

RESCINDED

Office of Thrift Supervision

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Department of the Treasury

Regulatory Bulletin RB 32-10

Handbook: **Thrift Activities**
Subject: **Various Sections**

This rescission does not change the applicability of the conveyed document. To determine the applicability of the conveyed document, refer to the original issuer of the document.



Thrift Activities Regulatory Handbook Update

Summary: This bulletin provides updates for the following Thrift Activities Regulatory Handbook sections: 060, Examination Strategy, Scoping, and Management; 071, CAMELS Ratings; and 280, Margin Securities (Regulation U). Please replace the existing handbook sections with the enclosed revised sections. We provide a summary of changes for each section below.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Supervision Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: www.ots.treas.gov. If you wish to purchase a handbook and a subscription to the updates, please contact the OTS Order Department at (301) 645-6264.

Regulatory Bulletin 32-10

SUMMARY OF CHANGES

OTS is issuing updates to the following Thrift Activities Handbook Sections. Change bars in the margins of handbook section 280 indicate revisions. Totally rewritten handbook sections such as Section 060 and 071 do not have change bars, but we provide a summary of all substantive changes to the Handbook Sections in the listing below. These handbook sections are in plain language to comply with the President's June 1, 1998, memorandum "Plain Language in Government Writing."

060 Examination Strategy, Scoping, and Management

Revises the section title to reflect the order of topics presented in the text. OTS totally rewrote this section to incorporate the June 11, 1998, memo to the Regional Directors regarding Examination Cycle Strategy.

Examination Strategy: Incorporates the final rule for the expanded examination cycle for certain small insured institutions.

Supplemental Examinations: Includes in the list of factors that determine whether a supplemental on-site examination is necessary "Deterioration in asset quality indicators such as non-performing assets."

Additional Scoping Considerations: Omits the discussion of providing TB 68 (previously RB 4a) to the CEO at the opening meeting. See Exam Closing Procedures.

Regulatory Bulletin 32-10

PERK: Adds reference to the electronically available PERKDOCS for ease of tailoring requests and printing necessary documents. Includes suggestions regarding sending the PERK to the institution in advance.

"Core" PERK: Adds discussion of the ELD Request.

Compliance Examinations: Revises heading of the former Nondiscrimination Questionnaire to the Fair Lending Questionnaire (PERK 007). Adds description of two new PERK documents, the CRA Optional Information (PERK 015) and the CRA Public File Summary (PERK 016).

Supplemental Schedules: Revises heading of the former Related Organizations Questionnaire to the Subordinate Organizations Questionnaire. Eliminates discussion of the Regulatory Limitations Worksheet.

Selecting Examination Programs and Procedures: Streamlines the section. For further discussion see Section 011, Program Use.

Work Paper Documentation: Incorporates the requirement that examiners support all of the applicable elements (previously referred to as subfactor ratings) either in the work papers or the appropriate program.

Continuing Examination File: Eliminates mandatory use of the CEF and allows the filing of documents with the applicable examination program to be carried forward from examination to examination until no longer applicable.

General File: Adds to the list the PERK Summary Schedule for the next examination.

Subfactor Ratings: Eliminates most of the discussion as OTS no longer includes subfactor ratings in EDS Part III. Moves the still pertinent discussion to the Work Paper Documentation section.

Off-Site Examination Procedures: New section that includes optional off-site examination procedures.

OTS/FDIC Joint Examinations Process: Revises the quarterly meeting of OTS and FDIC regional staffs to meet regularly to review the examination schedule. (Omits the six-month time frame.)

Capital Plan: Omits the last paragraph regarding the institution's failure to comply with its capital plan.

References: Deletes reference to RB 4a; includes reference to TB 68, Supervisory Review, Appeal and Reconsideration Process and Ombudsman Matters.

Program; Examination Closing Procedures: Adds new No. 3 to provide a copy of TB 68 to the CEO if deemed constructive. Revised No. 8 to include in the General File rather than the EF the PERK Summary Schedule and other information useful for future examination activities.

Appendix A: Regulatory Limitations Worksheet: Omits; regulators may refer to the lending and investment powers chart in 12 CFR 560.30.

071 CAMELS Ratings

OTS totally rewrote this section to incorporate the revised Uniform Financial Institutions Rating System adopted by OTS in January 1997. The interagency guidelines update each component and adds a new component, Sensitivity to Market Risk.

Disclosure of CAMELS Ratings and Management Discussions: Incorporates Thrift Bulletin 69, Revised Rating System; Disclosure of Component Ratings.

References: Includes new CFR regulatory cites.

Appendix A: Includes the UFIRS document. Deletes previous Appendix A, CAMEL Rating Form.

Appendix B: Includes Thrift Bulletin 69-1, the interagency Q & A.

280 Margin Securities (Regulation U)

Revisions reflect the FRB's decision to incorporate provisions of Regulation G into amended Regulation U. As of April 1, 1998, Regulation U requires savings associations that extend or maintain credit secured directly or indirectly by margin stock to register.

Lending Restrictions: Adds a discussion regarding special purpose credit. Regulation U permits savings associations to extend and maintain special purpose credit.

Exempted Borrowers: Adds this new section.

Reporting and Regulatory Requirements: The OTS and the other financial regulatory agencies are responsible for monitoring Regulation U compliance.

Deregistration: States that a registered association meeting certain criteria may apply to deregister.

Regulatory Bulletin 32-10

References: Adds Part 221 in place of Part 207.

Program: Adds to No. 8, the review of loans to determine whether they qualify as special purpose loans.

Appendix A through E: New appendices; a Q & A and four FRB forms.

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—Scott M. Albinson
Managing Director, Supervision

CHAPTER: Administration

SECTION: Examination Strategy, Scoping, and Management

Section 060

This Handbook Section provides guidance to you as the examiner. We refer to “you” in a general sense. Regional directors may assign responsibilities to certain other positions as appropriate.

This section provides guidance in five areas:

- Examination strategy (includes scheduling).
- Scoping examinations.
- Managing examinations.
- Off-site examination procedures.
- Joint examinations.

EXAMINATION STRATEGY

Concentration on improving examination efficiency and a risk-focused regulatory approach are critical strategies to ensuring a sound thrift industry. These strategies will help you assess the overall safety and soundness of an institution in a timely manner and ensure the accuracy of its composite and component ratings. As a regional office, you are responsible for developing appropriate management tools and performance standards to affirm that our examination strategy is consistently met. An important aspect of this strategy is the scheduling of examinations.

Scheduling Examinations

You must schedule full-scope (type 10), on-site examinations of insured depository institutions once during a 12-month cycle or once during an 18-month cycle. Supplemental examinations are necessary under certain conditions.

The Office of Thrift Supervision (OTS) measures the 12-month and 18-month cycles from the “close date” of the last examination to the “start date” of the next examination. The “close date” is the date the Report of Examination (ROE) is transmitted to the institution.

Regional offices may accept full-scope, on-site examinations conducted by the regulatory authorities of state depository institutions on an alternating basis instead of an OTS examination, if such examinations meet the requirements and objectives of OTS’s examination strategy.

12-month cycle

You must conduct a full-scope (type 10), on-site examination of the institution once during each 12-month period unless the institution meets the 18-month cycle requirements below.

By conducting examinations annually you increase your chances of discovering problems and resolving them early. Regional offices may conduct full-scope, on-site examinations more often than prescribed by statute.

All de novo institutions are subject to the 12-month examination cycle. The 12-month examination cycle should continue until management has demonstrated its ability to operate an institution in a safe and sound manner.

18-month cycle

An 18-month examination interval applies to insured institutions of \$250 million or less that meet all of the criteria of a “well-run” institution (12 CFR § 563.171):

- The most recent examination received a composite CAMELS rating of 1 or 2.
- The most recent examination received a Management component rating of 1 or 2.
- The institution is well-capitalized as defined under Section 38 of the Federal Deposit Insurance Act (FDIA) and 12 CFR §565.4.
- The institution is not currently subject to a formal enforcement proceeding or order by the OTS or the FDIC.
- The institution has not been acquired (change in control) during the 12-month period since completion of the last full-scope examination.

Vary from the 18-month examination schedule in the event of an enforcement action, an acquisition or change in control; or a change in asset size, PCA rating, CAMELS rating, or management component rating. If a triggering event occurs in any of the following timeframes at an institution that otherwise meets all of the criteria for an 18-month examination interval, you must conduct a full-scope examination within the appropriate interval:

- Within 9 months of the "close" date of the prior full-scope examination, start the next examination no later than 12 months from the close of the last full-scope examination.
- Between 9 and 12 months since the close of the last full-scope examination, start the next examination within 90 days.
- Twelve or more months since the close of the last full-scope examination, start the next examination within 90 days, but no later than 18 months from the close of the last full-scope examination.

Conversely, if an institution under a 12-month examination interval later becomes eligible for an expanded interval, the interval can be expanded to 18 months immediately.

Supplemental Examinations

More frequent or supplemental examinations may be necessary for the following institutions:

- De novo or newly insured institutions.
- Institutions that have had a change in management, control, or operations.
- Institutions under an enforcement agreement.
- Institutions whose conditions undergo a significant change.

Use special limited examinations (type 40) for supplemental reviews focusing on high-risk areas. Special limited examinations or other abbreviated

examination programs do not satisfy the 12/18 month requirement.

To determine if an institution needs a supplemental on-site examination, focus on the following factors:

- Changes in key financial ratios and indicators.
- Changes in business activity and strategy, such as a change in loan product lines, the investment portfolio, or the deposit structure.
- Deterioration in asset quality indicators such as non-performing assets.
- Compliance with prior enforcement actions.
- Negative earnings, unfavorable earnings trends, or dependence on nonoperating income.
- The levels and composition of capital, as well as trends in capital formation and accumulation.
- An excessive rate of growth or a level of growth that exceeds capital levels or regulatory or supervisory directives.
- Other information such as the independent audit report, news articles, supervisory correspondence, and information obtained from examinations of other institutions.

SCOPING YOUR EXAMINATION

Scoping an examination means you determine the specific examination procedures to use and the depth of review. Scoping may occur on site or off site before the examination, when it begins, or both.

To help OTS meet its strategy of an on-site presence in each institution every 12 or 18 months, place a special emphasis on risk analysis and prioritization. That is, vary the depth of review in each area according to an institution's size, activities, and condition. Do less review in those areas where no significant present or potential risks exist

and more review where major risks are present or possible.

Consider all handbook programs and questionnaires when setting the initial depth of examination review. Use only programs and questionnaires appropriate to the scope and examination. In some circumstances, you will not need all or even a majority of the programs. (See “Selecting Examination Programs and Procedures” discussed later in this section and Thrift Activities Handbook Section 011, Program Use.)

Preliminary Scoping of Examinations

The preliminary scope may provide information needed to determine staff expertise requirements, the examination start date and duration, and strategies for conducting the examination.

Preliminary scoping may be done off site or on site. Items that may be reviewed off site include the following:

- The Regulatory Plan (see Thrift Activities Regulatory Handbook Section 050) for the institution.
- Prior thrift, holding company, and service corporation examination reports, work papers, and recommendations.
- Preliminary Examination Response Kit (PERK) documents completed by institution management prior to the start of the examination.
- Documentation on supervisory and enforcement actions.
- Results of off-site monitoring.
- Correspondence and internal memoranda involving the institution.
- Economic information about the institution's market area(s).
- News articles.

Ensure that the scope does two things:

- Provides for a sufficient review of high-risk areas.
- Includes clear, specific guidelines on the depth of review needed in each area.

