Bank:

Date of Exam:

Charter #:

Prepared By:

#12 – Interbank Liabilities (Risk Focused)

ASSIGNMENT OVERVIEW

Interbank liabilities are created as depository institutions perform transactions and services for one another. A bank's exposure to its correspondents may take the form of federal funds sold, uninsured transaction accounts used to facilitate the transfer of funds or compensate for services performed, and interest-bearing time deposits as a form of investment. Banks also utilize other banks to provide certain services which can be performed more economically or efficiently by the other banks because of their size or geographic location. Such services include acting as an agent for federal funds, processing cash letters, funding overline loan requests, performing EDP and payroll services, collecting out of area items, etc. Significant reliance upon, or concentrations of assets with, another institution exposes a bank to risk in the event of that institution's failure to perform or insolvency. Bank management and board of directors should identify and control risk associated with interbank liabilities, especially when the exposure to any particular institution becomes significant. All insured institutions are required to establish and maintain written policies and procedures to prevent excessive exposure to any individual correspondent, in accordance with the Federal Reserve's Regulation F (12 CFR Part 206), Limitations on Interbank Liabilities. Refer to internal Reference Material document for additional resources and information.

INSTRUCTIONS

All examiners performing these procedures must be listed above in the "Prepared By" section. All of the CORE ANALYSIS PHASE should be completed. Comments and findings for each step should be made in the comment box below each question. Reference to work paper documentation should also be included here. Documentation is to be sufficient to allow an audit trail of the examiner's thought process and all significant findings.

Based on any weaknesses or risks noted in the CORE ANALYSIS PHASE or as directed by the EIC, the applicable SUPPLEMENTAL ASSESSMENT PHASE (SAP) should also be performed. Responses should be entered in the SAP. All of the important findings/deficiencies identified while performing the SAP should be summarized in the corresponding CORE ANALYSIS comment section.

The EIC/AEIC should review this procedure when complete. Acknowledgement that this procedure has been reviewed by the EIC/AEIC will be noted on the SCOPE FORM.

EXAMINERS ARE RESPONSIBLE FOR EXERCISING SOUND JUDGMENT AND UTILIZING REASONABLE INVESTIGATIVE AND ANALYTICAL SKILLS TO ARRIVE AT AN ACCURATE ASSESSMENT OF THE RISK PROFILE OF THIS SEGMENT OF THE INSTITUTION'S OPERATIONS. PERFORMING ALTERNATE PROCEDURES NOT LISTED WITH THESE GUIDELINES MAY BE NECESSARY TO COMPLETE THIS RISK ANALYSIS.

CORE ANALYSIS PHASE

#12 – Interbank Liabilities

1. Prior Criticisms

1. Determine whether deficiencies noted in the last examination and most recent internal/external audit have been addressed and/or corrected by management. Detail how deficiencies were corrected. *Include copy of exam and/or audit exceptions and management response in work papers, or summarize exceptions/criticisms below or indicate the page number in the last examination report where deficiencies are noted, if applicable.*

Comment:

2. Reconcilements

2a. Review a sample of reconcilements and correspondent bank statements of due from bank accounts and FFS accounts. Determine the following:

- Are all reconciling items clearly described and dated?
- Are active accounts balanced daily and inactive accounts balanced monthly?
- Do starting balances agree with general ledger accounts?
- Are there items over 30 days that should be considered for possible classification?
- Are there an inordinate number of correcting entries and any repetitive pattern of off-setting items that need to be investigated?

Comment on any deficiencies. Refer to **Appendix** for additional guidance on stale or unusual items. *Include in 12-A of work papers a copy of reconciliations and bank statements with comments on exceptions.*

Comment:

2b. Review and describe the bank's reconciling procedures. If a lack of segregation of duties is noted, describe the bank's internal controls or alternate procedures used to mitigate risk. Refer to **Appendix** for guidance.

Comment:

3. Policies, Procedures & Compliance

3a. Review the Interbank Liability Policy for compliance to the minimum criteria established in **12 CFR 206 (Regulation F)**. Comment on deficiencies and cite any violations. *Include a copy of the policy in 12-C of work papers and indicate date approved by the Board.*

#12 – Interbank Liabilities

Comment:

3b. Determine if any deficiencies exist regarding the bank performing periodic reviews of the condition of all significant correspondents and performing at least quarterly reviews for any correspondent to which its potential credit exposure is more than 25% of its capital. Document any deficiencies and discuss with the EIC.

