appropriate caption in the open section of the report. Any comments in the report regarding the scope of the investment advisory inspections should note that such inspections are primarily focused on safety-and-soundness considerations and not on compliance with securities laws.

In those cases in which a separate Report of Bank Holding Company Inspection on Investment Advisory Activities is prepared, examiners may use the Uniform Interagency Trust Rating System (see SR-98-37 FRB, revised October 13, 1998, and effective January 1, 1999), which provides a basis for the evaluation of critical areas of supervisory concern. The rating system is generally used by federal supervisory agencies to assess the condition of trust companies. However, the system can be adopted to report on advisory operations as well. When the inspection uncovers significant deficiencies which require corrective action, and the inspection was not done in conjunction with a concurrent bank holding company inspection, a separate report should be prepared and delivered to the inspected nonbank adviser. Send a copy of the summary and any report comments to the Trust Activities Program, Washington, DC 20551.

3130.1.5 ON-SITE INSPECTION BY TRUST EXAMINERS

An investment advisory subsidiary of a bank holding company will normally be registered as an investment adviser under the federal securities laws, and will be subject to examinations of its advisory activities by the Securities and Exchange Commission (SEC). Nevertheless, because investment responsibility is involved in any investment adviser's activities, and since the SEC's routine examinations may be infrequent, periodic on-site inspections should be conducted as an integral part of BHC inspections.

Consideration should be given to using trust examiners to conduct, or at least participate in, on-site inspections of financial and investment advisory nonbank subsidiaries, especially when the subsidiary provides services to an affiliate bank trust department examined by the Board of Governors of the Federal Reserve System. If the bank holding company has to "spin off" the investment research and selection process of its banks' trust departments into an investment advisory subsidiary, there may be a need to review the activities of the trust departments together with those of the advisory subsidiary through an on-site inspection.

The companies being advised on a contractual basis and which were sponsored by the holding company or any affiliate are also defined as affiliates in sections 23A and 23B of the Federal Reserve Act. The examiner should therefore be alert to any intercompany transactions between a bank subsidiary and the advised company. A review of financial statements of such companies is warranted.

3130.1.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Limitations and activity approval	15 U.S.C. 80; section 23A FRA 371c	225.28(b)(6) 225.125	4–177	1997 FRB 275 1971 FRB 512 1972 FRB 149, 571
Activity approval—real estate development advisers for state and local governments		225.28(b)(6)		1997 FRB 275 1980 FRB 962 and 984
Merger of two BHCs under Section 3 of the BHC Act, acquisition of a bank, and followed by the acquisition of nonbanking subsidiaries engaged in financial and investment advisory activities	1843(c)(8) and (j)	225.28(b)(6)	225.125	2015 FRB 82 (Board Order No. 2015-26

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

This section renders inspection guidance on financial and investment advisory activities that are provided in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, capital structurings, and financing transactions and similar transactions, and on conducting financial-feasibility studies.[1] This section also provides historical examples of financial and investment advice previously approved by Board order. The examples consist of various kinds of advice with regard to mergers and similar corporate transactions under the current Regulation Y, section 225.28(b)(6)(iii). Some of the examples of advisory nonbank activities were approved for inclusion into Regulation Y long before the revision of Regulation Y that was effective April 21, 1997. The reader of these examples must only take into consideration the current provisions of Regulation Y. There should be no reliance on Board order commitments, old regulatory provisions, supervisory policies, and interpretations made before April 21, 1997, unless they were not revised. Certain former provisions or commitments may no longer be applicable. The historical examples discussed in this section have been revised according to the new regulatory provisions.

If inspection objectives and procedures are stated in a specific section, the examiner should use this specialized guidance. In addition, the examiner should use the generalized inspection objectives and procedures in section 3130.0, which are generally applicable to all advisory activities.

3130.3.1 ADVISER TO A MORTGAGE OR REAL ESTATE INVESTMENT TRUST

An adviser to a mortgage or real estate investment trust (REIT) furnishes expertise in the areas of funds acquisition, lending, investing, and servicing that is similar to the role of adviser to a mutual fund. The contracted service is performed on a fee basis that is generally based on a percentage of the trust's total assets. The intention of the exemption, found in section 225.28(b)(iii) of Regulation Y, is to allow the relationship to be advisory in nature as opposed to controlling. However, in some instances, the relationship between trusts and their advisers has gone beyond the parameters of advice and resulted in legal entanglements, conflicts of interest, and financial exposure for the bank holding company. Because of the potential risk exposures which may result when a bank holding company or its subsidiary engages in this activity, the overall relationship must be subject to particular scrutiny during an inspection.

REITs were established by the U.S. Congress in 1960, effective January 1, 1961. A REIT is a hybrid form of an investment vehicle which is essentially a financial intermediary specializing in real estate lending and investment. A REIT obtains funds by borrowing from financial institutions or other lenders or by issuing shares (equity capital). It invests the funds in real estate, either as a lender or equity owner. REITs are usually owned by passive owners, not operators. REITs are designed to take advantage of benefits within the federal Internal Revenue Code.

There are generally four types of REITs: equity, mortgage, hybrid, and "finite-life." An equity REIT acquires income-producing properties, deriving its earnings mostly from rents. A mortgage REIT provides financing to real estate projects that are owned by others, deriving its earnings from interest charged on the loans. A hybrid REIT combines the equity REIT and the mortgage REIT. The finite-life REIT is structured to self-liquidate within an established time frame.

By meeting certain prescribed requirements during a taxable year, a REIT may function as a conduit with respect to income distributed to its beneficiaries. If at least 95 percent of the trust's income is distributed to the beneficiaries (excluding capital gains), the trust pays no taxes on the distributed income, thus avoiding the double taxation associated with corporations. Therefore, this investment vehicle has the tax advantage of a partnership but offers the limited liability and perpetuity of a corporation.

A REIT must be a corporation (other than an insurance company or bank), an association, or a trust, or it must be managed by at least one trustee, with transferable shares of beneficial interest as form and evidence of ownership. There must be at least 100 beneficial owners, and the trust must elect to be treated as a REIT for tax purposes. A REIT must meet the following threefold gross income test. At least 95 per-

1. Feasibility studies do not include assisting management with the planning or marketing for a given product or providing general operational or management advice.

cent of the trust's income must come from real property rentals, dividends, abatements and refunds of real property taxes, interest on loans, or gains from the sale of securities or real estate, with the further stipulation that no less than 75 percent of the trust's income must be directly related to real property. Also, less than 30 percent of the trust's income can be derived from the sale of any securities held for less than six months and from foreclosure property and real property held for less than four years that is not involuntarily converted.

In addition to the threefold gross income test, there is a twofold investment test which must be met. First, at least 75 percent of the value of the trust's total assets must be real estate assets, government securities, and cash. Second, 25 percent of the trust's total assets may be securities, but the trust cannot hold securities from one issuer which amount to greater than 5 percent of the trust's total assets and more than 10 percent of the outstanding voting securities of the issuer.

3130.3.1.1 Evaluating Advisory Activities for a REIT

A bank holding company may have an insignificant amount of capital invested in the advisory company. However, if the bank holding company or its subsidiaries have extensions of credit or unfunded commitments outstanding, an evaluation of the credit may be needed using normal classification criteria as to their collectibility, particularly if there is substantial risk exposure. Examination/inspection reports of subsidiaries should be reviewed to determine the consolidated exposure. The holding company or its banking subsidiaries may be participating in exchanges or swaps with the advised REIT, whereby trust assets are exchanged for forgiveness of bank debt. Such pending asset swaps should be considered in conjunction with the credit evaluations. The swaps may be for the purpose of reducing the REIT's liabilities, which can involve an exchange of assets with the lender. The lender's balance sheet reflects an exchange of one asset for another together with, possibly, a lump-sum payment of cash to the trust. If a swap is pending, review the criteria that the holding company used to (1) determine the benefit of the swap to the company and (2) select which of the REIT's assets would be considered for the swap. Also, determine the amount of any cash or earning assets that will be given to the trust.

A holding company and a trust have separate and distinct shareholders but common management. The potential exposure in such cases may be pronounced. Such relationships should be reviewed for conflicts of interest. Loans may be booked by the holding company or its subsidiary and subsequently sold to the trust. The credit decision may have been made by the subsidiary, and the REIT's purchase of the loans may have been approved by the affiliated adviser. The benefits to the holding company may include receiving the origination fee and selling the loan to the trust, thereby increasing the REIT's assets, upon which the holding company's advisory fee is based. Following receipt of the sale's proceeds, the process may be repeated. If the holding company has participated in this type of process, there is potential for a conflict of interest. The holding company or its subsidiary may have to repurchase the credit.

Theatened or pending litigation may result from loans that were originated by the holding company or its subsidiaries or that were recommended by the adviser. The number of such loans together with the current payment status of the credit should be determined. If there are numerous loans on a nonaccrual status, the holding company may have accumulated a significant loss. Finally, any suit involving the adviser which pertains to services it performed should be explored as to its validity and potential financial exposure.

3130.3.2 INSPECTION OBJECTIVES

1. To determine the level of risk involved when the bank holding company or its subsidiaries have extensions of credit and unfunded commitments outstanding to the advised trust.
2. To review for conflicts of interests in cases when a holding company and a trust have separate and distinct shareholders but common management.
3. To review all threatened or pending litigation involving loans originated by the holding company or its subsidiaries that were recommended by the adviser.
4. To review all covered transactions between a bank holding company's subsidiary bank and a REIT, if the REIT is sponsored and advised on a contractual basis by the bank or any subsidiary or affiliate of the bank, to ensure that transactions are permitted pursuant to sections 23A and 23B of the Federal Reserve Act.

5. To determine whether the REIT has been advised to sell real estate in the ordinary course of business and, if so, whether the appropriate liability account for corporate federal and state taxes has been established by the advised subsidiary.
6. To determine whether the REIT adviser is providing the appropriate advice to the REIT to generate nonspeculative high yields; adequate liquidity; portfolio diversification; sufficient cash flow to pay dividends; continuous repricing; and adequate public disclosure, including the extent of risk involved.
7. To determine the adequacy and quality of professional management and the level of management's equity stake in the REIT.
8. To determine the effect on net earnings from floating interest rates on asset yields that may have been caused by prepayment risk.