Major areas of risk do not necessarily mean problems; some risk is part of conducting any profitable institution. Include procedures that enable you to determine if the institution's level and management of risk is unsafe and unsound. Also concentrate on changes in operations or management because these can pose a significant risk.

Ongoing Scoping of Examinations

Whatever the size or condition of the institution, you will be more productive by using a well-defined scope. Avoid beginning with a broad scope and then trying to narrow it during the examination. Instead, focus first on areas of major risk and then expand the scope as you uncover or suspect significant problems or changes. Also expand the scope if you can assign ratings only by doing more procedures. Determining the depth of review (Level II and Level III procedures) within specific programs may require a preliminary analysis (Level I procedures). For more information about the three levels of review, see Section 011 of this Handbook, Program Use.

The ongoing determination of scope, particularly the depth of review within each program, requires the involvement of each member of the examination team:

- The Examiner in Charge (EIC): Ensure that the team is aware of the procedures needed to efficiently meet the scope. Discuss possible changes to the scope with your team throughout the examination.

Discuss any significant changes in the scope, projected staffing needs, or completion date with your managing supervisor as soon as you anticipate these changes. These discussions are

important because any changes will affect how your regional office plans its regulatory activities.

- **The regional director or designee:** Approve expansions of scope that will cause the examination to extend beyond the original time frame.
- **Safety and soundness examiners:** Communicate any significant changes to the scope and the reasons for them with examiners involved in holding company, consumer compliance, trust, and information systems (IS) examinations. Share significant findings and conclusions to avoid duplicating efforts.
- **Regulators when FDIC is involved:** Maintain close communication with FDIC regulatory authorities and appropriate state regulatory authorities.

When you start an on-site examination, review additional information that may affect the scope as soon as possible. Examples of scoping materials commonly reviewed on site include the following:

- PERK documents available at examination commencement.
- Minutes from the meetings of the board of directors, board committees, and management committees.
- Board reports and management reports.
- Internal audit reports.
- Internal Asset Review (IAR) reports.
- General ledger and subsidiary ledgers.
- Business plan.
- Operating budget.
- Any new contracts (e.g., employment, information systems).
- Leases.

- Loan registers.

Additional Scoping Considerations

As soon as practical, before or at the beginning of the examination, the EIC must meet with the CEO to discuss items of interest or concern that could affect the scope. At this meeting, you should clarify administrative details.

It is helpful to prepare for the meeting with the CEO in advance so that you cover all items of interest efficiently. Topics that could affect the scope of this discussion include the following:

- Changes in control.
- Changes in management.
- Actions taken to correct deficiencies mentioned in prior examination reports and audit reports.
- Operating performance in comparison with the budget.
- Significant changes in operations or strategies.
- Any significant concerns expressed by management.
- Economic and competitive conditions in the market area.

The EIC might also discuss with the CEO, or with a designated institution representative, the following administrative details:

- Time limits for receiving requested information.
- The availability of the examiners to answer questions from the staff preparing requested information.
- Names of key contact people, facilities and parking availability, hours for work, use of equipment, etc.
- The expected duration of the examination, any planned interruptions (these should be kept to

a minimum), and names of assisting examiners.

- A meeting with the independent auditor and review of independent audit work papers, in accordance with regional policy, if applicable.
- Regular meetings with the CEO to discuss the progress of the examination and to address any other issues of concern to the CEO or the EIC.
- An examination exit meeting with the institution's senior management to discuss examination findings, the examiner's overall conclusions, and recommendations (see Thrift Activities Regulatory Handbook Section 070, Overall Conclusions).

Preliminary Examination Response Kit

Several documents comprise the Preliminary Examination Response Kit (PERK). The regulator selects certain documents and sends them to the institution for completion by institution management prior to the examination. The preparation and availability of this information before the beginning of the examination, assists OTS and the institution by determining examination scope and increasing the efficiency of the on-site examination.

General Instructions

Prepare the PERK by selecting various documents and information requests specific to the institution from the list on the Summary Schedule (PERK 001). You may access the PERK electronically from your regional office M: drive. This enables you to revise and print the individual documents needed for the examination of a particular institution.

You should tailor the summary schedule to the institution and type of examination. Request the minimum information needed to conduct a risk-focused examination based on the examination scope. This approach will increase the efficiency of the on-site examination and reduce the burden on savings associations, particularly for highly rated,

well-managed institutions engaging in traditional activities.

List items needed for both phases of a concurrent examination, for example, concurrent safety and soundness and compliance examinations, as an information request in only one schedule – either the safety and soundness examination summary schedule or the compliance examination summary schedule.

To meet the OTS customer service plan standards, send the PERK to an institution four weeks prior to the examination start date. Contact the institution and inform management of any delays so that they can plan for a shorter turnaround. If you are performing off-site examination procedures, consider advancing the request date beyond the four weeks prior to the examination start date.

The EIC or designee: At the beginning of the examination, request the completed PERK from institution management. Be aware of information that management may have sent to the regional office prior to examination commencement.

Encourage institution management to submit the requested information on internally generated reports, such as computer printouts or software spreadsheets if these reports will facilitate the completion of the examination.

At the conclusion of the examination, complete a summary schedule for the PERK at the next examination. Update it when necessary to facilitate the scoping and planning process for the next examination.

The examiner: Review management's responses and discuss them in greater detail with management including any unclear answers or areas that may affect the scope of the examination. Ensure that the appropriate dates are entered on the first page of each document and that the "Institution Name" and "Docket Number" are indicated on each document and any attachments.

PERK Letter (PERK 000) – Prepare the PERK Letter on OTS regional/area office letterhead in the same general format exhibited in the sample letter.

SECTION: Examination Strategy, Scoping, and Management

Section 060

You may modify the PERK letter for use with safety and soundness, compliance, information systems, trust, special limited examinations, or concurrent examinations of any combination. Insert the appropriate paragraph as provided in the examples or create a paragraph accordingly. You may identify in the letter items needed for both phases of a concurrent examination, such as concurrent safety and soundness and compliance examinations. The institution need only provide one copy.

The PERK letter must include all of the following information:

- A start date for the on-site examination.
- The examination as of date.
- The number of on-site staff and an estimation of the amount of time required to conduct the examination.
- A contact person's name and phone number, usually the OTS official who signs the PERK letter and expects to field questions from the institution, e.g., the EIC.

Summary Schedule (PERK 001) – The summary schedule lists (1) the PERK documents enclosed in the package to the institution and (2) suggested CAMELS-related requests that should be tailored to the scope of the examination. You may add additional requests and delete unnecessary or irrelevant requests. You should make a determination as to the items necessary to complete an on-site examination of the institution, and provide dates and dollar limits where appropriate. Each request should be indicated by an "A" (completion required 10 days in advance of the examination), "X" (provide at examination commencement), or "R" (make available for on-site review). In a concurrent examination, the safety and soundness and compliance EICs should coordinate to ensure that items needed for both examinations are listed in either the safety and soundness summary schedule or the compliance examination summary schedule.

Institution management should complete summary schedule requests and provide the information to

the EIC prior to or at the commencement of the examination as indicated ("A," "X," or "R"). The examiners may also use the summary schedule as a checklist to keep track of the documents as institution management provides them.

"Core" PERK

Include the following documents in the PERK that is sent to the institution.

Management Questionnaire (PERK 002) – Prior to sending the PERK to the institution, enter the previous examination date and the examination commencement date at the top of the questionnaire.

You should carefully review written explanations for completeness and accuracy, and initiate further discussion with the managing officer, if necessary. If the response to No. 14.a. or 14.b. indicates a reportable event or violation of the applicable regulation, you must notify the FDIC regional office.

Schedule of Directors, Senior Executive Officers, and Attorneys (PERK 003) – The institution may complete the compensation schedule in the format exhibited in the PERK or any format currently in use by the institution that contains substantially equivalent information. Directors, senior executive officers, and designated attorneys are to be listed on the compensation schedule. "Senior executive officers" are those responsible for the management function of the institution. See RB 27a and 12 CFR § 563.555 for pertinent definitions.

Internal Control Procedural Questionnaire (PERK 004) – Each section of the questionnaire should be completed by institution personnel familiar with that section; for instance, the Vice-President of Lending might complete the Lending section. The EIC, or designee, should review the entire questionnaire and sign in the spaces provided. Note that the appropriate response may not always be in the affirmative, in which case the institution should provide an adequate written explanation.

Information Systems (IS) Questionnaire for Insured Institutions (PERK 005) – The IS Questionnaire should be sent out on every annual

safety and soundness examination and completed by institution personnel. The institution should forward a copy of the completed questionnaire to the IS examination manager at the regional office. You should review the questionnaire and investigate inappropriate responses. Note that the appropriate response may not always be in the affirmative.

Electronic Loan Data (ELD) Request – The ELD Request is a new method for reviewing and analyzing loan portfolios. It is a voluntary submission by institution management of certain loan information in an electronic format, such as a personal computer diskette. If you request this schedule, you must ensure that duplicative information requested in the summary schedule is deleted from the request. The ELD Request will formally be included in the PERK when it is approved.

Compliance Examinations

Include the following documents in the PERK when a compliance examination and a safety and soundness examination are conducted concurrently. The regional office may (1) determine that a compliance examination will be conducted separately from the safety and soundness examination or (2) consider requests by the institution to conduct non-concurrent examinations.

Compliance Examination Summary Schedule (PERK 006) – The Compliance Examination Summary Schedule is a list of standard requests that should be tailored to the scope of the examination, i.e., you may add additional requests and delete unnecessary requests. Coordinate with the safety and soundness EIC to ensure that items needed for both the safety and soundness and the compliance examinations are listed on either PERK 001 or PERK 007. Information requested on the Compliance Examination Summary Schedule should be provided to the EIC prior to or at the commencement of the examination.

Fair Lending Questionnaire (PERK 007) – The managing officer should provide answers to the questionnaire and attach additional pages if space provided is inadequate.

Community Reinvestment Act Information (PERK 008) – Responses to requests for CRA information should be as specific as possible and signed by both the institution's managing officer and CRA officer. If the institution is not involved in a particular activity, management should explain why they chose not to participate in a program addressing the specific assessment factor.

CRA Optional Information - Small Institutions (PERK 015) – This outline guides an institution by identifying the types of supplementary information that may provide examiners with a better understanding of the institution's performance. Response to this request is voluntary.

CRA Public File Summary (PERK 016) – This document summarizes the information from the CRA Public File that the OTS uses to evaluate CRA performance in both small and large institutions.

Supplemental Schedules

You may include in the PERK the applicable documents listed below if the particular area is to be examined in conjunction with the safety and soundness examination.

Schedule for Retail Nondeposit Investment Products (PERK 009) – Request completion of this schedule by any savings association engaged in the retail sale of nondeposit investment products such as stocks, bonds, mutual funds, or annuities.

Subordinate Organization Questionnaire (PERK 010) – The institution should complete this questionnaire for each subordinate organization that significantly affects, or has the potential to significantly affect the institution's operations, unless noted otherwise. Subsidiaries that have an insignificant effect on the institution should be listed separately with an explanation as to why they are considered insignificant. The Subordinate Organization Questionnaire should be completed by those who have direct knowledge or can obtain it by appropriate inquiry. If the institution has no investment in subordinate organizations, it should so state in answer to No. 1. Separate questionnaires should be used for each subordinate

organization, including second tier corporations and other sublevels.

Information Systems (IS) Information Request Schedule for In-House Institutions and Service Bureaus (PERK 011) – This schedule should be used for examinations of independent service bureaus and institutions with an in-house data center. The schedule of information requests should be provided to the EIC prior to or at the commencement of the IS examination.