Refer to **Appendix** for additional guidance on significant correspondents and credit risk as well as Part 364 of the FDIC Rules & Regulations-Interagency Guidelines Establishing Standards for Safety and Soundness. Also review **FIL-18-2010** *Interagency Guidance on Correspondent Concentration Risk.* The guidance outlines expectations for identifying, monitoring and managing correspondent concentration risks between financial institutions; and expectations relative to performing appropriate due diligence on all credit exposures to and funding transactions with other financial institutions.

Comment:

3c. Determine if the aggregate of demand and due from time balances and federal funds sold (net those sold as agent) to one financial institution of affiliated group equal or exceed 100% of Tier 1 Capital. If so, cite a concentration.

Comment:

3d. Review agency relationships/agreements for adequacy and compliance with **Regulation F** guidelines. Comment on any deficiencies. Determine the following:

- Does the Board approve a list of eligible investors provided by agent bank?
- Does management monitor the financial condition of eligible investors?
- Does the agent bank provide a periodic accounting for each purchaser to whom the banks federal funds were sold, or is it available upon request?
- Does the accounting include the name and location of the purchaser; the amount of the transaction; the federal funds rate earned and expiration date?
- Does management monitor the condition of the agent bank?

Comment:

4. Confirmations

4. Compare confirmations to general ledger and bank records on interest bearing due from accounts, federal funds purchased/sold, and time deposits. Report any discrepancies to the EIC. *Include copy of confirmations in 12-D of work papers.*

#12 – Interbank Liabilities
Comment:
5. Purchased Time Deposits

5. Review bank owned time deposits for the following documentation:

- Evidence of ownership (bank or investor);
- Method of acquisition (i.e. directly from issuing bank, deposit listing service, deposit broker);
- Evidence of purchase (i.e. wire transfer receipt, canceled check, etc.); and
- Interest payment documentation (i.e. check, ACH, wire transfer).

If any time deposits are purchased through a deposit listing service or deposit broker (third party), complete the **SAP**. *(*Refer to Regulatory Guidance 3003 – Brokered Certificates of Deposits*)* Comment on any deficiencies. *Include list of purchased time deposits with balances, interest rates, and maturity dates in work papers.*

Comment:

6. Final Analysis

6. Complete the **Summary of Findings**.

SUMMARY OF FINDINGS

#12 - INTERBANK LIABILITIES
Describe all strengths evident from the evaluation.
Describe all weaknesses evident from evaluation, including violations of law/regulation/rules; noncompliance with Departmental policies/guidelines; internal policy deficiencies/ noncompliance; internal control weaknesses; MIS problems; and deficiencies in management supervision.
Report Worthy:
Not Report Worthy:
Determine why weaknesses exist and comment on management's response and plan of action. Identify bank personnel making the response.
SUMMARY RISK RATING ASSIGNED: enter rating here

Risk Rating Definitions
1-Strong; 2-Satisfactory; 3-Less than satisfactory; 4-Deficient; 5-Critically deficient; NR-Not Rated

Provide copy of this page to EIC/AEIC. Receipt and review of this form by the EIC/AEIC will be evidenced by his/her initials in the appropriate column for this procedure on the SCOPE FORM.

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SUPPLEMENTAL ASSESSMENT PHASE (SAP)

SAP

Document findings within the SAP and summarize (include weaknesses and statements on compliance with regulations or policies) in the corresponding CORE ANALYSIS section.

PURCHASED TIME DEPOSITS (Q5a)

Determine the following:

1. **(a)** Does the bank own the time deposits in its own right or are they owned by two or more investors?

(b) If several investors own a portion of the master time deposit, do account records of the issuing bank reflect that the broker is acting as agent for the institution and other owners?

(c) If the bank has purchased "fractionalized" investments, explain ownership.

2. Are the time deposits held by the issuer in the name of the bank? If the bank is not the recorded owner:

- Identify the person/bank/broker that is paying the interest.
- Determine the name of the recorded owner.
- Are those investments subject to the bank's legal lending limit?

3. Has management determined the characteristics of the time deposits through documented confirmations or verifications with the issuers? Review the confirmations/ verifications for the following:

- Is the maturity date in writing?
- Do any of the time deposits include call features?
- Are there withdrawal penalties? If not, is a buyer necessary prior to withdrawing the funds?
- Is there a disclosure statement that specifies the interest rate and whether it is fixed or variable?