3130.3.3 INSPECTION PROCEDURES

1. Determine if there are any significant extensions of credit or unfunded commitments outstanding. If so—
   a. evaluate the credit using normal classification criteria as to collectibility;
   b. review examination or inspection reports of the holding company's subsidiaries and determine the consolidated exposure; and
   c. review any pending asset swaps in conjunction with the credit evaluations, if the holding company or its banking subsidiaries are participating in exchanges or swaps with the advised REIT whereby trust assets are exchanged for forgiveness of bank debt.
      - Review the lender's balance sheet to make certain that it reflects an exchange of one asset for another, as well as any lump-sum payment of cash to the trust.
      - Review the criteria the holding company used to (1) determine the benefit of the swap to the company and (2) select which of the REIT's assets would be considered for the swap.
      - Determine the amount of any cash or earning assets that will be given to the trust.
2. Determine and evaluate any significant conflicts of interests in cases when a holding company and a trust have separate and distinct shareholders but common management.
   a. Determine if there are any loans booked by the holding company or its subsidiary and subsequently sold to the trust, if the credit decision was made by the subsidiary, and if the REIT's purchase of the loans was approved by the affiliated adviser.
   b. If significant conflicts of interest exist, determine whether the holding company or its subsidiary must repurchase any associated credit.
3. Review all threatened or pending litigation involving loans originated by the holding company or its subsidiaries that were recommended by the adviser.
   a. Determine the number and amount of such loans together with the current payment status of the credit and whether any loans are on a nonaccrual status.
   b. Evaluate any suit involving the adviser that pertains to services it performed as to the suit's validity and potential financial exposure.
4. Evaluate the effect on net earnings and dividends that declining rates (floating-rate assets) have on the prices of floating-rate mortgage assets. Determine the results and the nature of any hedging strategies that are used to offset a decline in net earnings.

See also the inspection procedures in sections 3130.0 and 3130.1.

3130.3.4 FINANCIAL ADVICE ON ISSUING SECURITIES OF FOREIGN GOVERNMENTS IN THE UNITED STATES

3130.3.4.1 Financial Advice to the Canadian Federal, Provincial, and Municipal Governments

An example of providing financial and investment advisory activities is a Board order that was previously approved (now authorized under section 225.28(b)(6)(iii) of Regulation Y). The order specifically authorized the providing of financial advice to the Canadian federal and provincial governments for issuing their securities in the United States. Also, the Board's Regulation K authorizes the provision of such investment, financial, or economic advisory services to foreign governmental entities (see section 211.10(a)(8)). The Board approved the proposed activity on February 12, 1988 (1988 FRB 249).

Another Board order authorized a foreign bank, subject to the BHC Act, to acquire a securities firm to engage in this activity, but to expand the activity to include the providing of such advice to the Canadian municipal governments in addition to the federal and provincial governments. The Board concluded that the slight modification would not alter the activity to render it less closely related to banking. The Board approved the order on March 28, 1988 (1988 FRB 334). Other approved Board orders for this activity are 1988 FRB 500 and 1988 FRB 571.

3130.3.4.2 Providing Financial Advice to the Japanese National and Municipal Governments and Their Agencies

Another example of providing advice to foreign governments is a bank holding company that applied for the Board's approval to engage, through its wholly owned securities subsidiary, in certain securities-related, foreign-exchange, and investment and financial advisory activities. The activity, which consisted of providing financial advice to the Japanese national and municipal governments, had not previously been authorized for bank holding companies. When making its decision, the Board referred to similar orders as well as to the facts provided. It approved these advisory services by order on June 4, 1990. (See 1990 FRB 654.)

The Board, effective September 10, 1992, added the providing of financial advice to foreign governments, such as advice with respect to the issuance of their securities, to the activities permissible by Regulation Y, currently authorized by section 225.28(b)(iii).

3130.3.5 PROVIDING FINANCIAL-FEASIBILITY STUDIES AND VALUATION SERVICES

The following provides an example of a bank holding company that was authorized to provide financial-feasibility studies and valuation services, including expert-witness testimony in connection with the valuation services. A bank holding company (the applicant) had requested the Board's approval to acquire 100 percent of the voting shares of a company (the company) that engaged in investment advisory, investment management, and financial advisory services. The company engaged in providing (1) financial-feasibility studies for specific projects of private corporations, (2) valuations of companies and of large blocks of utility stock for a variety of purposes, and (3) expert-witness testimony on behalf of utility companies in rate cases.

In providing financial-feasibility studies, all financial aspects of the particular project were evaluated, including economic conditions, sales and earnings statements, balance sheets, and cash-flow data. Each engagement involved analyzing and projecting the income to be generated by a particular project. The Board believed that this activity was functionally similar to the financial advice traditionally offered by banks to their commercial lending customers. The applicant provided evidence revealing that certain major banks perform similar financial-feasibility analysis services for their customers. The Board thus approved the provision of such financial-feasibility studies for corporations. Certain commitments were made to guard against any possible conflicts of interests and related adverse effects between the applicant's credit-extending subsidiaries and the company, acting as an adviser regarding the financial-feasibility studies. Included was the condition that the company's financial advisory activities would not encompass the performance of routine tasks or operations for a customer on a daily or continuous basis.

Upon consideration of the above, the Board also determined the activity of providing valuations of companies, as well as the expert-witness testimony incidental to such valuations, to be permissible. The commercial lending and trust departments of banks commonly make valuations of a broad range of tangible and intangible property, including the securities of closely held companies. The applicant provided evidence that numerous banks compete directly with the company in offering corporate valuations for a fee.

The Board, effective September 10, 1992, added the providing of financial-feasibility studies to the list of nonbanking activities permitted by Regulation Y (see section 225.28(b)(6)(iii)). With the Regulation Y revisions, effective April 1997, the Board specifically determined that feasibility studies do not include assisting management with the planning or marketing for a given project or providing general operational or management advice. The 1992 amendment to this regulation permitted bank holding companies to conduct feasibility studies for high net worth individuals, as well as corporations, and financial and nonfinancial institutions. With the April 1997 amendment, such services could be provided to any person.

3130.3.5.1 Valuation Services

The valuation services included the following activities:

1. the valuation of a company for purposes of acquisitions, mergers, and divestitures
2. tender-offer evaluations
3. advice for management or for a bankruptcy court on the viability and capital adequacy of financially troubled companies and on the fairness of bankruptcy reorganizations
4. valuation opinions on transactions in publicly held securities
5. valuations on the fair market value of employee stock ownership trusts
6. periodic valuation of stock of privately owned companies held in pension or profit-sharing plans, charitable trusts, or venture-capital funds
7. the valuation of a privately owned company or of a large block of publicly owned securities for estate-tax purposes
8. for estate-tax purposes, valuations of a company's common stock and other securities for recapitalization of a privately held company

3130.3.5.2 Utility-Rate Testimony in Support of Utility-Company Valuations

The company frequently provided expert witness testimony on behalf of utility firms in rate cases. The company's personnel were retained to give expert testimony on financial matters such as the cost of capital, economic conditions, and the rate of return expected by investors in utility securities. The Board believed that to a large degree the activity may be considered incidental to the company's general provision of economic information and advice which is permissible under section 225.28(b)(6)(ii) of Regulation Y. Also, banks routinely calculate the cost of capital for customers to advise them regarding financial alternatives.

3130.3.6 EDUCATION-FINANCING ADVISORY SERVICES

Four bank holding companies (collectively, the notificants) gave notice pursuant to section 4(c)(8) of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of their intention to each acquire more than 5 percent of a company (the company) that would provide education-financing advisory services.[2] The company would enable state governments to assist parents in financing the higher education of their children.

The company will (1) develop and manage an educational savings and lending program on behalf of the state, (2) design and provide necessary computer software for the program, (3) provide marketing and program materials, and (4) train state personnel to implement the program. The notificants would eventually provide the services to various state governments nationwide.

As part of developing the education savings and lending program, the company would assist in formulating and defining its overall scope; provide the research necessary to begin operations; design the program's operations; and organize the program in cooperation with all interested parties, including coordinating participation among the state authorities. The company would also coordinate key functions of a college-funding program, such as marketing, public relations, training, investment, lending, legal documentation, financial recordkeeping, and ongoing program evaluation. In addition, the company would design, install, and maintain the computer software necessary to implement the program's services. The company's compensation would be based on application fees received by a state educational assistance authority and the amount of investment and loan balances held by the program.

All of the intended services are integrally related to advising and administering student-loan and college-savings programs. Banks offering their own student-loan and college-savings programs engage in many of the planned activities and are uniquely suited to advise and assist other potential providers, including state governments, in structuring and implementing student-loan and college-savings programs.[3] The Board previously concluded that bank holding companies may provide similar advisory and support services to state authorities that are engaged in making student loans.[4] Accordingly,

2. The notificants would have varying ownership interests in excess of 5 percent. Other individual ownership interests of less than 5 percent would be held by various banks and savings institutions located in one state. Each notificant committed that the company would be treated as a subsidiary within the meaning of the BHC Act (12 U.S.C. 1841(d)).

3. See 12 C.F.R. 225.28(b)(1) and (6).

4. See 1985 FRB 725.

based on all the facts of record, the Board concluded that the proposed activities are closely related to banking under section 4(c)(8) of the BHC Act. The Board approved the notice on September 25, 1995 (1995 FRB 1042). Approval of this proposal is specifically conditioned on the notificants' compliance with the commitments made in connection with this notice.