Trust Examination Summary Schedule (PERK 012) – The Trust Examination Summary Schedule of information should be made available to the EIC prior to or at the commencement of the trust examination. Management should provide a brief explanation, or the name of an individual to contact, for any information they do not provide.

Mortgage Banking Questionnaire (PERK 013) – Completion of this questionnaire should be included in the PERK if the institution or any subsidiaries are engaged in mortgage banking during the examination period.

Schedule of Stockholders (PERK 014) – This schedule should be completed to determine the stock activity that has taken place between examinations.

Selecting Examination Programs and Procedures

You should consider all programs and questionnaires within the scope of the examination. Use programs and questionnaires deemed appropriate, but only to the extent necessary to address the scope and support the examination conclusions. In some circumstances, not all or not even a majority of the procedures will be needed.

For example, if your review of the policies, structure, administration, and results of the institution's internal asset review program reveals that the program is sufficient and the results are accurate, you may place a greater reliance on the institution's internal review. The risk that the institution is not adequately reviewing and classifying its assets

would be low, so more detailed examination procedures would generally not be necessary.

When using this risk-focused examination approach, use sound professional judgment to ensure that the depth of review is sufficient to accurately assess the institution's condition, but is not excessive. For further information regarding the examination program and the three levels of review, refer to Section 011 of this Handbook, Program Use.

Work Paper Documentation

Examination work papers should include a title or well-marked description of the work paper purpose, the scope for the particular area of review, the sampling criteria used, the procedures performed, and the preparer's initials. Documented procedures support the analysis and help maintain the integrity of the work paper.

You are required to support all the applicable elements reviewed under each CAMELS component either in the work papers or in a conclusion documented on the appropriate program. In addition, the conclusion for each work paper or area of review should summarize the examination findings, support the composite rating (in addition to the component rating), and indicate if any corrective or enforcement action is necessary.

However, you should avoid excessive documentation and include only information that is relevant or may require follow-up. Time spent recording extraneous information would be better spent examining high-risk areas. To facilitate any follow-up review that may be necessary, you should also document the name and title of persons or a description of the records from which information was obtained. Schedules prepared by the institution should be clearly marked as such.

The EIC or designee is required to review and initial all work papers, indicating agreement with the conclusions reached and ensuring that assistants have complied with the applicable documentation requirements. The TFR, UTPR, and other multi-page printed documents need only be initialed and dated on the first page. The EIC should ensure that all comments, charts, and appendices

have been carefully checked by exam staff. At a minimum, the EIC's supervisor will review the work papers prepared by the EIC and the supporting documentation for the report comments.

Continuing Examination File and the General File

Continuing Examination File

Include the following items, only if applicable to the particular institution being examined, in the Continuing Examination File (CEF), or file them with the applicable examination programs and carry them forward from examination to examination until no longer applicable. Maintenance of these documents preserves examination continuity and reduces excessive requests for information during examinations.

- Management and Director Committees and Members (PERK)
- Organizational Chart (PERK)
- Officer Resumes (PERK)
- Directors' and Officers' Home Addresses (PERK)
- Enforcement Documents
- Schedule of Branch Offices and LPOs
- Copy of Charter and Bylaws
- Copy of Conditions for Insurance (in force)
- Summary of Leases
- Holding Company/Affiliates Corporate Structure (PERK)
- Internal Audit Program (PERK)
- Stockholders' Schedule (PERK)
- Proxy Statement
- Approved Appraisers and Qualifications (PERK)
- Employment Contracts (PERK)

If an institution policy must be included as part of work paper support, file it in the appropriate CAMELS section of the work papers. Similarly, include the business plan and budget requirements in the Management/Administration work paper file.

General File

The general file contains the administrative information related to the examination, and is organized

to correspond with the administrative section of the Handbook.

Include the following items in the general file:

- Exception Sheets
- Examination Strategy, Scoping, and Management Program
- PERK Summary Schedule (for next exam)
- Regulatory Plan
- Pre-Assignment Analysis
- Overall Conclusions Program
- EDS Part III Interim Report
- Recent Correspondence
- Newspaper Clippings

You should use exception sheets to record all specific regulatory and policy violations that are not specifically discussed in the ROE. Either the managing officer or the appropriate department head must provide a disposition for each problem noted and initial the exception sheet. Provide a copy of all exception sheets to the managing officer.

EXAMINATION MANAGEMENT

Managing examinations is as important as scoping them. Effective management of the examination expedites and enhances the examination process by ensuring that objectives are met efficiently. The level and sophistication of management methods and procedures will vary depending on the activities to be performed and the size and nature of the institution.

EIC Responsibilities

The EIC carries the primary responsibility for managing the examination. Key elements the EIC should consider:

- The examination objectives: The EIC must ensure that the assistants understand the objectives of the examination and for their assigned programs. Objectives should be specific as to results desired.

— The examination procedures contained in the individual programs are designed to be comprehensive. So, select only the appro-

appropriate procedures within each program. Assistants should notify the EIC as questions occur regarding scope or depth of review.

- Organization: This involves scheduling meetings with institution personnel; arranging appropriate workspace for regulators; prioritizing and scheduling work flow; communicating examination status; preparing the examination report; and preparing, filing, indexing, and reviewing work papers.
- Assignments and job monitoring: The EIC must determine the expertise necessary to perform certain aspects of the examination and make assignments accordingly. When warranted, assign major areas to individual assistants. Depending on the size of the job, delegate certain management responsibilities to assistants for efficiency and to improve upon administrative and management skills of assistants. Also consider training and development needs when making examination assignments.
 - Whenever possible, assign assistants to program areas that they can complete, including report pages and comments, before leaving the assignment. This allows for efficiency and accountability and provides necessary on-the-job training.
 - Monitor assistants' performance throughout the examination to ensure that objectives are being met according to schedule and to prevent minor problems from growing. Early identification of work-related problems also allows the assistants the opportunity to correct mistakes and to immediately improve upon skills.
- Budgeting and monitoring overall time: Consider the time budget when assigning tasks. A useful tool for improved personnel planning is a time and planning summary that is organized according to the sections contained in this Handbook. It specifies the areas for which

procedures are planned and provides for a comparison of actual and budgeted hours. Add, as needed, any activities not included on the time sheet.

- Assign priorities to the critical categories and determine optimal timing of simultaneous activities. Ordinarily this can be accomplished by assigning categories of related programs to one assistant who subsequently may supervise others. If time allows, it is also most efficient to have one assistant complete interrelated programs to avoid duplication of effort.
- To minimize costs and disruption for the institution, it is important that the examination be conducted as quickly as practical. A stable crew with minimal interruptions of staff time allows for continuity and efficiency. It is the EIC's responsibility to discuss any planning problems with a supervisor. If institution management is concerned about scheduling, include this matter in your discussion.
- Monitoring the progress of the examination allows for early adjustments to the scope, staffing, and completion date, as necessary, for the examination. The EIC is responsible for notifying a supervisor as soon as adjustments to scope are a consideration.
- On-the-job training and evaluation of assistants: Assistants may need guidance, depending on their experience and ability. The EIC should encourage questions and ensure that someone is available to provide guidance. Depending on the size of the job, the EIC should be familiar with the work performed by the assistant(s) so that you can make fair and constructive evaluations of the work performed.
- Ensuring that PERK information is received and distributed: The PERK is sent to the in-

stitution prior to the beginning of the examination. The EIC should set up controls to ensure that all information requested is received as early as possible. The EIC should also list any other items needed and submit the list to the contact person as early as possible to allow time for preparation by institution personnel. Encourage institution personnel to ask questions if instructions for preparation of requested information are unclear.

- Serving as the primary communications link: The EIC is the focal point for communications on significant matters. Assistants, institution personnel, and regional office staff must all know how to communicate information and when to share information. During examinations it is important that answers to significant items be given by only one responsible individual. The EIC should coordinate this in case questions arise.
- Ensuring a cooperative and positive working environment: Conduct examinations with as little disruption, conflict, and confusion as possible. A positive work environment fosters the productivity of the team members. Disagreements will occur at times, but avoid an antagonistic role. Allow for regular meetings with management to discuss findings and questions, and avoid monopolizing the time of the staff as much as possible. A professional and considerate approach usually results in cooperation from the institution staff.
- Determining that the examination meets the overall examination objectives: At the conclusion of the examination, the EIC should ensure that the examination meets the objectives and that examiners followed appropriate procedures for all examination functions.

Off-Site Examination Procedures

On-site examinations are essential to OTS's mission; however, some examination procedures may be conducted off site as proficiently as they can be conducted on site. Given the overall health of the industry and the experience level of the examination staff, the OTS may be able to fulfill its

examination responsibilities at many institutions and limit on-site examination time.

Performing examination procedures off site is optional. Regional directors or their designee should determine whether off-site examinations are feasible and develop appropriate policies and procedures.

An off-site examination does not replace an on-site examination. In simple terms, more procedures may be performed off site at the beginning and end of an examination. Some of the advantages of performing procedures off site may include reduction in travel expenses and a reduction in the disruption to normal thrift operations attendant with even the best-run examinations.

Institution Selection Criteria and Examination Procedures

You should determine whether off-site examination procedures may be used in an institution based on certain criteria, including the institution's CAMELS rating, prior history, complexity of operations, reliability of data, and other factors. Typically, small, highly rated institutions would be the most likely candidates for these procedures. You should be able to demonstrate that a tangible benefit can be gained from using off-site examination procedures.

The exact combination of on-site and off-site work is a function of relevant factors unique to the institution and the examination crew. Flexibility is retained through the absence of any firm guidelines such as asset size, rating, or location where an off-site examination may or may not be conducted. Open lines of communication with institution personnel are essential at all examinations, but extra steps may have to be taken to keep those lines open during off-site portions of the examination. Advise thrift management of the start and completion of off-site work. Finally, exercise judgment so that work that is best performed on site is performed on site.

PERK

You may revise the PERK letter to alert institution management that some of the examination work will be conducted off site.

As discussed in greater detail in this section, you may request PERK information from institution management in several ways:

- Complete the information prior to the start of the examination.
- Provide the information at examination commencement.
- Make the information available for on-site review.

Unless it is practical to retrieve items from the institution, at least some items should be requested in advance for delivery to the field office or other appropriate location. If you select this option, the PERK should go out a few days earlier than recommended in the normal customer service standards.

Do not require thrifts to photocopy and ship materials to examiners if it creates rather than reduces regulatory burden. Regulatory staff will have to gauge the resources and attitudes of each thrift examined using off-site examination procedures. Again, keep open the lines of communication with management.

Examination Data System I & II

Examination Data System (EDS) I and II should continue to reflect the actual start and completion dates of examination work performed on site. The dates used for EDS I and II should correspond with the dates disclosed in the cover page of the examination report.

Scoping

Scoping may be done off site and on site. See the discussion presented earlier in this Section on Examination Scoping.

Examination "Entrance" Meeting

At the initiation of the examination, hold a meeting with management. Discuss examination objectives, examiner assignments, and any other relative administrative issues. This meeting can be held by telephone, or in person if distance permits. In addition to an entrance meeting, the EIC should conduct weekly meetings (by telephone if off site) with the appropriate institution personnel to discuss current findings, as required by the OTS Customer Service Plan.