4. If the bank uses a deposit listing service or a deposit broker, does the bank rely on the third party for the purchase, settlement, or holding of the time deposits? If so:

- Has the Board approved the type and nature of ownership for time deposits?
- Does management perform routine screening checks into the qualifications and backgrounds of these individuals or entities?
- Has management determined whether the third party is, or is required to be, registered with the Securities and Exchange Commission and/or the State Securities Board? As a general rule, an unregistered firm or individual should only be used as a finder with the bank

SAP
purchasing the time deposits directly from the issuing depository institution. **5.** Are policies and procedures regarding purchased time deposits comprehensive and approved by the Board? Do the policies address the following as appropriate: • The use of bank-purchased time deposits • Limits on the volume and types of time deposits • Approved banks, deposit listing services, and deposit brokers, including screening requirements • Positive direct confirmation procedures at inception and on an ongoing basis • Documentation requirements
Comments:
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APPENDIX

Reconcilements – Stale or Unusual Items

If large amounts of stale or unusual items exist, consider preparing an aging report that reflects the number and amount of open items over 30 days old for each due from account as of financial date. General time frames for credits and debits are as follows:

Item	Time Frame
Cash Letters	Next Day
ACH Transactions *	Same or next day
ACH Returns	Within 2 days
Non-ACH Returns	Within 1 week
E Bonds and TT&L	Within 2-3 days
Cash Shipments	Next Day
Bond Transactions	Same or Next Day
Interest Payment or Charges	Next Day

ACH rules allow for three returns rather than the paper presentation of two times. However, only two of the returns can be by the same method (i.e. one physical and two ACH or two physical and one ACH.)

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APPENDIX

Reconcilements – Internal Controls

Shortcomings in the bank's procedures and controls, as they relate to correspondent bank accounts, can lead to manipulation and shortages.

Internal Control Considerations:

1. Is the employee reconciling the accounts also preparing/approving/posting general ledger entries, issuing drafts or official checks, or performing federal funds transactions?

    - What other internal controls does the bank have in place to mitigate the lack of segregation of duties?
    - Are alternative procedures in place to ensure that one individual does not have exclusive control over reconcilements while also preparing or entering data to the general ledger or subsidiary ledger?

2. Are permanent records of reconcilements and investigations maintained and safeguarded?

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APPENDIX

Policies, Procedures, and Compliance

Significant Correspondents

1. General Rule: A bank should limit overnight credit exposure to a correspondent to 25% of the exposed bank's capital, unless the bank can demonstrate that it is at least "adequately capitalized".

2. The Federal Reserve Bank and Federal Home Loan Bank are not included in the definition of a correspondent and should be excluded.

3. Correspondents are considered insignificant when the exposure is limited to:
   - Small account balances maintained for clearing purposes;
   - A collecting bank's risk that a check will be returned;
   - An originating bank's risk that an ACH debit transfer will be returned or its settlement reversed;
   - A receiving bank's risk that settlement for an ACH credit transfer will be reversed; or
   - A credit card transaction.

Credit Exposure

1. **Credit exposure includes:**
   - Due from deposit balances;
   - Federal funds sold (except when sold under an agency agreement);
   - Credit equivalent amounts of interest rate and foreign exchange rate contracts; and
   - Other off-Balance sheet transactions.

2. **Credit exposure does not include:**
   - Transactions in an agency or similar capacity;
   - Exposure related to the settlement of transactions;
   - Intra-day exposure; or
   - Fully secured transactions.

Highlights from Federal Financial Regulatory Agency Guidance on *Correspondent Concentration Risks*

- A financial institution's relationship with a correspondent may result in credit (asset) and funding (liability) concentrations. On the asset side, a credit concentration represents a significant volume of credit exposure that a financial institution has advanced or committed to a correspondent. On the liability side, a funding concentration exists when an institution depends on one or a few correspondents for a disproportionate share of its total funding.
- While the federal banking agencies recognize some concentrations meet certain business needs or purposes, correspondent concentrations represent a lack of diversification, which adds a dimension of risk that management should consider when formulating strategic plans and internal risk limits.
- Institutions should implement procedures for identifying correspondent concentrations, which encompass their aggregate credit and funding concentrations to each correspondent on both a stand-alone basis and on an organization-wide basis.
- Institutions should specify prudent internal parameters relative to what information, ratios or trends will be monitored for each correspondent on an ongoing basis.
- Institutions should develop plans for managing concentration risks when internal limits, ranges or tolerances are met or exceeded, either individually or collectively.
- Institutions that maintain or contemplate entering into any credit or funding transactions with another financial institution should ensure the terms for these transactions are on an arm's-length basis; conform to sound investment, lending and funding practices; and avoid potential conflicts of interest.

Read the guidance and view the illustrations in FIL-18-2010 issued April 30, 2010.

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