3130.3.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Providing financial-feasibility studies, valuation services, utility-rate testimony, but not "public" credit ratings		225.28(b)(6)(iii)		1985 FRB 118, 120
Financial-feasibility studies for issues of tax-exempt revenue bonds and private corporations				1987 FRB 59
Advice in connection with merger, acquisition/ divestiture, and financing transactions and advice regarding loan syndications, interest-rate swaps, and interest-rate-cap transactions		225.28(b)(6)(iii)		1987 FRB 59
Providing financial advice to the Canadian federal, municipal, and provincial governments, such as with respect to the issuance of their securities in the United States		225.28(b)(6)(iii)		1988 FRB 249 1988 FRB 334
Financial advice to the Japanese national and municipal governments		225.28(b)(6)(iii)		1990 FRB 654
Financial advice to state and local governments		225.28(b)(6)(iii)		1973 FRB 701
Financial advice vs. management consulting				1972 FRB 674, 676
Investment advice pertaining to income-producing real property				1983 FRB 564
Investment advisory activities and joint ventures with securities firms		225.28(b)(6)(iii)		1994 FRB 638
Education-Financing Advisory Services				1995 FRB 1042
Regulation Y revision		62 *Federal Register* 9290 to 9307 (February 28, 1997)		1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3130.4.1 INFORMATIONAL, STATISTICAL FORECASTING, AND ADVICE ON SUCH TRANSACTIONS AS FOREIGN EXCHANGE, SWAPS, COMMODITIES, AND DERIVATIVES

Providing financial and investment advisory activities may consist of a bank holding company's providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, caps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments.[1] The Board has found financial advice regarding interest-rate swap and cap transactions to be permissible. The Board has also found that providing advice in connection with currency swaps is permissible,[2] as well as providing advice regarding loan syndications.[3] This section provides an example of a February 16, 1983, Board order permitting a bank holding company to establish a de novo subsidiary to offer certain informational, advisory, and transactional services including the provision of the following:

1. General economic information and statistical forecasting with respect to foreign exchange and money markets through time-sharing networks. The services included the analysis of foreign-exchange and money market trends in the context of economic and political developments and the provision of information with respect to foreign exchange.
2. Advisory services designed to assist customers in monitoring, evaluating, and managing their foreign-exchange exposure, including making recommendations regarding policies and procedures to enhance a customer's ability to identify, measure, and manage financial risks in a multicurrency environment. The newly formed subsidiary would also provide advice on the timing of purchases and sales of foreign exchange in both spot and forward markets.
3. Transactional services with respect to foreign-exchange exposures. The subsidiary would arrange foreign-exchange transactions by anaffiliated bank holding company and other commercial banks.

As a condition for approval, the applicants were required to seek the Board's authorization if they engaged in any additional activities within the United States. (See 1983 FRB 221.)

Effective February 6, 1984, the Board amended Regulation Y to allow bank holding companies to offer foreign-exchange advisory and transactional services that include providing general information and statistical forecasting with respect to foreign-exchange markets. The activity included arranging for "swaps" among customers with complementary foreign-exchange exposures and the execution of foreign-exchange transactions, provided the activity would be conducted through a separately incorporated subsidiary of the bank holding company that will observe the standards of care and conduct applicable to fiduciaries with respect to its foreign-exchange advisory and transactional services.

3130.4.1.1 Inspection Objectives

1. To determine the financial effect of the activity on the parent BHC and its bank subsidiary (or subsidiaries).
2. To determine that the specific activities provided by the company are permissible.
3. To determine that the company is not exposing itself to conflicts of interest between its own role of recommending foreign-exchange positions to its customers and any role its affiliates may have in executing foreign-exchange transactions.

3130.4.1.2 Inspection Procedures

1. Review the company's financial statements for accuracy, and determine if there are any factors or trends that could have an adverse impact on the parent holding company or the bank subsidiary (or subsidiaries).
2. Review the company's policies and procedures to determine that the following are present:
   a. adequate minutes of the board and board committee meetings
   b. adequate blanket bond coverage
3. Review a sample of recommendations to determine that a reasonable basis exists for the company's recommendations.

1. See 62 Federal Register 9,290 (February 28, 1997) (12 C.F.R. 225.28 (b)(6)) or 1997 FRB 275.
2. See 1989 FRB 308.
3. See 1987 FRB 220.

4. Review the company's fee schedule for providing advice and the fees charged by affiliated banks to conduct foreign-exchange transactions for the company's customers. Determine whether bank subsidiaries are being adequately compensated for executing trades, or whether these profits are accruing largely to the benefit of the bank holding company or its nonbank subsidiaries.
5. Review the company's revenue sources to determine that it has not taken foreign-exchange positions and does not execute foreign-exchange transactions.

3130.4.2 FINANCIAL ADVICE AS TO THE STRUCTURING OF AND ARRANGING FOR LOAN SYNDICATIONS, INTEREST-RATE SWAPS, CAPS, AND SIMILAR TRANSACTIONS

A bank holding company may provide information, statistical forecasting, and advice with respect to any transaction in swaps, caps, and similar transactions; commodities; and any forward contract, option, future, option on a future, and similar instruments.[4] The Board has found financial advice regarding interest-rate swap and cap transactions to be permissible.[5] The Board has also found the provision of advice regarding loan syndications to be permissible.[6]

An example of a Board order regarding providing financial advice is one in which a bank holding company (BHC) applied for the Board's approval to establish its company de novo as a financial advisory firm. The Board had not previously approved the structuring of and arranging for loan syndications (see section 225.25(b)(6)(ii) of Regulation Y) or arranging for interest-rate "swaps" and interest-rate caps, and similar transactions (see section 225.28 (b)(6)(iv) of Regulation Y). Interest-rate caps are contractual agreements wherein the seller of a cap agrees to make payment to the purchaser of a cap if a particular interest-rate index (prime) exceeds a predetermined level, with payments calculated on an assumed principal amount for a deferred time period. The caps and swaps are typically used to manage or hedge outstanding positions in the financial markets.

The Board's authorization included the following conditions:

1. The advice rendered by the company on an explicit fee basis will be rendered without regard to correspondent balances maintained by the customers of the company at any depository institution subsidiary of the BHC.
2. Company's financial advisory activities shall not encompass the performance of routine tasks or operations for a customer on a daily or continuous basis. The Board, on November 28, 1986, approved the activity by order (1987 FRB 59). (See 1990 FRB 756.) The Board subsequently, effective September 10, 1992, added this nonbanking activity to the list of activities permitted by Regulation Y. (See section 225.28(b)(6)(iii) for loan syndications and 225.28(b)(6)(iv) for interest-rate swaps and caps.)

Reference can also be made to another Board order (1991 FRB 184) relating to providing advice on joint ventures, leveraged buyouts, restructurings, recapitalizations, and other corporate transactions (see 225.28 (b)(6)(iii) of Regulation Y), as well as to providing advice regarding the structuring and arranging of swaps, caps, and similar transactions relating to interest rates, currency and exchange rates and prices, and economic and financial indexes (see 225.28(b)(6)(iv) of Regulation Y).

3130.4.3 ADVICE RELATING TO THE STRUCTURING OF AND ARRANGING FOR CURRENCY SWAPS

A foreign bank subject to the BHC Act applied for the Board's approval to acquire a company engaged in certain securities, foreign-exchange, and financial advisory activities. The Board previously determined the activities proposed by the BHC, except for providing advice relating to the structuring of and arranging for currency swaps, to be closely related to banking. As for advice on currency swaps, it was noted that most banks that provide advice relating to interest-rate swaps also provide advice relating to currency swaps. Providing advice as to currency swaps was deemed to be functionally and operationally similar to providing advice relating to the structuring of and arranging for interest-

4. See 62 Federal Register 9,290 (February 28, 1997) (12 C.F.R. 225.28 (b)(6)) or 1997 FRB 275.
5. See 1989 FRB 308.
6. See 1987 FRB 220.

rate swaps. Both transactions have the common objectives of securing low-cost funds and converting one type of risk to another, and both transactions require similar documentation. The Board approved the activity by order on February 13, 1989 (1989 FRB 308). The Board, effective September 10, 1992, added providing advice as to currency swaps to the nonbanking activities permitted by regulation. See section 225.28(b)(iv) of Regulation Y.

3130.4.4 ADVICE WITH RESPECT TO FUTURES CONTRACTS

3130.4.4.1 Limited Advisory Services with Respect to Futures Contracts on Stock Indexes and Options on Such Futures Contracts

The following is an example of a bank holding company that applied to the Board to engage de novo, through a wholly owned subsidiary, in the provision of advisory services with respect to futures contracts on stock indexes and options thereon. The advisory services to be provided consisted of general research and advice on market conditions and hedging strategies, client-account information and reconciliation of trades, and communication linkage between clients and exchange floors in connection with the subsidiary's futures commission merchant activities. The services offered to customers were provided either as part of an integrated package of services or for a separate fee.

The futures advisory services were essentially identical to the advisory services previously approved by the Board by regulation and order with respect to other financially related futures contracts. The Board concluded the applicant's provision of advisory services for futures contracts on stock indexes and for options thereon to be permissible (1987 FRB 220 and section 225.28(b)(6)(iv) of Regulation Y).

Previously, the Board had approved the execution and clearance of futures contracts on stock indexes and options thereon (1985 FRB 251). At that time, however, the Board had not approved a proposal to provide investment advisory services in connection with the execution and clearance of such instruments.

3130.4.4.2 Advice on Certain Futures and Options on Futures

This section is a historical example of a bank holding company that requested the Board's approval to provide de novo investment advice concerning futures and options on futures contracts on foreign exchange, government securities, and bullion and money market instruments. In addition, the company would provide portfolio investment advice, for which applicant had previously received authorization pursuant to Regulation Y (the authorization is currently included in section 225.28(b)(6)(iv)).

Previously, the Board had approved the provision of investment advice as a futures commission merchant (FCM) (section 225.28(b)(7)(iv)(A)) or as a commodity trading adviser (CTA) registered with the Commodity Futures Trading Commission (CFTC). The provision by an FCM or CTA of such advice could include providing counsel, publications, written analyses, and reports relating to the purchase and sale of futures contracts and options on futures contracts that bank holding company futures commission merchant subsidiaries are permitted to execute and clear. Such advisory services could also consist of providing written or oral presentations on the historical relationship between the cash and futures markets or the functions of futures as hedging devices, demonstrating examples of financial futures uses for hedging, and assisting in structuring a hedging strategy for a cash position. FCMs and CTAs are subject to registration with and regulation by the Commodity Futures Trading Commission pursuant to the Commodity Exchange Act, as amended. (7 U.S.C. 1).

Before incorporation of the advisory activity into Regulation Y (see 1986 FRB 369), the Board had determined by order that the provision of futures and options advice by FCMs is permissible and closely related to banking (see 1985 FRB 168 and 111, 1984 FRB 780, and 1984 FRB 369). A CTA could provide such advice even though it is not acting as an FCM.

The issue presented by this latter proposal was whether the conduct of this activity by company would be a proper incident to banking if company, serving as an adviser, did not meet the *former* Regulation Y requirement of registering with the CFTC as a CTA or FCM. The applicant expected to qualify for a statutory exemption (7 U.S.C.6m) from the registration under section 4m of the Commodity Exchange Act. This exemption provides that any person who, during the previous 12 months, has not furnished commodity advisory services to more than 15 persons and has not represented himself or herself to the public as a CTA is exempt from the registration requirements for CTAs under the act. The applicant's proposal permitted company to provide commodity trading advice without those safeguards. The Board held that it expects the adviser to disclose to its customers substantially the same information required for registered CTAs, including the CTA's performance record, conflicts of interest, possible trading risks, and civil and criminal actions against the CTA.