Suggested Off-Site Examination Procedures

Other than asset review and TFR verification, many of the examination procedures could potentially be completed off site, as long as the appropriate information is obtained. The following is a partial list of examination procedures that could be considered for off-site completion. Again, flexibility is the operative word. If the procedures listed below or any other procedures can be efficiently performed in whole or in part off site, consider doing them off site during the time frame assigned to an off-site office.

Capital

- Review SEC filings and pertinent correspondence.
- Evaluate adequacy of and trends in capital.
- Evaluate management reports and the business plan to determine adequacy of capital planning, earnings retention, and dividend policy.
- Outline and draft comment.

Asset Quality

- Review applicable policies, as deemed necessary (loan, investment, appraisal, etc.).
- Identify asset review samples.
- Review internal loan review procedures and resulting reports.
- Review asset quality trends to determine any potential areas of concern. Stratify loan data in pivot tables to identify concentrations, sources of delinquencies (loan type, loan age, loan office), etc.
- Evaluate the adequacy of loss allowances.

- Review regulatory limitations.

Management

- Review business/strategic plan.
- Review employment contracts.
- Review completed management questionnaire.
- Review internal/external audit reports.
- Review electronic data processing agreements.

Earnings

- Review financial reports.
- Identify earnings components, identify trends, and assess results.
- Review budget and the planning/monitoring processes.
- Outline or draft comment.

Liquidity

- Review applicable policies and procedures.
- Outline or draft comment.

Sensitivity to Market Risk

- Review applicable policies and procedures.
- Review IRR modeling and assess the institution's exposure position.
- Determine overall funds management strategies.

Administrative

- Construct work paper files.
- Prepare/finish ROE.

Examination Conclusion

At the conclusion of the examination, review the examination report and update the regulatory plan. Also ensure that the institution takes prompt corrective action for any problems found during the examination and closely monitor the institution's condition for any recurrence of these or new problems.

OTS regional staff must send the report of examination to 1- and 2-rated institutions within 30 days and to 3-, 4-, and 5-rated institutions within 45

days from completion of on-site examination activities.

Refer to Thrift Activities Regulatory Handbook Section 070, Overall Conclusions, and Section 320, Meetings with the Board of Directors, for other appropriate examination closing procedures.

OTS/FDIC Joint Examinations Process

The OTS and FDIC regional staffs should meet regularly to review the examination schedule. The FDIC should indicate those examinations in which they desire joint participation. All FDIC savings association examination activities will be performed on a joint basis unless compelling reasons dictate otherwise.

For joint examinations, the FDIC and OTS should jointly scope the examination at the EIC level or at the respective regional office level. Disagreements over scope should default to the broader alternative. When examinations of savings association affiliates are considered necessary, the EIC should decide how to conduct the examinations.

For non-joint examinations, the OTS should determine the scope and provide the FDIC a copy of the proposed final report and allow a ten-day period for review and comment prior to the OTS transmission to the institution.

OTS is responsible for specialty examinations.

Nothing in the joint OTS/FDIC agreement should alter the normal examination and supervisory cooperation with state authorities.

Report of Examination

Joint examinations will represent a division of responsibilities among the joint staff; the OTS and FDIC should each provide an EIC, who will share responsibility for managing the examination and will be responsible for resolving interagency differences during the examination process. EICs of both agencies should coordinate and communicate during the examination to assure examination objectives are achieved with a minimum of redundancy.

The FDIC's ROE will be for internal purposes only, although they will provide a copy to the OTS. If the FDIC Board authorizes an enforcement action, however, the FDIC would then transmit its examination report to the institution. As the OTS and FDIC regional staffs prepare the concurrent reports, they should attempt to resolve all significant differences of opinion concerning the thrift's overall condition and the enforcement or corrective action needed.

The OTS view will prevail concerning non-substantive differences in examination interpretations, conclusions, and report comments. Substantive differences in examination conclusions that could lead to an enforcement action by the FDIC if not pursued by OTS, and that the EIC cannot resolve, should be referred to the OTS and FDIC regional offices for resolution at the time such differences are identified. The regional offices must resolve such differences within ten working days. If they cannot resolve such differences following full review and communication between the regional offices within ten working days, the regional offices refer the matter to the FDIC Director of Supervision and OTS Deputy Director. It is expected that they will resolve such differences within ten working days. If the differences remain unresolved, the FDIC should so notify OTS of the differences and that they will seek corrective action authorization from the FDIC Board.

Prepare the OTS examination report using GAAP as the appropriate accounting treatment for financial accounting information. Use OTS regulations, policies, and directives in reaching examination conclusions.

The OTS and FDIC should routinely copy one another on institution-related correspondence. The OTS provides the FDIC with copies of examination-related correspondence.

Examination work papers, loan line sheets, report pages, and findings should be shared, but retained by the OTS following completion of the examination, with interim examination access provided to the FDIC upon request.

Board of Directors Meeting

The OTS and FDIC should jointly participate in examination-related meetings with management and directors during and at the conclusion of joint examinations.

The FDIC should communicate all actions taken by the FDIC Board to the institution after notification to the OTS.

Enforcement Actions

The OTS regional director should endeavor to advise the FDIC regional director of, and solicit written input on, all proposed OTS enforcement actions. The FDIC will have ten working days to respond. The OTS regional director should provide the FDIC regional director with a copy of the final enforcement document within five working days of execution. The OTS regional director should also provide a written explanation of the reasons why OTS did not take any of the FDIC-recommended actions.

Likewise, the FDIC regional director should endeavor to advise the OTS regional director of, and solicit written input on, all proposed FDIC enforcement actions. The OTS will have ten working days to respond. The FDIC regional director should provide the OTS regional director with a copy of the final recommendation to Washington. The FDIC regional director should also provide a written explanation of the reasons why the FDIC did not take any of the OTS-recommended actions.

Regional staff should resolve significant differences concerning corrective and enforcement actions. If regional staff cannot resolve a significant issue, they should submit the issue to the FDIC Director of Supervision and the OTS Deputy Director. It is expected that they will resolve such differences within fifteen working days. If the differences are irresolvable, the FDIC can recommend backup action to the FDIC Board. The FDIC should not direct corrective action until the FDIC Board authorizes such action.

Divestiture Plans/Brokered Deposit Waivers

The FDIC regional director should advise the OTS regional director of its intent to approve or deny, or otherwise exercise its independent authority with respect to a divestiture plan or brokered deposit waiver, prior to communication with the thrift institution.

The FDIC should coordinate its efforts with the OTS to ensure that such actions are consistent with OTS-approved capital plans, as long as conditions at the savings association have not changed to any material extent (in the opinion of FDIC).

Capital Plans

The OTS addresses inadequate capital in savings associations as required by 12 CFR Parts 565 and 567, or through the impositions of an individual minimum capital requirement, or through other enforcement action.

The OTS regional director should provide copies of capital plans, revisions and modifications, requests for additional information, and proposed actions to the FDIC regional director for review and comment. Unless the FDIC regional director submits to the OTS regional director a written objection to the capital plan within thirty working days, the FDIC will normally not take backup enforcement action or action on divestiture plans that are contrary to the action taken by the OTS in approving a capital plan.

The FDIC regional director and the OTS regional director should resolve any differences with respect to capital plans. The regional directors should refer

significant issues they cannot resolve to the OTS Deputy Director and the FDIC Director of Supervision. If such issues remain unresolved, the OTS may then approve the capital plan, but the FDIC may pursue backup enforcement action to resolve its concerns.

REFERENCES

Code of Federal Regulations (12 CFR)

§ 563.171 Frequency of Examinations

Office of Thrift Supervision Bulletins

TB 68 Supervisory Review, Appeal and Reconsideration Process and Ombudsman Matters

Closely Related Thrift Activities Regulatory Handbook Sections

Section 010	Handbook Use
Section 011	Program Use
Section 040	EDS/ROE
Section 045	Regulatory Action Data System (RAD)
Section 050	Regulatory Plan
Section 070	Overall Conclusions
Section 071	CAMELS Ratings

OTS Report of Examination Instructions Manual for Safety and Soundness Examinations

FFIEC Guidelines for Relying on State Examinations (June 27, 1995)

Examination Strategy, Scoping, and Management Program

Examination Objectives

To determine overall objectives for the examination and ensure that the examination meets the objectives.

To determine the refined examination scope, the procedures to use, and the depth of testing and verification needed.

To determine personnel requirements, organize and coordinate human resources to attain optimum efficiency, and to supplement formal education programs through on-the-job training.

To facilitate clear and open communications between field staff, office staff, other regulatory bodies, and institution personnel.

To provide useful information for future planning, scoping, monitoring, and management.

Scoping

1. Prior to the examination, review the objectives, strategies, and preliminary scope outlined in the Regulatory Plan for the institution.
2. If applicable, coordinate with the OTS specialty (compliance, information systems, etc.) examiner in charge and the FDIC examiner in charge or FDIC regional office for joint scoping.
3. Review the most recent scoping materials available (those available in advance of the examination). This Handbook Section provides a list of scoping materials.
4. Ensure that the PERK requests on the summary schedule are tailored to the institution and type of examination. Send the PERK to the institution at least four weeks prior to the examination start date.
5. Establish and document the detailed scope for the examination.

Note: For branch reviews, evaluate internal controls, management reporting, and audit coverage and findings before establishing scope. It may be necessary to perform only limited reviews of branches, particularly if credit files and other information can be sent to the office where the examination is being conducted.

6. Finalize staffing and examination dates.
7. Prepare assignments for assistants (before commencing the examination, if possible). If helpful, prepare time management forms. Contact assistants and inquire whether they have scheduled any time off or will be attending any training seminars during the estimated duration of the examination.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Examination Strategy, Scoping, and Management Program

Examination Procedures

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The EIC should perform the following procedures as soon as possible to ensure that the examination is properly managed:

Level I

1. Meet with the CEO or designee as soon as possible at the beginning of the examination. Refer to this Handbook Section for a list of recommended items to discuss. Notify the appropriate office when the examination has begun.

2. Discuss assignments with assistants including estimated time for completion. Determine that assistants are aware of the objectives stated in the Regulatory Plan and the specific activities included in the scope. Assist in establishing the scope for each of the assigned programs. Reiterate that material revisions to planned scopes should be approved by the EIC first.

3. Ensure the timely receipt and dissemination of information requested from management. Discuss problems with the appropriate contact person and establish revised deadlines for receipt of materials, if necessary.

4. Coordinate and oversee the review of materials obtained from the institution that might give an early indication of a need to change the scope (refer to this Handbook for a list of these materials). This review should include the following procedures:
 - a. Review the institution's current Thrift Financial Reports (TFR) and Management Information Systems (MIS) reports and determine if there have been significant changes in the level of capital, lending or investment activity, earnings, or nonperforming assets.
 - b. Review the minutes of the board of directors' meetings. Focus attention on significant changes in the institution's business activities (lending, investment, joint ventures, etc.). Assess the level of oversight performed by the directorate.
 - c. Discuss with management any changes in key management, the directorate, or business activities that have occurred since the preceding examination. Also inquire as to any proposed changes or pending litigation that may affect earnings and capital.
 - d. Determine through a review of correspondence, discussions with management, and other appropriate verification methods, if management corrected any problems related to the following areas:

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Examination Strategy, Scoping, and Management Program

Wkp.Ref.

- Prior examination report comments and supervisory letters;
 - Independent auditor's exceptions;
 - Internal auditor's exceptions; and
 - Any enforcement actions and directives.
- e. Determine if there are written policies governing key areas such as lending and investments. Evaluate the adequacy of new or revised written policies, procedures, and strategic plans. These guidelines should adequately address safety and soundness (including internal controls), profitability, and compliance with laws and regulations.

-
5. Make adjustments to the examination scope as necessary, but preferably as early as possible. Notify a supervisor if significant changes are anticipated in scope, staffing needs, duration, etc.

-
6. Throughout the examination:

- Review on a regular basis the work flow, findings, and actual versus budgeted time.
- Take appropriate steps to include on-the-job training.
- Discuss all items of concern with the assistants to ensure that the OTS presents accurate information at the closing conference with the CEO.
- Keep the supervisor and the CEO abreast of any developing significant issues.
- Determine that all examination work is prepared in accordance with policies, including: work papers, interim reports, exception sheets, draft comments, report pages, time sheets, administrative reports, and transmittal file information. Refer to Thrift Activities Regulatory Handbook Section 070, Overall Conclusions, for a discussion of report content.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Examination Strategy, Scoping, and Management Program

Wkp.Ref.

7. If you need additional verification, review, or analysis of any areas, complete or assign the completion of selected procedures from Levels I, II, and III for the particular area of review. (Refer to instructions for selecting Levels I, II, and III procedures in Thrift Activities Regulatory Handbook Section 011, Program Use.)

8. Ensure that the examination meets the *Examination Objectives* of this Handbook Section.

Examination Closing Procedures

1. Schedule a closing conference and incorporate comments in the report. (For further instructions see Thrift Activities Regulatory Handbook Section 070, Overall Conclusions, and Section 071, CAMELS Ratings.) Notify all attendants of the closing conference date and time, preferably with the use of an agenda.

2. If appropriate, recommend any necessary administrative actions. Prepare a confidential memorandum if necessary.

3. If deemed constructive, provide a copy of Thrift Bulletin (TB) 68 to the CEO and discuss the process for resolving differences with examiners, including the TB 68 appeal process.

4. Complete the ROE and EDS (refer to Thrift Activities Regulatory Handbook Section 040, EDS/ROE, and the ROE Instructions). Complete a time and planning summary to compare actual and budgeted hours. (You should verify all totals in the examination report and other reports with an adding machine or with the use of spreadsheet software.) Refer to Section 070, Overall Conclusions, and the ROE Instructions.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Examination Strategy, Scoping, and Management Program

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5. Ensure that the General File is completed.	
6. Review work papers for completeness, proper indexing, date stamping, etc. (The EIC may delegate this responsibility. The EIC should have reviewed the work paper content and conclusions, and initialed all work papers, before finalization of the conclusions and comments.)	
7. Prepare, if appropriate, evaluations of assistants. Recommend formal instruction and on-the-job experience that would further each of their careers. Discuss the evaluation with the individual and their supervisor, if applicable.	
8. Complete a PERK summary schedule and summarize any other information that will be useful to the planning, scoping, and control of future examination activities and include in the General File.	
9. Update the Regulatory Plan with any significant data obtained from the examination so that the plan is always current.	
10. Transmit the completed report and return work papers and related files to the regional office in accordance with established procedures.	

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

INTRODUCTION

OTS uses the CAMELS rating system to evaluate an institution's overall condition and performance by assessing six rating components. The six components are Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. OTS then assigns each institution a composite rating based on the examiner's assessment of its overall condition and level of supervisory concern. The rating system was revised in December 1996. The four federal banking agencies updated the rating definitions and addressed changes in the financial services industry and in supervisory policies and procedures that occurred since the rating system was first adopted in 1979. The Office of Thrift Supervision (OTS) adopted the revised Uniform Financial Institutions Rating System (UFIRS) effective for all safety and soundness examinations with start dates after January 31, 1997.

Aggregate rating information enables the public and Congress to assess the condition of the savings and loan industry. Because each of the banking regulatory agencies adopted this uniform rating system, Congress can readily compare composite rating data for all types of insured financial institutions.

Changes to UFIRS

The revised rating system places additional emphasis on management's effectiveness in identifying, measuring, monitoring and controlling risk. The interagency group made two principal enhancements to update the rating system while retaining its basic framework. First, the evaluation of interest rate and other non-credit financial risks was moved from the Liquidity and other components to a new sixth component called "Sensitivity to Market Risk." Thus, the revised rating system acronym is CAMELS. The new "S" component rating addresses the degree that changes in interest rates, commodity prices, and equity prices could adversely affect the institution's earnings or economic capital. The new

component, while broad in scope, only focuses on those elements that are relevant to the thrift being examined. For example, foreign exchange and price risks may not be relevant to some thrifts and thus their "S" component rating will primarily focus on interest rate risk.

Another noteworthy change is that the definitions for composite 1-, 2-, and 3-rated institutions establish more explicit guidance for the component ratings:

- For composite 1-rated institutions, all components should generally be rated 1 or 2.
- For composite 2-rated institutions, component ratings should normally be no worse than 3.
- For composite 3-rated institutions, none of the component ratings should be worse than 4.

Such guidance, while not an absolute requirement, is more specific than previous CAMEL rating guidance. The revised UFIRS statement is the definitive statement on safety and soundness ratings. (See Appendix A.) The remainder of this handbook section expands on, or highlights certain parts of the policy statement as it applies to thrift institutions.

Composite Ratings

The composite rating is a qualitative assessment by the agency of the institution's condition and the agency's overall level of supervisory concern. Although the composite rating assigned to the thrift should normally have a close relationship to the individual CAMELS component ratings, you should not derive the composite rating merely by computing an arithmetic average of the component ratings. Such a simplistic, mechanical approach will not reflect the true condition of the savings association; nor will it indicate the appropriate supervisory actions.

You should include in the Examination Conclusions and Comments page of the report of examination (ROE) the following items:

- A discussion of the institution's composite rating.
- A reference to (not a repetition of) the applicable rating definition.
- A description of the institution's particular circumstances that affected the rating as defined.

You must ensure that the report comments and work papers support the assigned ratings.

One of the principal objectives of the CAMELS rating process is to identify, through the composite rating, those thrifts that pose a risk of failure and merit more than normal supervisory attention. Thus, you should give more weight to individual CAMELS criteria that more strongly affect the condition and viability of the thrift.

The composite CAMELS rating, the CAMELS component ratings, and supporting documentation all play an important part in the regulatory process in support of any necessary enforcement action.

OTS uses an institution's composite rating as one of the factors to determine whether the institution should be designated as being in "troubled condition." Any thrift that has a composite CAMELS rating of 4 or 5, is designated in troubled condition by OTS. Other qualifiers of "troubled condition" are defined in 12 CFR § 563.555. These thrifts are subject to greater regulatory scrutiny and restrictions, such as requirements to receive prior approval before engaging in certain activities.

When examining a thrift in troubled condition, you should consult the regulatory plan, supervisory correspondence, the previous examination, and any other pertinent information to determine the operating restrictions to which a thrift is subject. You must then analyze the institution's operations and ensure that it is in compliance with all restrictions. For further information regarding operating restrictions, refer to Handbook Section 370, Enforcement Actions.

The CAMELS ratings also support OTS's differential regulation policy. The composite CAMELS rating establishes both the OTS and the Federal Deposit Insurance Corporation (FDIC) fee assessment levels and determines the levels of supervisory oversight and restrictions. This policy provides tighter restrictions for thrifts with worse composite ratings and other factors, and is evident in the following guidance:

- Regulatory Bulletin (RB) 18 series (Enforcement Policy).
- RB 3b (Growth Restrictions).
- OTS asset-based assessment regulation at 12 CFR § 502.1.
- OTS audit regulation at 12 CFR § 562.4.
- OTS transactions with affiliates regulation at 12 CFR § 563.41.
- OTS capital regulations at 12 CFR § 565.4.
- OTS directors regulation at 12 CFR §§ 563.550 through 563.590.
- FDIC risk-based deposit insurance assessment regulation at 12 CFR Part 327.

Component Ratings

As the introduction states, component ratings indicate an institution's performance in the six key performance groups that are common to all institutions.

Capital Adequacy

Maintaining an adequate level of capital is a critical element for depository institutions. While meeting regulatory capital requirements is a key factor in determining capital adequacy, the institution's operations and risk position may warrant additional capital beyond the minimum regulatory requirements. You should determine whether capital is adequate in relation to the risk profile and operations of the thrift. In addition, you should evaluate capital levels in relation to future needs.

Since maintaining a sufficient level of capital is critical for an institution to maintain operations, you should appropriately weigh the importance of capital on the viability of the thrift when formulating the composite rating. You should also consider the institution's dividend payout policy and practice. You should rate an institution's capital adequacy considering all criteria cited in the UFIRS statement.

PCA Levels

Note that, in general, an institution in any of the three lower-tier Prompt Corrective Action (PCA) categories warrants a 4 or 5 Capital component rating. A capital rating of 4 is appropriate if the thrift is undercapitalized or significantly undercapitalized but asset quality, earnings, or interest rate risk problems will not cause the thrift to become critically undercapitalized in the next 12 months. Also, a capital rating of 4 may be appropriate for an institution that does not have sufficient capital based on its capital level compared with the risks present in its operations, even though the thrift may meet the minimum regulatory requirements.

An institution is presumed to warrant a 5 rating if it is "critically undercapitalized," or has significant asset quality problems, negative earning trends, or high interest rate risk exposure that will cause the thrift to become critically undercapitalized within the next 12 months.

See the Capital Chapter of this Handbook for more detailed instructions for reviewing capital adequacy.

Asset Quality

An accurate evaluation of an institution's asset quality can be one of the most important products of the examination. The asset quality rating reflects the extent of credit risk associated with the loan and investment portfolios, real estate owned, other assets, and off-balance sheet risks as well as the institution's ability to manage those risks. The evaluation of an institution's asset quality is dependent on the institution's policies and procedures relating to loan underwriting and asset procurement, the proper classification of assets,

and the adequacy of the institution's valuation allowances.

The component and composite ratings demonstrate the level of supervisory concern over an institution, its activities, and its performance. When asset quality is in doubt because of excessive or inadequately controlled risk, the institution's asset quality component rating should reflect this concern. In order to attain a 1 or 2 Asset Quality component rating, an institution must fully control its credit risk. If an institution has a high exposure to credit risk, it is not sufficient to demonstrate that the loans are profitable or that the institution has not experienced significant losses in the near term. Management must demonstrate that it has identified credit risks, measured the potential exposure to loss, established systems to monitor such risk on an ongoing basis, and has adequate measures in place to limit and control those risks. Otherwise, a significant supervisory concern will exist relative to the institution's asset quality.

Management

The management rating is a reflection of the performance of the entire management team of the thrift. This includes the board of directors and all levels of management. The rating is an assessment of management's overall effectiveness.

The directors have two basic responsibilities:

- Provide for effective thrift management.
- Establish objectives and policies appropriate for their thrift.

Directors are also responsible for ensuring that management effectively implements these policies and initiates corrective action when necessary to ensure adequate management control and results.

You should base your assessment of management on a historical, current, and prospective evaluation of management's effectiveness in addressing problems the thrift encounters. Since financial performance is the primary indicator of the viability of an institution, the thrift's financial performance will strongly influence the management rating.

Often a new management team or a new key senior executive officer assumes the administrative responsibility of a thrift in troubled condition. You should not rate new management too highly based on performance projections, newly implemented policies and procedures, or management's aggressive attempts to solve those problems. The management rating should reflect the actual results of management's efforts. As such, the management component rating should be conservative until new management demonstrates the ability to actually improve the institution's condition, or at a minimum, its policies, procedures, and key operational areas. For example, new management improved loan underwriting, collections, and the Internal Asset Review (IAR) functions on a consistent basis. Unless management implements such broad improvements, the management rating should generally be no higher than a 3 for an institution with poor operating performance.