The Board concluded that the possible adverse effects would be further minimized by the following conditions:

1. Company will remain subject to the antifraud provisions of the Commodity Exchange Act as well as other restrictions in the act.
2. The adviser will not trade for its own account (except to hedge), will limit its advice to instruments that banks deal in extensively (foreign exchange, bullion, government securities, and money market instruments), and will only serve customers that are financially sophisticated and have significant dealings or holdings in the underlying commodities or instruments. The Board approved the application by order on October 18, 1988 (1988 FRB 820).

3130.4.5 PROVIDING DISCRETIONARY PORTFOLIO MANAGEMENT SERVICES ON FUTURES AND OPTIONS ON FUTURES ON NONFINANCIAL COMMODITIES

With respect to the Regulation Y provisions effective April 21, 1997, discretionary portfolio management advice is not separately listed in section 225.28(b)(6)(iv). Discretionary investment advice is discussed, however, within the preamble to the final rule. The preamble emphasizes that such advice may be provided to any person (such advice is no longer limited to institutional investors) regarding contracts relating to financial and nonfinancial assets.

Foreign banking organizations (applicants) subject to the BHC Act provided notice to engage through their subsidiary (company) in providing investment advisory services with respect to futures and options on futures on financial and nonfinancial commodities, including discretionary portfolio management services.[7] The Board previously determined that the proposed activities, with the exception of providing discretionary portfolio management services with respect to futures and options on futures on nonfinancial commodities, are closely related to banking.

The Board had permitted bank holding companies to provide investment advice with respect to futures and options on futures on both financial and nonfinancial commodities. (See section 225.28(b)(6)(iv) of Regulation Y.) The Board also previously approved providing discretionary portfolio management services with respect to futures and options on futures on financial commodities. (See 1995 FRB 386.) In addition, the Office of the Comptroller of the Currency permits national banks to engage in discretionary funds management with respect to futures and options on futures on nonfinancial commodities. (See OCC Interpretive Letter No. 494 (December 20, 1989).)

In this regard, applicants committed that company would provide the proposed discretionary portfolio management services only at the request of the customer. Applicants also committed that company would comply with applicable law, including fiduciary principles. In addition, applicants proposed that company exercise its discretionary portfolio management authority only in purchasing and selling exchange-traded futures and options on futures contracts previously approved by the Board. The Board gave its approval on June 30, 1995 (1995 FRB 803).

3130.4.6 COMBINATION OF PROVIDING ADVICE WITH OTHER NONBANKING ACTIVITIES

3130.4.6.1 Providing Nonfinancial Futures Advice and the Combining of Foreign-Exchange, Government Securities Advisory, and Execution Services

A BHC applicant requested the Board's permission to engage in trading options on foreign exchange and offering investment advice on financial and nonfinancial options and futures contracts, securities, and interest-rate and currency swaps. The applicant applied to provide these advisory services through a partnership, of which it would own 80 percent of its equity.

7. Company does not trade futures or options on futures for its own account or provide futures commission merchant execution or clearance services.

This partnership would provide these advisory services only to the applicant, its affiliates, and the applicant's partner, a commodity trading organization. The partnership would provide execution services only to the applicant and its affiliates, not to the applicant's partner.

The Board had not previously approved the provision of nonfinancial futures advice for bank holding companies. The Board noted that the Office of the Comptroller of the Currency (OCC), by OCC Interpretive Letter 494 (December 20, 1989), determined that a national bank could provide execution, clearing, and advisory services for customer transactions in standardized, exchange-traded "nonfinancial" futures contracts and options, such as futures on oil and agricultural products. The OCC determined that the contracts are financial products and that the provision of investment advice was essentially the same as the advice given with respect to financial futures contracts. The OCC contends that investment advice is incidental to the bank's authority to purchase and sell the instruments on behalf of its customers.

The Board has permitted bank holding companies to provide advice with respect to futures and options on futures relating to bank-eligible securities, bullion, and foreign exchange (12 C.F.R. 225.28(b)(6)(iv)). The Board also has permitted bank holding companies to provide investment advice with respect to options and futures contracts based on broad-based indexes of stock and bonds (1990 FRB 770). The Board thus determined that the provision of investment advice with respect to investing in options and futures, based on nonfinancial instruments, to be the functional equivalent of providing advice on options and futures based on financial instruments. In each case, the bank holding company subsidiary is furnishing advice with respect to trading of a financial instrument. The partnership would not provide advice to third parties without Federal Reserve approval. The Board thus approved the providing of investment advice on nonfinancial futures, options, and options on futures.

The applicant also proposed that the partnership provide execution services to the applicant's wholly owned subsidiary and to the applicant's U.S. branches with respect to—

1. over-the-counter options on foreign exchange, U.S. government securities, and other money market instruments, and indexes on such securities and instruments;
2. exchange-traded transactions in futures, options, and options on futures on foreign exchange, U.S. government securities, and other money market instruments, and indexes on such securities and instruments; and
3. spot and forward transactions in foreign exchange.

The Board previously approved the combination of advice and execution for—

1. foreign-exchange transactions (1990 FRB 649),
2. transactions on derivative instruments based on U.S. government securities and other money market instruments (1990 FRB 664), and
3. securities brokerage (1989 FRB 396).

The Board approved by order the providing of the combination of foreign-exchange and government securities advisory and execution services on December 21, 1990 (1991 FRB 126).

For these reasons, the Board approved the providing of discretionary portfolio management services with respect to futures and options on futures on nonfinancial commodities on June 30, 1995. (See 1995 FRB 803).

3130.4.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Provide information and advice on foreign operations and arrange foreign-exchange transactions				1983 FRB 221
Foreign-exchange and advisory and transactional services added to Regulation Y		225.28(b)(6)(iv)		
Financial advice as to the structuring of, and arranging for loan syndications, interest-rate swap, caps, and similar transactions		225.28(b)(6)(iii) and (iv)		1987 FRB 59 1990 FRB 756
Advisory services with respect to futures contracts on stock indexes and options on such futures contracts		225.28(b)(6)(iv)		1987 FRB 220
Providing discretionary portfolio management services on futures and options on futures on nonfinancial commodities		225.28(b)(6)(iv)		1995 FRB 803
Providing nonfinancial futures advice and the combining of foreign-exchange, government securities advisory, and execution services		225.28(b)(6)(iv)		1995 FRB 803
Advice in connection with currency swaps		225.28(b)(6)(iv)		1989 FRB 309

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The financial and investment advisory nonbanking activity of consumer financial counseling may consist of providing advice, educational courses, and instructional materials to individuals on consumer-oriented financial-management matters, including debt consolidation, applying for a mortgage, bankruptcy, budget management, real estate tax shelters, tax planning, retirement and estate planning, insurance, and general investment management. The authority for this advisory activity is currently derived from section 225.28(b)(6)(v) of Regulation Y.

This nonbanking activity was added to the Regulation Y "laundry list" in 1986. Previously, the Board authorized the provision of consumer financial counseling services by order. (See 1979 FRB 65, 1979 FRB 265, 1985 FRB 253, and 1985 FRB 662. These references are only historical examples.) A bank holding company may provide information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, caps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments.[1] The Board has found financial advice regarding interest-rate swap and cap transactions to be permissible. The Board has also found that providing advice in connection with currency swaps is permissible,[2] as well as providing advice regarding loan syndications.[3] The revised Regulation Y, effective April 1997, deleted restrictions on consumer-counseling services that prohibited bank holding companies from promoting specific products and services, and from obtaining or disclosing confidential customer information without the customer's consent. These restrictions do not apply to banks that engage in the above activities.

Prudent management should take into consideration certain actions to prevent potential conflicts from arising. When considering these orders, the Board was concerned that the provision of consumer financial counseling activities could potentially result in unfair competition, conflicts of interest, and other adverse effects. (See 1979 FRB 267.) Examiners should be alert to problems that may arise from such conflicts as they review this nonbanking activity. Further, the examiner should determine whether counselors, as a general practice, are advising each customer that they are not required to purchase any services from affiliates, and determine whether customers have the option to exclude themselves from service and product offerings provided by affiliates.

1. See 62 *Federal Register* 9,290 (February 28, 1997) (12 C.F.R. 225.28 (b)(6)) or 1997 FRB 275.
2. See 1989 FRB 308.
3. See 1987 FRB 220.

3130.5.1 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Providing financial-management courses, counseling, and related instructional materials				1979 FRB 265
Engaging, through an acquired bank, in consumer financial counseling				1985 FRB 253
Providing consumer financial counseling services as a permissible nonbanking activity		225.28(b)(6)(v)		1986 FRB 833 1985 FRB 662

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Financial and investment advisory services include tax-planning and tax-preparation services. Tax planning involves providing advice and strategies designed to minimize tax liabilities. For individuals, this includes analysis of the tax implications of retirement plans, estate planning, and family trusts; for corporations, it includes analysis of the tax implications of mergers and acquisitions, the portfolio mix, specific investments, previous tax payments, and year-end tax planning. Tax preparation involves the preparation of tax forms and advice concerning liability based on records and receipts supplied by the client. This nonbanking activity was included in the Regulation Y ''laundry list'' in 1986. (See section 225.28(b)(6)(vi).) Such services may be provided to any person. Effective April 21, 1997, certain restrictions were removed. These Regulation Y revisions deleted restrictions in the area of tax-planning and tax-preparation services that prohibited bank holding companies from promoting specific products or services and from obtaining or disclosing confidential customer information without the customer's consent. These restrictions do not apply to banks. This fact needs to be considered when referring to the historical examples that follow.

The Board had previously approved, by order (1985 FRB 168), the activity of tax-preparation services for individuals. Since tax-preparation services for corporations is functionally or operationally similar to the tax-preparation services that banks already provide to individuals as well as to their affiliates and other financial institutions, the Board approved the providing of corporate tax-preparation services. When the nonbanking activity was incorporated into Regulation Y in 1986, tax-planning and tax-preparation services were authorized, not only for individuals and corporations, but for noncorporate businesses, such as partnerships and sole proprietorships and tax-exempt nonprofit organizations. Tax-planning and tax-preparation services must be conducted in accordance with applicable jurisdictional law.

3130.6.1 INSPECTION OBJECTIVES

1. To ascertain whether the customer has the option to be excluded from promotions of other specific products and services.
2. To determine what financial effect the activity has on the parent company and its subsidiaries.
3. To determine whether the company has formal written policies and procedures to ensure accurate, timely, and confidential preparation and maintenance of customers' tax returns.
4. To determine whether the tax-return preparers are appropriately qualified to provide such tax services, and to determine the extent of management's involvement in the activity.
6. To identify the potential and extent of off-balance-sheet risk associated with the activity.

3130.6.2 INSPECTION PROCEDURES

1. Review the company's financial statements for accuracy, and determine if there are any factors or trends that could have an adverse impact on the parent company or the bank subsidiaries.
2. Determine whether bonding and other insurance coverage is adequate in relation to the risks associated with the activity.
3. Review pertinent contracts, client lists, public advertising and information, correspondence, and other documentation representing the services provided, and determine if charges for the tax-preparation service are on an explicit fee basis that is not dependent on the amount of tax savings achieved.
4. Determine if the client has a written legal opinion on file certifying that the activity is not considered the practice of law.
5. Review pertinent correspondence and the minutes of board of directors and board committee meetings, and determine if any significant law suits, Internal Revenue Service adverse actions, or other potential or contingency losses are pending and probable because of inaccurate tax-return preparation. Analyze their probable effect in relation to the financial condition of the company.
6. Review the company's formal written policies and procedures for assurance of professional competence in providing sound tax-planning advice and the accurate, timely, and confidential preparation and maintenance of customer's tax returns. The policies and procedures should require that tax-planning advice be clearly communicated by persons who are adequately supervised and who possess the necessary professional technical training and experience needed to provide tax-planning advice.

3130.6.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Preparation of tax returns in a non-fiduciary capacity is closely related to banking				1985 FRB 168
Permissible nonbanking activity		225.28(b)(6)(vi)		1986 FRB 833

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

WHAT'S NEW IN THIS REVISED SECTION

This section has been revised (subsection 3140.0.2.2) to include a brief summary of a June 10, 2016, Board order (FRB Order no. 2016-07) that approved a notice by a foreign bank holding company and its foreign wholly owned subsidiary bank to engage in permissible nonbanking activities under section 4(c)(8) of the BHC Act and section 225.24 of the Board's Regulation Y. The nonbanking activities include railcar leasing and the provision of certain railcar fleet management services pursuant to section 225.28(b)(3) of Regulation Y (leasing personal property and acting as an agent, broker, or advisor in leasing personal property) and section 225.21(a)(2) (engaging in incidental activities that are necessary to carrying on permissible nonbanking activities). The table of Laws, Regulations, Interpretations, and Orders has been amended to include the order in subsection 3140.0.7.

3140.0.1 LEASING AUTHORIZATIONS WITHIN REGULATION Y

Leasing is a form of financing that provides a lessee (the customer) the right to use land or depreciable assets without tying up working capital. As a result of the tax benefits that can arise from the ownership of equipment, real property, or tangible personal property, leasing provides the lessor (the owner of the property) with a generally higher rate of return than what could be achieved through lending. In 1971, ''leasing personal property or acting as agent, broker, or adviser in leasing such property'' was added to the Regulation Y list of permissible nonbanking activities for bank holding companies. In 1974, the authority to engage in this activity was expanded to include the leasing of real property.

In 1997, restrictions on leasing activities were removed to permit greater flexibility to acquire leaseable property in quantity and to sell or re-lease property upon the lease's expiration. The removed restrictions consisted of the maximum lease term, maximum holding period for leased property, limit on acquisitions of property to specific leasing transactions, restriction on leases to those that served as the functional equivalent of extensions of credit, and 100 percent limit on the amount of reliance that could be placed on the value of leased property. The added clarifications consisted of more details on the requirements for a nonoperating lease, particularly those for automobile rentals.

3140.0.2 PERMISSIBLE LEASING ACTIVITIES

Two types of leasing activities are permissible for bank holding companies: full-payout leasing and high-residual-value leasing. A *full-payout lease* is the functional equivalent of an extension of credit that relies primarily on rental payments and tax benefits to recover the cost of the leased property and related financing costs. *High-residual-value leasing* may involve significant reliance on the expected residual value of the leased property—on average, under 50 percent. However, this value can extend up to the full original cost of the property (that is, to recover the full acquisition cost of the leased property plus related financing costs).

When leasing personal or real property, or acting as agent, broker, or adviser, only those leasing transactions meeting the following criteria are considered permissible:

1. The lease must be on a nonoperating basis.
2. The initial lease term must be at least 90 days.
3. For leasing involving real property—
   a. at the inception of the initial lease, the effect of the transaction must yield a return that will compensate the bank holding company, as lessor, for its full investment in the property plus the estimated total cost of financing the property over the term of the lease (this includes rental payments, estimated tax benefits, and the estimated residual value of the property at the expiration of the initial lease); and
   b. the estimated residual value (yield) of the property at the expiration of the initial term of the lease may not exceed 25 percent of the acquisition cost of the property to the bank holding company (lessor).

With respect to leasing personal or real property on a nonoperating basis, the bank holding company or its subsidiary may not engage in operating, servicing, maintaining, or repairing leased property during the lease term. A bank holding company, however, can arrange for a third party to provide the services or products. (See Regulation Y, section 225.28(b)(3).)

As for automobiles, a bank holding company may not (1) provide servicing, repair, or maintenance of the leased vehicle during the lease term; (2) purchase parts and accessories either in bulk or for an individual vehicle after its delivery to the lessee; (3) provide the loan of an automobile during the vehicle's servicing; (4) purchase insurance for the lessee; or (5) provide for the renewal of the vehicle's license (registration) without authorization from the lessor.

3140.0.2.1 Automobile Fleet Leasing and Fleet-Management Services

A foreign banking organization (FBO) that is treated as a bank holding company requested an opinion from the Board's staff regarding leasing activities that the Board has determined to be permissible under section 225.28(b)(3) of Regulation Y. (See 12 C.F.R. 225.28(b)(3).) In connection with its automobile-leasing activities, the FBO provides, through a wholly owned automobile fleet leasing subsidiary (AFLS), fleet-management services to its automobile fleet leasing customers. In connection with making automobile and equipment leases that conform with the requirements of Regulation Y, AFLS engages in the business of commercial lending and financial leasing of motor vehicle fleets and equipment located throughout the United States, and providing fleet-management services to companies that lease corporate automobile fleets. AFLS and other participants in the business market and deliver the three services as a bundled service to clients.[1]

To better provide fleet-management services to its automobile-leasing customers (in connection with leases that conform with Regulation Y), AFLS acquired another fleet-management-services subsidiary company (FMSS) that (1) arranges for third parties to provide vehicle maintenance, accident-management services, and safety-management services and (2) directly provides client-support services in connection with the services arranged by AFLS. FMSS, in addition to permissible leasing activities, conducts some fleet-management services for automobiles that are owned by the client and that are not, therefore, subject to a lease.

As represented, approximately 90 percent of the vehicles serviced by FMSS are leased and 10 percent are client-owned. Revenues earned from fleet-management services that are provided for client-owned vehicles are less than 2 percent of the AFLS's total revenues. The FBO asked whether it would be permissible for it to provide fleet-management services with regard to automobile fleets if the customer owns rather than leases the vehicles.

In an opinion issued on December 19, 2003, Board staff noted that Regulation Y, as a general matter, permits a bank holding company to engage in any incidental activities that are necessary to carry on an activity permitted by the regulation.[2] Board staff stated also that, in light of the nature of the practices in the fleet-management industry and the difficulty in continually monitoring the migration between leased and owned vehicles in the same fleet, some ability to perform fleet servicing for owned vehicles is necessary to retain customers in connection with AFLS's fleet-leasing activities. Board staff determined, in view of all the facts of record, including this necessity, the minimal amount of revenue earned from servicing owned vehicles,[3] and the fact that the activity is primarily an agency activity, that the FBO could provide fleet-management services to owned vehicles as an activity incidental to the FBO's authorized leasing activities. In a December 19, 2003, opinion, Board staff stated that the provision of fleet-management services on owned vehicles is subject to the same restrictions set forth in Regulation Y for leased vehicles.[4]

3140.0.2.2 Railcar Leasing and Railcar Fleet Management Services

On June 10, 2016, the Board approved a notice (FRB Order no. 2016-07) by a foreign bank holding company and its foreign wholly owned subsidiary bank to engage in nonbanking activities under section 4(c)(8) of the BHC Act and section 225.24 of the Board's Regulation Y. Fifty percent of the voting shares of a rail trans-

1. The Board previously found providing fleet-management services to be permissible if the fleet involves vehicles that are under a lease that conforms to Regulation Y. (See 12 C.F.R. 225.28(b)(3).) Permissible leases are considered to be the financial equivalent of a loan.

2. See 12 C.F.R. 225.21(a)(2). Staff also noted that the courts have recognized the authority of bank holding companies to engage in incidental activities that are reasonably necessary to the conduct of closely related activities.

3. AFLS has stated that it will limit its fleet-management services involving vehicles not subject to a Regulation Y permissible lease to no more than 15 percent of the fleet-management revenues and to 5 percent of the total leasing revenues of AFLS.

4. See 12 C.F.R. 225.28(b)(3).

port company (Delaware Corporation) would be acquired, thereby acquiring its wholly owned Illinois corporate subsidiary that engages in railcar leasing and related activities in North America. As a result of the acquisition, the wholly owned subsidiary bank would engage in certain nonbanking activities. The nonbanking activities include railcar leasing and the provision of certain railcar fleet management services pursuant to section 225.28(b)(3) of Regulation Y (leasing personal property and acting as an agent, broker, or advisor in leasing personal property) and section 225.21(a)(2) (engaging in incidental activities that are necessary to carrying on permissible nonbanking activities).

3140.0.3 ACCOUNTING FOR LEASES

Leasing has become a prominent financing vehicle. Lessors have employed a number of different methods in structuring and accounting for leases. Standards for lease accounting are set forth in Accounting Standards Codification (ASC) Topic 840, "Leases" (formerly FASB Statement No. 13, "Accounting for Leases," as amended and interpreted).

Accounting for leases must be viewed from the perspective of the parties involved in the leasing transaction, the lessee and the lessor. Negotiations and closing costs incurred with respect to the lease should be written off over the life of the lease. In applying ASC Topic 840, certain terminology is used. Basic terms that should be considered are described below.