You must be keenly aware of unsafe and unsound practices such as self-dealing that results in unofficial compensation to management or directors. Self-dealing may result from actions undertaken directly by management or directors, or by their agents. Business dealings with insiders should be for the benefit of the thrift and on terms substantially the same as those with third parties. Self-dealing provides grounds for an unsatisfactory management rating.

Earnings

You must determine whether earnings are sufficient for necessary capital formation. An institution should have minimum earnings sufficient to absorb losses without impairing capital. Quality (stability) and composition (source) of earnings are important criteria. The thrift cannot rely on income that is nonrecurring, such as gains on the sale of portfolio loans, to maintain profitability. You should consider the extent to which extraordinary items, such as nonrecurring securities transactions and tax effects contribute to net income.

In some cases, thrifts are able to sustain volume and stable earnings from noninterest sources of income; for example, mortgage banking operations. In these thrifts (as well as all other thrifts),

you should use professional judgment and analyze the stability and sufficiency of noninterest earnings. This includes the institution's ability to react quickly to changing economic conditions, such as a decline in mortgage originations.

You should consider the adequacy of transfers to the general and specific valuation allowances; if the thrift needs more allowances, earnings will be negatively affected.

You should also consider the institution's operating risks to determine if its earnings position is stable and sufficient. For example, if an institution's interest rate risk management is inadequate, the institution's earnings may be adversely affected by a change in market interest rates.

Liquidity

OTS measures liquidity in relation to an institution's level of liquid assets, its outside sources of funds, and the adequacy of its funds (or cash flow) management practices. Historically, most thrifts have held sufficient liquid assets. OTS-supervised thrifts generally rely upon liquidity available from secured lines of credit with the Federal Home Loan Banks (FHLBs). As long as the thrift's performance is sufficient to allow it to maintain a favorable credit standing with the FHLBs, and as long as the FHLBs also have adequate liquidity, thrifts can continue to confidently rely upon them for their liquidity needs.

Sensitivity to Market Risk

The UFIRS bases the sensitivity to market risk component rating on two dimensions:

- The institution's level of market risk.
- The quality of the institution's practices for managing market risk.

Because few thrift institutions have significant exposure to foreign exchange risk or commodity or equity price risks, OTS generally assesses interest rate risk as the only form of market risk. You must assess both dimensions and combine those assessments into a component rating.

You must base your conclusions about an institution's level of interest rate risk – the first dimension for determining the S component rating – primarily on the interest rate sensitivity of the institution's net portfolio value (NPV). You must pay primary attention to two specific measures of risk: Interest Rate Sensitivity Measure and Post-shock NPV Ratio. (See the TB 13a glossary for definitions.)

- Interest Rate Sensitivity Measure. This measure by itself, may not give cause for supervisory concern when the institution has a strong capital position. Because an institution's risk of failure is inextricably linked to capital and, hence, to its ability to absorb adverse economic shocks, an institution with a high level of economic capital, that is, NPV, may be able safely to support a high sensitivity measure.
- Post-shock NPV Ratio. This ratio is a more comprehensive gauge of risk than the sensitivity measure because it incorporates estimates of the current economic value of an institution's portfolio, in addition to the reported capital level and interest rate risk sensitivity. There are three potential causes of a low, that is, risky, post-shock NPV ratio:
 - low reported capital
 - significant unrecognized depreciation in the value of the portfolio
 - high interest rate sensitivity.

Although the first two situations may cause supervisory concern and receive attention under the portions of the examination devoted to evaluating Capital Adequacy, Asset Quality, or Earnings, they do not necessarily represent an interest rate risk problem. Only when an institution's low post-shock NPV is, in whole or in part, caused by high interest rate sensitivity is there suggestion of an interest rate risk problem.

Refer to TB 13a (Section IV, Table 1) for the guidelines to determine the level of interest rate risk. Use these risk levels as starting points in your ratings assessments; however, you have broad discretion to exercise judgment. TB 13a provides these risk levels as guidance; they are not mandatory.

OTS produces quarterly estimates of the sensitivity measure of the post-shock NPV ratio for each thrift that files TFR Schedule CMR. You can find these estimates in the Interest Rate Risk Exposure Report for the thrift.

In drawing conclusions about the quality of an institution's risk management practices – the second dimension of the S component rating – you must assess all significant facets of the institution's risk management process.

Consider the following eight factors when assessing the quality of an institution's risk management practices:

- Quality of oversight by the board and senior management.
- Prudence of board-approved IRR limits.
- Adherence to IRR limits.
- Quality of system for measuring NPV sensitivity.
- Quality of system for measuring earnings sensitivity.
- Integration of risk management with decision-making.
- Investments and derivatives including risk management policies and procedures.
- Institution's size, complexity, and risk profile.

Although TB 13a (Table 2) provides guidelines on how to combine your assessment of these two dimensions into a component rating, you must exercise judgment in assigning ratings based on the facts you encounter at each institution. TB 13a (Section IV) provides a non-exhaustive list of factors you might consider in applying the S rating guidelines to a particular institution.

Thrift Performance Evaluation and CAMELS Rating Assignments

The Uniform Thrift Performance Report (UTPR) provides percentile rankings for many measures of thrift performance as compared to peer performance. Use the Thrift Monitoring System (TMS) Group Query process to find the CAMELS composite and component ratings of other thrifts with similar key ratios. These tools are useful in comparing a thrift's performance with that of its peers to assign ratings that are consistent with thrifts having similar ratios. However, since the composite CAMELS rating is an indicator of the overall health and viability of an institution, it is important that you rate thrifts on their absolute performance rather than only against regional or state peer performance. Thrifts in some states or regions may perform better than peer averages or medians, but perform poorly in absolute terms or when compared with peer averages or medians of other regions. Peer performance in such cases would not necessarily reflect thrifts that were being operated in a safe and sound manner. Rather, those averages could reflect substandard performance. The CAMELS ratings should accurately reflect the condition of a thrift, regardless of local or regional peer performance.

An institution's performance cannot be measured solely in numbers. The mere fact that an institution meets its minimum regulatory capital, liquidity, and other regulatory requirements does not guarantee that its condition is viable. Therefore, you must use professional judgment and consider both qualitative and quantitative criteria when analyzing an institution's performance.

You should consider the following items to determine the CAMELS composite and component ratings:

- Quality of management and the board of directors.
- Quality and composition of the asset portfolio.
- Risks inherent in the business activities.
- Financial data.

Further, since financial numbers are lagging indicators of an institution's condition, you must also conduct a qualitative analysis of current and projected operations when assigning CAMELS ratings. You should weigh the analysis of quantitative and qualitative data to determine the rating for each CAMELS component.

An institution with a high level of classified assets, a decreasing trend in foreclosures and delinquencies, and adequate general valuation allowances, loan underwriting, and an IAR program may merit a higher asset quality rating than an institution with the same level of classified assets, an increasing trend in foreclosures and delinquencies, and inadequate general valuation allowances, loan underwriting, and IAR program. Qualitative criteria related to these ratios may mitigate the institution's condition and, hence, the rating. You should consider all significant criteria, both qualitative and quantitative, when assigning CAMELS ratings.

You must consider all applicable information reviewed under each CAMELS component on a scale of 1 to 5. You must then make a qualitative assessment of the information reviewed for each CAMELS component to assign the ratings.

OTS structured this Handbook and the ROE around the CAMELS components. An analysis of an institution's overall soundness cannot be made without adequate consideration of all six areas and their interrelationships. This Handbook Section briefly presents the main areas you must review in order to assign the six CAMELS component ratings and the composite rating. The remaining chapters in this Handbook provide detailed instructions for the review of each CAMELS component. You should follow the examination procedures within each of the chapters as required by the examination scope to develop the CAMELS component ratings.

Consistency in CAMELS Rating Assignments

It is essential that OTS apply CAMELS ratings on a nationally consistent basis. Inconsistencies in assigning CAMELS component or composite ratings may result in confusion and degrade the integrity of the supervisory process. When OTS consistently applies CAMELS ratings, the condi-

tion of the thrift can be compared between the previous examination and the most recent examination. Furthermore, thrifts can be compared on an intraregional and a national basis using TMS Group Query reports sorted by key ratios or imported into a spreadsheet and sorted by component ratings. To ensure consistency in the CAMELS rating process, you must have a thorough understanding of the criteria to assign the different CAMELS component and composite ratings.

Maintaining and Updating the CAMELS Ratings

It is also essential that regional offices monitor new developments for each thrift and update the ratings, as needed, so that the rating is always a current indicator of the institution's condition. (Refer to the procedures for off-site CAMELS ratings at the end of this Handbook Section.) Maintaining these ratings requires periodic monitoring with an emphasis on the criteria supporting the CAMELS ratings for the thrift. For this reason, it is imperative that you document the significant points supporting the CAMELS rating.

Deterioration or significant changes in the institution's operations or condition may indicate a need for some special supervisory attention. Supervisory attention may include a telephone inquiry or written request for additional information, a special limited examination, or a regular examination. Any changes in the criteria that support the current ratings or any new developments may require a change in the CAMELS ratings and the supervisory treatment needed.

Since ratings affect the institution's assessment and supervisory treatment, they must be kept current. Analyze and adequately document any updates to the ratings. The rating reported to a thrift must always be the most recent rating based on all sources of information.

Documentation and Support

Given the importance of the CAMELS ratings, it is critical to clearly show and support how you determined these ratings. You should review ROE ratios, UTPR schedules, and customized TMS reports and use them to concisely document and support the analysis. You may also find these re-

ports useful in assimilating and reviewing work paper conclusions and organizing your thoughts before drafting the ROE.

Disclosure of CAMELS Ratings

Since 1988, OTS disclosed composite or overall examination ratings to each institution's management and board of directors. Concurrent with the adoption of the new UFIRS rating system, OTS began disclosing the CAMELS component ratings with the CAMEL composite rating in the ROE. Disclosure of the CAMELS component ratings encourages a more complete and open discussion of examination findings and recommendations between examiners and thrift management. Further, disclosure of the CAMELS component ratings in addition to the composite rating provides management with a better understanding of how OTS derives the composite rating. Disclosure also enables management to better address any weaknesses in specific areas before OTS finds it necessary to downgrade the institution's overall composite rating. Use the following rating disclosure procedures for all safety and soundness examinations, including joint and concurrent examinations, that OTS conducts.

You must disclose the assigned composite rating in accordance with OTS's ROE instructions. Add the component rating to the top left corner of each ROE core component page. Report comments on the Examination Conclusions and Comments page and on other related schedules throughout the report should fully support the composite and component ratings assigned. The individual core page for a component rating should continue to contain a clear and thorough discussion of that component. You should support component ratings with selected use of statistics. Use language that is clear and informative, appropriate in tone, and explain your assignments, conclusions, and reasoning.

Management Discussions

You must disclose CAMELS composite and component ratings at exit conferences with senior management and, when appropriate, the board of directors. You should obtain sufficient concurrence with the ratings from regional management, so that the component ratings disclosed are final,

or subject to revisions only in rare instances. If the ratings are subject to further review, you should disclose to thrift management that the ratings are not final. Each region has office procedures to implement this policy.

During the discussion with management, you should discuss the criteria you considered in assigning each component rating as well as the overall composite rating. You should indicate that you based the composite rating on a careful evaluation of the institution's managerial, operational and financial performance, and compliance with laws and regulations. You should clarify that you did not base the composite rating on an arithmetic average of the components, but on a qualitative analysis of the criteria comprising each component, the interrelationship between components, and, more importantly, the overall level of supervisory concern.