Inception of a lease. The inception of a lease refers to the date the lease contract was signed or to the date that the construction was completed, or, if earlier, to the date of the written commitment stating the significant terms.

Term of the lease. The lease term consists of the noncancelable term and the period comprising the bargain renewal option.

Fair value of lease property. The fair value of a lease consists of the price that the property could be sold in an arm's-length transaction.

Economic life of the leased property. The economic life of the leased property represents the period over which the property is expected to be economically beneficial to one or more users for its intended purpose.

Estimated residual value of the leased property (ERV). The residual value is the estimated fair value of the leased property at the expiration of the lease term.

Interest rate implicit in the lease. The implicit interest rate is the discount rate that causes the sum of the minimum lease payments and the unguaranteed residual value at the end of the lease term to be equal to the fair value of the property at the beginning of the lease term.

Lessee's incremental borrowing rate. The incremental borrowing rate is the interest rate at which the lessee could borrow the funds to purchase the leased property.

3140.0.3.1 Accounting for Leases by a Lessee

The two methods for accounting for leasing transactions by a lessee are the operating method and the capitalized-lease method.

3140.0.3.1.1 Operating Method of Accounting for Leases

The operating accounting method merely records the cost of the rental payments as an expense when it is required to be paid in accordance with the terms of the lease agreement.

Example: Assume that equipment is leased for $100,000 per year for three years. Under this method, the annual cost would be recorded as a rental expense on the income statement:

Dr. Rent	$100,000	
Cr. Cash		$100,000

To record an annual payment of rent based on an operating-lease agreement.

3140.0.3.1.2 Capitalized-Lease Method of Accounting for Leases

3140.0.3.1.2.1 When a Lessee Is to Use the Capitalized-Lease Method

If *any one* of the following conditions exist, the lessee must capitalize the lease:

1. The asset is owned by the lessee at the end of the lease term.
*2. The lease term is equal to or more than 75 percent of the estimated economic life of the asset.
3. The lessee can purchase the asset below its fair market value before or at the end of the lease term (bargain purchase option).
*4. The present value of the minimum lease payments at the beginning of the least term is equal to or more than 90 percent of the fair market value of the property.

* If the lease begins in the remaining 25 percent of the asset's estimated economic life, these items do not apply; such leases are considered operating leases.

Using this method, the lease is recorded as an asset at the lesser of the present value of the rental and other minimum lease payments or the fair value of the leased property as though the lease obligation was being purchased on credit. The payment made is treated as a payment made on an installment debt. At the same time, the asset is being amortized over the lease term. The lease obligation is treated as a long-term debt. The discount rate that is used to capitalize the lease is the lessee's incremental borrowing rate or the interest rate implicit in the lease agreement.

Example #1: This example illustrates the capitalized-lease method using the same example as above with the added fact that the lease agreement contains an interest rate of 10 percent. Assume that the interest rate of the lease agreement is the same as the lessee's marginal borrowing rate.

Dr. Capitalized Lease	$248,685	
Cr. Lease Obligation		$248,685

To record an equipment lease obligation under a capitalized-lease agreement.

(Present value of $100,000 per year for three years at a 10 percent interest rate)

1st Year

Interest Expense	$ 24,869	
Lease Obligation	75,131	
Cash		$100,000

To record the first year's payment on an equipment lease obligation.

($248,685 × .10 = $24,869)

Dr. Equipment Lease Amortization	$ 82,895	
Cr. Capitalized Lease		$ 82,895

To record the annual amortization of a capitalized equipment lease.

($248,685/3 years)

2nd Year

Dr. Interest Expense	$ 17,355	
Dr. Lease Obligation	82,645	
Cr. Cash		$100,000

To record the second annual lease payment under a three-year capitalized-lease agreement.

(Interest = $248,685 + 24,869 − $100,000 = $173,554 × .10 = $17,355)

Dr. Lease Amortization	$ 82,895	
Cr. Capitalized Lease		$ 82,895

To record the second year's lease amortization under a three-year capitalized lease.

3rd Year

Dr. Interest Expense	$ 9,091	
Dr. Lease Obligation	90,909	
Cr. Cash		$100,000

To record the third year's lease payment under a three-year capitalized-lease obligation.

(Interest = $173,554 + $17,355 = $190,909 − $100,000 = $90,909 × .10 = $9,091)

The financial statements are to include footnotes that disclose the present value of noncancelable lease commitments where the lessor either recovers more than 75 percent of the economic life of the asset leased or recovers the investment plus a reasonable return.

3140.0.3.2 Accounting for Leases by a Lessor

3140.0.3.2.1 Operating Lease (Lessor)

A lessor would have the following accounting entries for an operating lease:

Dr. Cash	$xxx,xxx	
Cr. Rent Income on Leased Assets[5]		$xxx,xxx
Dr. Depreciation Expense	$xxx,xxx	
Cr. Accumulated Depreciation—Leased Assets		$xxx,xxx

In order for the *lessor* to be able to capitalize a direct-financing lease, any one of the same four criteria for a lessee must apply along with two additional criteria:

5. Any rent received in advance would be initially credited to "unearned rent revenue."

1. Collectibility of the minimum lease payments must be reasonably predictable.
2. No important uncertainties exist as the amount of unreimbursable costs incurred.

In accounting for the lessor's capitalized lease transactions, there are some common accounts that are used. These are described below.

Unearned income from lease financing receivables. Unearned income represents the unearned interest liability account that is netted against the total of lease payments receivable which includes the estimated residual value for balance-sheet presentation. It represents the "interest" income equal to the excess of rentals receivable over the fair value of the property at the inception of the lease.

Lease financing receivables. This asset account is established in the amount of total lease payments to be received from the lessee. The amount by which the rentals receivable exceeds the cost of the property is the functional equivalent of interest and represents a portion of the income to be recognized over the life of the lease. In the example below, the cost of the property is temporarily charged to a fixed asset account, then transferred to lease payments receivable.

Throughout the lease term, the rentals receivable account is periodically reduced by the full amount of each rental payment received.

3140.0.3.2.2 Direct Financing Capitalized Lease

In this situation, a finance company purchases equipment from a manufacturer (recorded as equipment [asset] when purchased). The finance company (lease financing nonbanking subsidiary) then leases that equipment and records it as a normal financing lease. There is *no* dealer profit from the sale of the asset. Unearned interest income is recognized over the life of the lease using the effective interest method. Since the lessor has "sold" the asset, no depreciation is recorded.

Example #1: Lease with No Guaranteed Residual Value by the Lessee

Assume that the finance company purchases equipment costing $100,000. It then leases the equipment to a lessee under a five-year lease agreement that requires annual payments of $25,000 per year. At the end of the lease term, the lessee will own the equipment. The implied interest rate is 7.931 percent (comparison of the present value of the equipment of $100,000 against the $25,000 annual payment for five years).

Dr. Equipment	$100,000	
Cr. Cash		$100,000

To record the purchase of equipment to be leased

Dr. Lease Financing Receivables	$125,000	
Cr. Equipment		$100,000
Cr. Unearned Income from Lease Financing Receivables		25,000

To record the initial lease

Year 1

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 7,931	
Cr. Income from Lease Financing Receivables		7,931

To record the receipt of the first equipment lease payment.

Lease Payments Receivable	$125,000
Unearned Interest Revenue	−25,000
	$100,000 × .07931 = $7,931

Year 2

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 6,577	
Cr. Income from Lease Financing Receivables		$ 6,577

To record the receipt of the second equipment lease payment.

Lease Payments Receivable	$100,000
Unearned Interest	−17,069 ($25,000 − 7,931)
(Present Value of Remaining Receivable	$ 82,931) × .07931 = $6,577

Year 3

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 5,116	
Cr. Income from Lease Financing Receivables		$ 5,116

To record the receipt of the third equipment lease payment.

Lease Payments Receivable	$ 75,000
Unearned Interest	−10,492 ($17,069 − $6,577)
(Present Value of Remaining Receivable	$ 64,508) × .07931 = $5,116

Year 4

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$25,000
Dr. Unearned Income from Lease Financing Receivables	$ 3,539	
Cr. Income from Lease Financing Receivables		$ 3,539

To record the receipt of the fourth equipment lease payment.

Lease Payments Receivable	$ 50,000
Unearned Interest	−5,376 ($10,492 − $5,116)
(Present Value of Remaining Receivable	$ 44,624) × .07931 = $3,539

Year 5

Dr. Cash	$ 25,000	
Cr. Leases Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 1,837	
Cr. Income from Lease Financing Receivables		$ 1,837

To record the receipt of the fifth equipment lease payment.

Lease Payments Receivable	$ 25,000
Unearned Interest	−1,837 ($5,376 − $3,539)
(Present Value of Remaining Receivable	$ 23,163) × .07931 = $1,837

Example #2: Lease with a Residual Value (Guaranteed by the Lessee)

A lessor acquires property to be leased for $14,000 (its fair value at the inception of the lease). The estimated economic life of the property is five years. The lease has a noncancelable lease term of four years with a rental payment due of $3,649 at the end of each year. The lessee guarantees the residual value at the end of the four-year lease term in the amount of $4,000. The lessor's implied rate of interest in the lease is 10.8695 percent. The present value of the minimum lease payments at this interest rate and monthly payments exceeds 90 percent of the fair value of the property at the inception of the lease (.90 × $14,000 = $12,600).

Year 1

January 1, 19x1

Dr. Equipment	$ 14,000	
Cash		$ 14,000

To record purchase of equipment for the purpose of a financing lease.

Dr. Lease Financing Receivables	$ 18,596	
Cr. Equipment		$ 14,000
Cr. Unearned Income from Lease Financing Receivables		4,596

To record investment in direct-financing lease

December 31, 19x1

Dr. Unearned Income from Lease Financing Receivables	$ 1,521	
Cr. Income from Lease Financing Receivables		$ 1,521

To recognize the portion of unearned income that is earned at the end of the first year of investment.

(Fair value of property at inception of the lease of $14,000 × 10.8695% = $1,521)

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivables		$ 3,649

To record receipt of the first year's rental

Year 2

Dr. Unearned Income from Lease Financing Receivables	$ 1,290	
Cr. Interest Income from Lease Financing Receivables		$ 1,290

To recognize the portion of unearned income that is earned at the end of the second year of investment

($14,000 + 1,521 − 3,649 = $11,872 × 10.8695% = $1,290)

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivables		$ 3,649

To record the receipt of the second year's rental

Year 3

Dr. Unearned Income from Lease Financing Receivables	$ 1,034	
Cr. Income from Lease Financing Receivables		$ 1,034

($11,872 + 1,290 − 3,649 = $9,513 × 10.8695% = $1,034)

To recognize the portion of unearned income that is earned at the end of the third year of investment

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivables		$ 3,649

To record the receipt of the third year's rental.

Year 4

Dr. Unearned Income from Lease Financing Receivables	$ 751	
Cr. Income Lease Financing Receivables		$ 751

To recognize the portion of unearned income that is earned at the end of the fourth year of investment.

($9,513 + 1,034 − $3,649 = $6,898 × 10.8695% = $751)

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivable		$ 3,649

To record the receipt of the fourth year's rental.

Dr. Cash	$4,000	
Cr. Lease Financing Receivables		$ 4,000

To record the receipt of the lessor's guaranteed residual value (guaranteed by the lessee) at the end of the lease term.

($6,898 + 751 − $3,649 = $4,000)

3140.0.3.2.3 Balance-Sheet Presentation

The lease payments receivable would be reported on the balance sheet as a single amount "net investment" (Lease Financing Receivables less the balance of the Unearned Income from Lease Financing Receivables). If the lessor has established an allowance for possible lease losses, this amount is shown separately as a deduction from the net investment. The net investment in the direct financing lease is $18,000 for example #2 above. It consists of the gross investment of $18,596 ($3,649 × 4 annual rental payments) plus the $4,000 residual value less the unearned income of $4,596.

3140.0.3.2.4 Classification

If it is deemed appropriate to classify a lease, the amount to be classified (in example #2 above) would be the net investment. For illustration, assume that two of the four payments had been received on the lease, that income has been recognized monthly according to the effective interest rate method, and that the lease is now considered a loss. Further assume that the third payment should have been received eight months ago. It is determined during the inspection that the lease should be classified as doubtful of collection. The balance to be classified is the net investment of $7,728. This consists of the balance of Lease Financings Receivable of $9,513 (includes the $4,000 estimated guaranteed residual value) less the balance of Unearned Income from Lease Financings Receivable of $1,785 ($1,034 + $751 = amount due on regular payment intervals) or a net investment of $7,728.

3140.0.3.2.5 Delinquency

It is considered appropriate to state in the inspection report the percentage of delinquency in the lease portfolio. The percentage is calculated by deviding the aggregate rentals receivable on delinquent leases (less unearned income on the delinquent leases) by the total of rentals receivable on all leases (less their unearned income). Estimated realizable values would not be included in the delinquent amounts unless they were guaranteed by the lessee.

3140.0.4 LEVERAGED LEASES

The lessor can "leverage" a lease transaction by borrowing a substantial portion of the acquisition cost from a long-term lender, with the rentals and the property pledged as collateral for the loan. The lessor borrows in order to finance a leasing transaction with a small, or perhaps, a negative equity in the property to be leased.

The initial step in accounting for this type of lease involves calculating the cash flows over the term of the lease. The cash flows include the income tax effects of tax deductions to the lessor, the lessor's initial investment in the property, the rental receipts net of debt service, and the proceeds expected to be received from the sale of any residual. The next step in accounting for a leverage lease involves determining the applied interest rate that, when applied to the net investment in the years that the net investment will be positive, would precisely allocate the net income to the positive years. See appendix E of SFAS 13 for an example as to how to account for a leveraged lease.

3140.0.5 INSPECTION OBJECTIVES

1. To determine the effect of the investment in the leasing subsidiary upon consolidated operations, and indirectly upon the bank subsidiaries' safety and soundness.
2. To determine if the company is operating in compliance with applicable laws and regulations, and to ensure that corrective action is initiated if warranted.
3. To determine if policies, procedures, and controls are adequate to protect the company from mismanagement, unnecessary risk, and loss.
4. To assess the management's ability to operate the company in a safe and sound manner.
5. To determine that accounting practices do not overstate income.

3140.0.6 INSPECTION PROCEDURES

The decision whether the operations of a leasing subsidiary will be inspected "on-site" is based on the availability and adequacy of leasing company data at the offices of the parent company. Item 1 below provides a listing of information necessary to the inspection process. If this and any other information necessary to assess the overall condition of the subsidiary is available at the parent's office or can be obtained through a written request to the subsidiary, an on-site inspection may not be necessary. The inspection frequency requirements, found in section 5000.0.4, should be reviewed in making such a determination.

1. The following information should be available at the start of the inspection:
   a. trial balance of all leases and outstanding credits,
   b. listing of accounts on which payments are delinquent 30 days or more, or on which payments are otherwise not being made according to schedule,
   c. comparative interim and fiscal financial statements of the leasing company,
   d. listing of unbooked assets and contingent liabilities,
   e. cash-flow projections for the current fiscal year and the next fiscal year,
   f. listing of available lines of credit,
   g. copies of the most recent internal and external audit reports, and
   h. minutes of board and executive committee meetings since the date of the previous inspection.
2. Establish a "credit line" above which all leases will be reviewed. The line can be set at an amount that will cause a certain percentage of the dollar volume of the lease portfolio to be reviewed (e.g., between 70 percent and 80 percent), or at an amount that will cause the review of each lease exceeding a certain percentage of gross capital. Leases on which payments are delinquent are to be reviewed regardless of amount.
3. Analyze the creditworthiness of the lessees. Consideration is given to the figures derived from the lessee's financial statements, as well as cash flow, trends and projections of growth in sales and income, and the qualifications of management.

   Delinquency on a lease obligation is potentially more serious than delinquency on a conventional loan. If the property under lease is necessary for the lessee's continued production of income, as is frequently the case, the lessee's financial condition will be seriously deteriorated before the lessee is willing to risk losing the property by default.
4. For those leases which might result in loss to the lessor, or for which financial information was not adequate to make such a determination, transcribe the following information to line sheets:
   a. name and line of business of lessee

b. name of guarantor(s)
c. original date of the lease contract
d. original amount of the rentals receivable
e. ERV of the property
g. book value of the investment in the lease as of the inspection date
h. cost of the property
i. description and location of the property
j. amount and frequency of rental payments
k. original amount, term, rate, and schedule of amortization of any nonrecourse debt associated with the lease
l. lessor's percentage of equity participation in the lease obligation, if applicable
m. summary financial data indicating the creditworthiness of the lessee, and guarantors, if applicable

5. Before the conclusion of the inspection, discuss with management all classified leases. Inadequate or negative cash flow and unfavorable trends reflected in financial statements of the lessee are usually indicative of a substandard lease. Leases classified doubtful typically include those on which payments are delinquent for an extended period and those on which the lessor's recovery of investment is dependent upon an event of unknown probability, such as a pending lawsuit or insurance claim.

   A loss classification results from the lessee's inability or refusal to continue making payments.
6. Prepare a write-up to support the classifications. The write-up should include the lessee's type of business, present financial status, circumstances which led to the classification, the probability that the terms of the lease can be met, and the amount of protection afforded by sale or re-lease of the underlying property.
7. Review a sample of the lessor's computations of lease yields to determine whether the lessor will recover not less than the full investment in the property plus the estimated total cost of financing the property over the term of the lease. This includes rental payments, estimated tax benefits, and the estimated residual value of the property at the expiration of the initial lease.

   With respect to the full-payout lease, governmental entities may be prohibited from entering into leases for periods exceeding one year. In that case, the bank holding company or its subsidiary (as lessor) should demonstrate that the lease is expected to be continually renewed until the cost is fully recovered.
8. Ascertain whether title to the property rests with the lessor, and that the lessor has taken steps to protect its ownership rights. Evidence of filing under the Uniform Commercial Code, where appropriate, should be found in the documentation file. Aircraft should be registered with the FAA, interstate vehicles with the ICC, and ships with the Coast Guard.
9. Check for cancellation or other provisions in the contract which could jeopardize the full-payout status of the lease. There is no need to take exception to a cancellation provision which provides for payment by the lessee of an amount which allows the lessor to recover fully its investment in the property.
10. Check that insurance coverage is effective on leased property and is provided by the lessee in compliance with all insurance provisions of the contract in an amount sufficient to protect against loss from property damage. Public liability insurance should also be provided to protect against loss from lawsuits which could arise from situations such as the crash of leased aircraft.
11. Review the lessee's duties under the contract with respect to repairs and taxes. Determine whether the lessor has instituted procedures to check that the lessee's required duties are being performed.
12. Review the status of all property acquired for lease purposes but which is not now under lease. Determine the reason for the "off-lease" status of the property, ascertain the realizable value of the property, and investigate whether the off-lease property will be sold or re-leased within the required two-year period.
13. Investigate the lessor's procedures for periodic review of the reasonableness of the estimated residual value. The estimate should be reviewed at least annually and reduced in amount on the books if the value has declined on a presumably permanent basis.
14. Review past operations of the lease company to determine if projections of income and ERV have been realistic in light of actual experience.
15. Review the minutes of the meetings of the board and executive committees to determine whether purchases of property and delinquent leases are reported to the board.
16. Determine if the company has entered into leases with companies owned or controlled by any director, officer, or 10 percent share-

holder of the leasing company or holding company. Compare the rates and terms on such leases to the rates and terms offered on leases to companies of similar credit standing.