The quality of management is the single most important element in the successful operation of a thrift, and is usually the factor that is most indicative of how well the institution identifies, measures, monitors, and controls risk. For this reason, you should take sufficient time to explain to senior management and, when appropriate, to the board of directors, the criteria you considered in assigning the management component rating, and the meaning of the rating. Your written comments in support of the management rating should include an assessment of the effectiveness of existing processes to identify, measure, monitor, and control risk. Finally, you should remind management that the CAMELS composite and component ratings disclosed in the examination report remain subject to the confidentiality rules imposed by 12 CFR Part 510 of the OTS Regulations. This includes the verbal disclosures made at the conclusion of the examination.

REFERENCES

Code of Federal Regulations (12 CFR)

OTS Regulations

- §502.1 Asset-based Assessments
- §562.4 Audit of Savings Associations and Holding Companies
- §563.41 Loans and Other Transactions With Affiliates
- §563.550 Additions of Directors and Employment of Senior Executive Officers
- §565.4 Capital Measures and Capital Category Definitions

FDIC Regulations

- Part 327 Assessments

Office of Thrift Supervision Bulletins

- RB 3b Policy Statement on Growth for Insured Institutions
- RB 18 General Enforcement Policy Series
- TB 13a Management of Interest Rate Risk, Investment Securities, and Derivative Activities
- TB 69 Revised Rating System; Disclosure of Component Ratings (the UFIRS is attached)
- TB 69-1 Common Questions on the Revised UFIRS (the FFIEC document is attached)

Other References

- OTS Report of Examination Instructions Manual
- FFIEC Press Release, "Uniform Financial Institutions Rating System," December 19, 1996
- OTS Transmittal 166: Regulatory Citations to UFIRS

CAMELS Ratings Program

Objectives

To consider all significant financial, operational, and compliance performance measures for an institution and assign CAMELS ratings that accurately reflect the institution's condition and viability.

To clearly support the CAMELS ratings in the examination report and enable OTS to initiate corrective action with the institution's directors and management.

To provide the institution's management and the board of directors with CAMELS ratings that signify the OTS assessment of the institution's overall condition.

Examination Procedures

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The following procedures depend on information obtained from all phases of the examination and from all off-site sources. The examiner in charge (EIC), or designee, should complete the following procedures for developing the CAMELS ratings during the final stages of the examination.

On-Site CAMELS Ratings

Note: If the EIC completed the overall conclusions program, Section 070 of this Handbook, on-site steps are substantially complete.

1. Review analyses, exceptions, and conclusions in the work papers for each CAMELS component. Support all conclusions with objective information. Resolve any contradictory conclusions.

2. Review assisting examiners' comments on individual CAMELS criteria. If necessary, make adjustments to ensure that comments are comprehensive and to eliminate any duplication. If the EIC is aware of other criteria that are not known to assisting personnel, the EIC should determine if these criteria are relevant and whether or not to include the comments.

3. Review the preliminary CAMELS component ratings that assistant examiners recommend. Discuss the recommendations with assistant examiners to ensure the accuracy of their interpretations. Ensure that assistant examiners provided well-supported conclusions and opinions. Ensure that assistant examiners consistently applied the standard criteria set forth in this Handbook Section for determining and weighing the CAMELS criteria and assigning the CAMELS component ratings.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

CAMELS Ratings Program

Wkp.Ref.

4. If necessary, adjust the CAMELS ratings so that they accurately and objectively present the institution's performance in each CAMELS component. Document the basis for each rating. Include the ROE ratios as well as any other pertinent ratios. Also include the most significant points supporting each CAMELS rating.

5. Weigh the relative importance of the various criteria considered when developing the CAMELS component ratings, and analyze their effect on the overall condition of the thrift. Determine the composite rating, applying the standard criteria set forth in the UFIRS statement following this Handbook Section. Clearly support the composite rating with the facts and comments within the ROE.

6. Prepare the Examination Conclusions and Comments page. Refer to the ROE Instructions manual for a list of the elements you should include on this page.

7. Discuss findings with management. Refer to Section 070, Overall Conclusions, for further instructions for meeting with thrift management.

8. Review the comments again to ensure consistency with the assigned ratings. Finalize the CAMELS ratings and comments after a thorough review. Ensure that the assistant examiner correctly completed the Examination Data System (EDS) III, Section R (Ratings).

9. Ensure your review meets the *Examination Objectives* of this Handbook Section.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

CAMELS Ratings Program

Wkp.Ref.

Off-Site CAMELS Ratings

Supervisory managers, analysts, or other staff should complete the following procedures as applicable when analyzing and updating CAMELS ratings off-site:

Note: Any off-site CAMELS rating updates should be done using the Type 22 Examination Report, "Off-Site Monitoring."

1. Review the most recent examination report and the regulatory plan for the thrift to identify areas of concern.

2. Analyze reported financial information to determine current trends and any new areas of concern, with an emphasis on the period since the last examination.

3. Review any applications the thrift submitted since the last rating to determine whether there are any material changes in the structure or business plan.

4. Review correspondence between the thrift and OTS to learn the status of significant issues arising since the most recent examination. Verify, to the extent possible, through a review of the financial statements and other reports that the thrift is correcting any problem areas.

5. Review the most recent independent audit report, the certified public accountant's management letter addressing internal control issues, and the institution's response to that letter to determine if management corrected all reported internal control deficiencies.

6. If necessary, contact the thrift to verify specific facts or address concerns.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

CAMELS Ratings Program

Wkp.Ref.

7. Identify any changes in the institution's condition and operating practices. Determine if a change in a CAMELS component or composite rating more appropriately reflects the condition of the thrift.

8. Determine the need for and recommend, if necessary, a supplemental or full-scope examination or an on-site review of areas that you cannot adequately analyze off-site.

9. Recommend any change in the CAMELS component or composite ratings to the supervisory manager or other appropriate manager in the regional office. Support any recommendation for change with a narrative memorandum and documented analysis explaining and supporting the reasons for the change.

10. If the regional office approves a change in a composite or component CAMELS rating, prepare a supervisory letter or memorandum to the institution's board of directors to inform them of the change in the rating. The memo should explain the reasons for the change and any resulting consequences. The memorandum should also contain a definition of the new rating assigned and standard language prohibiting disclosure of the rating.

11. Enter the new ratings in EDS III, Section R (Ratings) and make certain they are correct.

12. Update the Regulatory Plan with any other appropriate information.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

UNIFORM FINANCIAL INSTITUTIONS¹ RATING SYSTEM

Introduction

The Uniform Financial Institutions Rating System (UFIRS) was adopted by the Federal Financial Institutions Examination Council (FFIEC) on November 13, 1979. Over the years, the UFIRS has proven to be an effective internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern. A number of changes, however, have occurred in the banking industry and in the Federal supervisory agencies' policies and procedures which have prompted a review and revision of the 1979 rating system. The revisions to UFIRS include the addition of a sixth component addressing sensitivity to market risks, the explicit reference to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating descriptions.

The revisions to UFIRS are not intended to add to the regulatory burden of institutions or require additional policies or processes. The revisions are intended to promote and complement efficient examination processes. The revisions have been made to update the rating system, while retaining the basic framework of the original rating system.

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

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

Overview

Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These component factors address the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the sensitivity to market risk. Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

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

¹ For purposes of this rating system, the term "financial institution" refers to those insured depository institutions whose primary Federal supervisory agency is represented on the Federal Financial Institutions Examination Council (FFIEC). The agencies comprising the FFIEC 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. The term "financial institution" includes Federally supervised commercial banks, savings and loan associations, mutual savings banks, and credit unions.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

The ability of management to respond to changing circumstances and to address the risks that may arise from changing business conditions, or the initiation of new activities or products, is an important factor in evaluating a financial institution's overall risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.

The ability of management to identify, measure, monitor, and control the risks of its operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices vary considerably among financial institutions, depending on their size, complexity, and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, on the other hand, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-to-day activities. All institutions are expected to properly manage their risks. For less complex institutions engaging in less sophisticated risk taking activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Foreign Branch and specialty examination findings and the ratings assigned to those areas are taken into consideration, as appropriate, when assigning component and composite ratings under UFIRS. The specialty examination areas include: Compliance, Community Reinvestment, Government Security Dealers, Information Systems, Municipal Security Dealers, Transfer Agent, and Trust.

The following two sections contain the composite rating definitions, and the descriptions and definitions for the six component ratings.

COMPOSITE RATINGS

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are: capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk. The rating scale ranges from 1 to 5, with a rating of 1 indicating: the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile; and the level of least supervisory concern. A 5 rating indicates: the most critically deficient level of performance; inadequate risk management practices relative to the institution's size, complexity, and risk profile; and the greatest supervisory concern. The composite ratings are defined as follows:

Composite 1

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

Composite 2

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

Composite 3

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

Composite 4

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

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institution's size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or

other assistance is needed in order for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and failure is highly probable.

COMPONENT RATINGS

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

Capital Adequacy

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

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

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

Ratings

- 1 A rating of 1 indicates a strong capital level relative to the institution's risk profile.
- 2 A rating of 2 indicates a satisfactory capital level relative to the financial institution's risk profile.
- 3 A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.
- 4 A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.
- 5 A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

Asset Quality

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

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

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

tion of problem assets.

- The adequacy of internal controls and management information systems.
- The volume and nature of credit documentation exceptions.

Ratings

- 1** A rating of 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset quality in such institutions is of minimal supervisory concern.
- 2** A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.
- 3** A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.
- 4** A rating of 4 is assigned to financial institutions with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.
- 5** A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

Management

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

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

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

- The level and quality of oversight and support of all institution activities by the board of directors and management.
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products.
- The adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile.
- The adequacy of audits and internal controls to: promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies.
- Compliance with laws and regulations.
- Responsiveness to recommendations from auditors and supervisory authorities.
- Management depth and succession.
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority.
- Reasonableness of compensation policies and avoidance of self-dealing.
- Demonstrated willingness to serve the legitimate banking needs of the community.
- The overall performance of the institution and its risk profile.

Ratings

- 1** A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.
- 2** A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

- 3 A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.
- 4 A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.
- 5 A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

Earnings

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

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

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

Ratings

- 1 A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.
- 2 A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.
- 3 A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.
- 4 A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.
- 5 A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

Liquidity

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

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

- The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition.
- The availability of assets readily convertible to cash without undue loss.
- Access to money markets and other sources of funding.
- The level of diversification of funding sources, both on- and off-balance sheet.
- The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered depos-

its, to fund longer term assets.

- The trend and stability of deposits.
- The ability to securitize and sell certain pools of assets.
- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

Ratings

- 1** A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.
- 2** A rating of 2 indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.
- 3** A rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.
- 4** A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.
- 5** A rating of 5 indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Sensitivity to Market Risk

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

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

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

- The sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes

in interest rates, foreign exchanges rates, commodity prices, or equity prices.