17. Check for lease concentrations to any one lessee or industry and prepare a comment for the inspection report if any concentration is considered unwarranted.
18. Determine whether the company has established limits for the maximum amount of ''credit'' to be extended to a single lessee. If such limits have been established, investigate whether the company adheres to them. If they have not been established, inquire as to the company's policy on this matter.
19. Provide the examiner-in-charge with information to be included in the inspection report, including:
    a. scope of the inspection (on- or off-premises)
    b. comments concerning any policies or conditions having an adverse effect on the leasing company or parent company
    c. brief history of the company and a description of its activities
    d. summary analysis of financial factors of the company, including trends in the volume and classification of receivables, adequacy of capital and reserves, return on assets, and contribution to consolidated income and consolidated assets
    e. statutory authority under which the company operates
    f. details of all borrowings of the company from within the holding company system and from external sources
    g. details of any litigation in which the company is a defendant
    h. scope and frequency of audit of the company by both internal and external auditors
20. Compare current earnings performance and balance-sheet ratios of the company with past performance and industry composites.
21. Determine whether cash flows of the company are adequate to service all debts.
22. Assess the adequacy of internal controls over the company's operations.
23. Check for action taken on matters criticized in the most recent audit reports and the previous inspection report. Determine if leases classified ''loss'' were removed from the books.
24. Investigate whether any affiliated banks maintain compensating balances for lines of credit of the leasing company, and if so, whether the leasing company compensates the bank for maintenance of the balances. If ''loss'' leases have not been removed from the books, discuss with management the reasons why the charge-offs were not made. Determine whether the financial statements and reports submitted to the Board of Governors were misstated as a result of the ''no charge-off'' decision.
25. For higher residual value leasing, determine that—
    a. the residual values have been estimated accurately;
    b. residual values are reviewed and adjusted annually;
    c. the initial terms of the lease are at least 90 days;
    d. the lessor relies on a residual value of the leased property that will recoup the acquisition cost of the property and any related financing or other associated costs;
    e. the aggregate book value of all tangible personal property held for such a lease, having an estimated residual value in excess of 25 percent of the acquisition cost of the property, does not exceed 10 percent of the BHC's consolidated domestic and foreign assets;
    f. the BHC maintains separately identifiable records of the leasing transactions and activities; and
    g. each company maintains capitalization fully adequate to meet its obligations and support its activities, and that its capital levels are commensurate with industry standards for companies engaged in comparable leasing activities.

3140.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Automobile Leasing				1976 FRB 930
Consumer leasing	15 U.S.C. 1667			
Higher residual value leasing				1991 FRB 490, 187 1990 FRB 462, 960
Personal or real property leasing activities of bank holding companies		225.28(b)(3)		
Special-purpose leasing corporation			3-712	
Railcar leasing, railcar fleet management services (leasing personal property and acting as agent, broker, or adviser in leasing personal property)		225.28(b)(3)		2016 FRB Q2 Board Order 2016-07
Engaging in incidental activities reasonably necessary to carrying on permissible nonbanking activities		225.21(a)(2)		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

The Board considers the making of equity and debt investments in corporations or projects designed "primarily to promote" community welfare as an activity closely related to banking. The Board includes such investments in the list of permissible nonbanking activities in Regulation Y; however, bank holding companies must obtain prior approval to engage in these activities. The Board, effective April 21, 1997, included the provision of advisory and related services for programs designed primarily to promote community welfare into Regulation Y. Such advisory activities had previously been permitted only by Board order. For examples of advisory services approved for community development projects, see 1990 FRB 671, 1989 FRB 576, and 1988 FRB 140.

3150.0.1 INVESTMENTS IN CORPORATIONS OR PROJECTS TO PROMOTE COMMUNITY WELFARE—BOARD INTERPRETATION

The Board also provides guidance with regard to investments in community welfare projects through its interpretation (see section 225.127 of Regulation Y (12 C.F.R. 225.127)). This interpretation describes projects that the Board has considered as promoting community welfare as their primary intent. These include but are not limited to—

1. projects to construct or rehabilitate housing for low- or moderate-income persons,
2. projects for construction or rehabilitation of ancillary local commercial facilities necessary to provide goods or services principally to persons residing in low- or moderate-income housing, and
3. projects designed explicitly to create improved job opportunities for low- or moderate-income groups.

Because the Board believes that bank holding companies should take an active role in the quest for solutions to the nation's social problems, it has not defined other types of investments designed primarily to promote the community welfare in order to give bank holding companies greater flexibility in developing new and creative approaches to resolving community problems. Accordingly, the Board has maintained the flexibility to determine whether an activity is primarily designed to promote the community welfare. Factors that the Board might consider include whether the activity benefits low- and moderate-income individuals in areas such as housing and employment and the need for specialized community development activities in different localities. The Board will consider a range of different activities, but will probably not approve a proposal that does not in some way either benefit low- or moderate-income individuals or benefit the specialized needs of local communities.

Once a bank holding company has obtained Board approval to engage in community development activities pursuant to Regulation Y, the holding company may, without further System approval, engage either directly or through a subsidiary in certain community development activities, so long as such activities do not exceed 5 percent of the bank holding company's total consolidated capital stock and surplus.

A bank holding company may invest and provide financing—

1. to a corporation or project or class of corporations or projects that the Board previously has determined is a public welfare project pursuant to paragraph 23 of section 9 of the Federal Reserve Act (12 U.S.C. 338a);
2. to a corporation or project that the Office of the Comptroller of the Currency previously has determined, by order or regulation, is a public welfare investment pursuant to section 5136 of the Revised Statutes (12 U.S.C. 24 (Eleventh));
3. to a community development financial institution (other than a bank or bank holding company) pursuant to section 103(5) of the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C. 4702(5));
4. for the development, rehabilitation, management, sale, and rental of residential property if a majority of the units will be occupied by low- and moderate-income persons or if the property is a "qualified low-income building" as defined in section 42(c)(2) of the Internal Revenue Code (26 U.S.C. 42(c)(2));
5. for the development, rehabilitation, management, sale, and rental of nonresidential real property or other assets located in a low- or moderate-income area provided the property

is used primarily for low- and moderate-income persons;

6. to one or more small businesses located in a low- or moderate-income area to stimulate economic development;
7. for the development of, and to otherwise assist with, job training or placement facilities or to foster programs designed primarily for low- and moderate-income persons;
8. to an entity located in a low- or moderate-income area if that entity creates long-term employment opportunities, a majority of which (based on full-time equivalent positions) will be held by low- and moderate-income persons; and
9. for providing technical assistance, credit counseling, research, and program development assistance to low- and moderate-income persons, small businesses, or nonprofit corporations to help achieve community development.

3150.0.2 EXAMPLES OF BOARD-APPROVED ACTIVITIES DESIGNED TO PROMOTE COMMUNITY WELFARE

With its primary thrust to promote community welfare rather than creating a focus on a collateral effect, economic rehabilitation and development should focus on providing housing, services, or jobs for low- or moderate-income residents or groups. Examples of projects previously approved by the Board include an investment in—

1. an agricultural test farm (testing crops, equipment, alternative farming methods and chemicals, and providing student agricultural research opportunities and financial planning workshops for farmers (see 1990 FRB 671);
2. an entity that provides education to young persons (see 1991 FRB 70) through a nonprofit, tax-exempt bank holding company (educational programs consisted of the American economic system, how to start a business, college financial planning, and career opportunities in banking);
3. the acquisition and redevelopment of a sole medical clinic in a small rural town without public transportation that was located 30 miles from another facility and was needed to attract new physicians to replace those retiring (see 1991 FRB 63); and
4. a limited partnership to develop a nearly vacant office building into a hotel complex within a major city, located adjacent to a public housing project. Commitments included providing training to welfare recipients residing in public housing projects and employing low- and moderate-income individuals at the hotel complex, and donating a portion of the profits to a nonprofit corporation designated to provide low-cost housing, employment, and business opportunities for disadvantaged residents. (See 1996 FRB 679.)

3150.0.3 EXAMPLES OF INVESTMENTS VIEWED AS NOT PROMOTING COMMUNITY WELFARE

The Board has indicated that some investments are not designed primarily to promote community welfare unless there is substantial evidence to the contrary, even though the investment may benefit the community to some extent. Examples include investments to build or rehabilitate high-income housing or commercial, office, or industrial facilities which are not designed explicitly to create job opportunities for low-income persons, even though the investment may benefit the community to some extent. This latter point was made in an order (see 1996 FRB 679) whereby the Board denied an application by a bank holding company to acquire an investment in an industrial development corporation involved in the construction of a shopping and office complex in an urban renewal area. The Board identified the critical issue as whether the project was devised primarily to promote the community welfare or primarily designed as a profit-making venture in which the benefits to the community were merely a collateral effect.

In another case, the Board denied a proposal intended to acquire a company that indirectly acted as a managing general partner of a private development venture. The venture was a large-scale, urban redevelopment initiative, jointly sponsored by government and private entities, that was intended to revitalize a geographic area that was largely abandoned within a working middle-class community. (See 1990 FRB 672.)

3150.0.4 INSPECTION OBJECTIVES

1. To determine that new investments and financing in community development and other corporations and projects are designed primarily to promote community welfare.
2. To determine that previous investments and financings continue to meet the standards

imposed by section 225.28(b)(12) of Regulation Y.

3. To determine that the activity remains within the scope of regulatory approval when such approval involves specific rather than general investments.
4. To determine that advisory and related services for programs designed primarily to promote community welfare are being conducted within the scope of their regulatory approval.

3150.0.5 INSPECTION PROCEDURES

As is standard practice in the examination of other subsidiaries engaged in nonbanking activities, a thorough review of pertinent books, records, contracts, and financial statements should be undertaken by the examiner. To fulfill the inspection objectives concerning this activity, the examiner may have to go beyond routine investigative practices. Since this activity encompasses a wide variety of programs, procedures will have to be developed on an ad hoc basis. When federal or state approval of the program is required, the examiner may wish to review applications and other materials submitted to such authorities. The terms or conditions imposed by such bodies as well as the subsidiary's continued eligibility may also be of importance. Contact with responsible federal or state officials may be deemed appropriate in certain cases. Such contacts, however, should be initiated only in accordance with respective Reserve Bank procedures. When a community welfare project or financing does not include the involvement of another governmental body, the examiner will need to verify directly whether goals essential to the nature of the activity, such as providing housing for the elderly or jobs for low- or moderate-income people, are being met. In this regard, the burden should be on the holding company to provide such data. In some instances, an on-site visit to the project may be appropriate.

3150.0.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Permissible investments described	1701	225.28(b)(12) 225.127	4–178	1972 FRB 495 1978 FRB 45 1984 FRB 452
Provision of community development advice on a fee-for-service basis				1988 FRB 140 1989 FRB 576
Purchase of land for agricultural testing activities				1990 FRB 672
Nonprofit, tax-exempt BHC—educational programs in economics, starting businesses, financial planning, career opportunities in banking				1991 FRB 70
Projects to create improved job opportunities for low- or moderate-income groups				1992 FRB 619
Approval of community development converting an office building into a hotel complex, located next to a public housing project designated as ''difficult to develop''				1996 FRB 679
Denial of a bank holding company formation by a community development corporation				1976 FRB 639
Denial of a venture that would revitalize an abandoned area in a middle-class community				1994 FRB 733

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.