- The ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile.
- The nature and complexity of interest-rate risk exposure arising from nontrading positions.
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

Ratings

- 1** A rating of 1 indicates that market risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.
- 2** A rating of 2 indicates that market risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.
- 3** A rating of 3 indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.
- 4** A rating of 4 indicates that control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.
- 5** A rating of 5 indicates that control of market risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

OFFICE OF THE COMPTROLLER OF THE CURRENCY
OFFICE OF THRIFT SUPERVISION
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
FEDERAL DEPOSIT INSURANCE CORPORATION

March 4, 1997

JOINT INTERAGENCY COMMON QUESTIONS AND ANSWERS ON THE REVISED
UNIFORM FINANCIAL INSTITUTIONS RATING SYSTEM

On March 4, 1997, the Task Force on Supervision of the Federal Financial Institutions Examination Council approved the issuance of common questions and answers about the recently revised Uniform Financial Institutions Rating System. The Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC) collectively developed common responses to questions asked to date by bankers and examiners regarding the revised rating system. The responses were coordinated with the Conference of State Bank Supervisors. The purpose of the questions and answers is to provide additional interagency guidance and clarification regarding the revised rating system.

On December 9, 1996, the Federal Financial Institutions Examination Council (FFIEC) adopted the revised Uniform Financial Institutions Rating System (UFIRS or CAMELS rating system). The UFIRS is an internal rating system used by the federal and state regulators for assessing the soundness of financial institutions on a uniform basis and for identifying those insured institutions requiring special supervisory attention. A final notice was published in the *Federal Register* on December 19, 1996 (61 FR 67021), effective January 1, 1997.

The major changes to UFIRS include an increased emphasis on the quality of risk management practices and the addition of a sixth component called "Sensitivity to Market Risk." The updated rating system also reformats and clarifies component rating descriptions and component rating definitions, revises composite rating definitions to parallel the other changes in the rating system, and highlights risks that may be considered in assigning component ratings.

The attached questions and answers are being distributed to bankers and examiners to ensure consistent and uniform implementation of the revised rating system.

COMMON QUESTIONS AND ANSWERS ON THE REVISED
UNIFORM FINANCIAL INSTITUTIONS RATING SYSTEM

(1) How will the new Sensitivity to Market Risk (S) component rating be determined?

The rating assigned to the S component should reflect a combined assessment of **both** the level of market risk and the ability to manage market risk. Low market risk sensitivity alone may not be sufficient to achieve a favorable S rating. Indeed, institutions with low risk, but inadequate market risk management, may be subject to unfavorable S ratings. Conversely, institutions with moderate levels of market risk and the demonstrated ability to ensure that market risk is, and will remain, well controlled may receive favorable S component ratings.

In assessing the level of market risk exposure and the risk management process in place to control it, examiners will rely on existing supervisory guidance issued by their respective agencies, including guidance issued on interest-rate risk, investment, financial derivatives, and trading activities.

(2) Will institutions be expected to have formal, sophisticated risk management processes in order to receive the favorable ratings for S?

In line with the general thrust of the agencies' various guidance on market risk, the sophistication of an institution's risk management system is expected to be commensurate with the complexity of its holdings and activities and appropriate to its specific needs and circumstances. Institutions with relatively noncomplex holdings and activities, and whose senior managers are actively involved in the details of daily operations, may be able to rely on relatively basic and less formal risk management systems. If the procedures for managing and controlling market risks are adequate, communicated clearly, and well understood by all relevant parties, these basic processes may, when combined with low to moderate levels of exposure, be sufficient to receive a favorable rating for the S component.

Organizations with more complex holdings, activities and business structures may require more elaborate and formal market risk management processes in order to receive ratings of 1 or 2 for the S component.

(3) How much weight should be placed on the S component in determining the composite rating?

The weight attributed to any individual component in determining the composite rating should vary depending on the degree of supervisory concern associated with the component. The composite rating does not assume a predetermined weight for each component and it does not represent an arithmetic average of assigned component ratings. As a result, for most institutions where market risk is not a significant issue, less weight should be placed on the S component in determining a composite rating than on other components.

- (4) **How should the S rating be applied when evaluating small community banks or thrifts with limited asset/liability management processes?**

For most small community banks or thrifts, sensitivity to market risk will primarily reflect interest-rate risk. Regardless of the size of an institution, the quality of risk management systems must be commensurate with the nature and complexity of its risk-taking activities, and management's ability to identify, measure, monitor and control the risk. Evaluation of this component will be based on the degree to which interest-rate risk exposure can affect the institution's earnings and capital, and the effectiveness of the institution's asset/liability or interest-rate risk management system, given its particular situation.

- (5) **If the levels of market risk change between examinations, is it always necessary to change the rating assigned to the S component?**

The rating assigned to the S component should reflect a combined assessment of both the level of market risk and the ability to manage market risk. Accordingly, changes in either quantitative or qualitative aspects of market risk exposure or management may necessitate changes in the rating assigned to the S component. While changes in the level of market risk between examinations may in some circumstances necessitate a change in the rating assigned to the S component, this does not automatically imply a rating change. For example, an institution that accepts additional market risk between examinations, but maintains risk management processes and earnings and capital levels commensurate with the level of risk, need not have its S rating changed.

- (6) **Does the increased emphasis on market risk management practices place new and burdensome requirements on institutions or examiners?**

The updated rating system incorporates examination considerations that were not explicitly noted in the prior rating system. Under the prior rating system, examiners considered market risk exposure and risk management practices when assigning component and composite ratings. Consequently, examiners are not required to perform any additional procedures, and institutions are not required to add to their management procedures or practices, solely because of the updated rating system.

- (7) **Will the revised rating system, with the addition of the new Sensitivity to Market Risk (S) component and increased emphasis on the quality of risk management practices, result in a change in a bank's or thrift's composite rating?**

The revised rating system generally should not result in a change in the composite rating assigned to a particular bank or thrift simply because of the addition of the new component and the increased emphasis on risk management practices. The level of market risk has traditionally been taken into consideration when evaluating an institution's capital, earnings and liquidity. The quality of an institution's risk management practices has also traditionally been considered by examiners when assessing an institution's condition and assigning ratings, particularly in the Management component.

- (8) **How much weight should be given to risk management practices versus the level of exposure, as measured by specific ratios, when assigning a component rating?**

The CAMELS rating system assesses an institution's overall condition based on both quantitative and qualitative elements. Quantitative data such as the level of classified assets remain an integral part of that measurement. Qualitative elements, such as the adequacy of board and senior management oversight, policies, risk management practices, and management information systems are also central to the evaluation of components. The relative importance given to the qualitative considerations for each component depends on the circumstances particular to the institution. Risk management systems should be appropriate for the nature and level of risks the institution assumes. However, unacceptable risk levels or an unsatisfactory financial condition will often outweigh other factors and result in an adverse component rating.

- (9) **Why aren't peer data comparisons specifically mentioned in the revised rating system? May they still be used in assigning ratings?**

Peer data are an integral part of the evaluation process and, when available and relevant, may be used in assigning a rating. However, peer data should be used in conjunction with other pertinent evaluation factors and not relied upon in isolation when assigning a rating.

- (10) **Agency guidelines require examiners to discuss with senior management and, when appropriate, with the board of directors the evaluation factors they considered in assigning component ratings and a composite rating. Are examiners limited to only those evaluation factors listed in the revised rating system and must each evaluation factor be addressed when assessing a component area?**

No. Examiners have the flexibility to consider any other evaluation factors that, in their judgment, relate to the component area under review. The evaluation factors listed under a component area are not intended to be all-inclusive, but rather a list of the more common factors considered under that component. Only those factors believed relevant to fully support the rating being assigned by the examiner need be addressed in the report and in discussions with senior management.

- (11) **With multiple references to some items across several components, such as market risk and management's ability to identify, measure, monitor, and control risk, are we "double counting" these and other items when assigning a rating?**

Each component is interrelated with one or more other components. For example, the level of problem assets in an institution is a primary consideration in assigning an asset quality component rating. But it is also an item that affects the capital and earnings component ratings. The level of market risk and the quality of risk management practices are elements that also can affect several components. Examiners consider relevant factors and their interrelationship among components when assigning ratings.

- (12) **To what extent should market risk be carved out of the earnings or capital evaluation? Should institutions with high market risk receive an adverse rating in the earnings or capital components as well as the market sensitivity component?**

Market risk is evaluated primarily under the new S component and is only one of several evaluation factors used to assess the earnings and capital components. Whether the institution's exposure to market risk results in an unfavorable rating for earnings or capital, however, is based on a careful analysis of the effect of this factor in relation to the other factors considered under these components. The capital component is evaluated based on the risk profile of an institution, including the effect of market risk, and whether the level of capital supports those risks. The earnings component evaluates the ability of earnings to support operations and maintain adequate capital after considering factors, such as market risk exposure, that affect the quantity, quality, and trend of earnings. The importance accorded to an evaluation factor should thus depend on the situation at the institution.

INTRODUCTION

This Handbook Section briefly describes Regulation U requirements and offers guidelines to you as the regulator in determining compliance with Regulation U.

The Federal Reserve Board (FRB) issued this regulation pursuant to the Securities Exchange Act of 1934 to prevent the excessive use of credit when purchasing or carrying margin stock. The regulation sets out certain requirements for banks and others including savings associations who extend or maintain credit secured directly or indirectly by margin stock. Regulation T governs the extension of credit by brokers and dealers. The reporting requirements and lending restrictions of Regulation U apply only to those institutions required to register.

Until April 1, 1998, 12 CFR Part 207 - Securities Credit by Persons other than Banks, Brokers, or Dealers (Regulation G) governed savings associations. The National Securities Markets Improvement Act of 1996 ("NSMIA") repealed section 8(a) of the Securities Exchange Act of 1934 (the '34 Act). Section 8(a) of the '34 Act mandated a distinction between bank and nonbank lenders with respect to loans to broker-dealers. Regulation U prior to April 1, 1998, applied exclusively to banks. The FRB concluded that with repeal of Section 8(a) of the '34 Act there was no longer a need to distinguish between Regulations G and U. With certain exceptions, the FRB incorporated provisions of Regulation G into amended Regulation U under the revised title: Credit by Banks and Persons Other than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stock (Regulation U).

Registration

Any savings association that extends credit, directly or indirectly secured by margin stock, and that meets either of the following two requirements must register with the Federal Reserve Board:

- extending margin-stock-secured credit in any calendar quarter equaling \$200,000 or more, or
- maintaining margin-stock-secured credit outstanding at any time during a calendar quarter totaling \$500,000 or more.

Margin stock consists primarily of equity securities, convertible debt, and mutual funds.

Federal Reserve Form FR G-1 (OMB Control Number 7100-0011) (see Appendix B)¹ is the vehicle a savings association uses to register. The savings association mails the form to the Federal Reserve Bank serving the area of the savings association's principal office. A savings association must register within 30 days after the end of the calendar quarter in which it becomes subject to Regulation U. Registration under Regulation U sets both lending restrictions and reporting requirements on savings associations.

Lending Restrictions

Regulation U prohibits lenders from extending credit in excess of the maximum loan value if the purpose of the credit is to buy or carry margin stock. Credits of this nature are "purpose loans." The maximum loan value of any margin stock is 50 percent of its current market value. Regulation U thus prohibits savings associations from lending on more than 50 percent of the current market value of margin stock if the purpose of the loan is to buy or carry margin stock.

Each purpose credit extended to a customer, including revolving credit or multiple draw agreements, is subject to the "single credit rule." All purpose credit extended to a customer is a single credit. Compliance includes aggregation of all collateral. Withdrawal provisions of the Regulation consider all secured and unsecured credit.

The maximum loan value is the good-faith basis, not to exceed 100 percent of the current fair market value of the collateral, if the proceeds of a margin-

stock-secured loan are for a purpose other than to purchase or carry margin stock. Good-faith basis is the amount that a lender would be willing to lend without regard to any other assets of the borrower. Credits of this nature are "non-purpose loans."

The Regulation allows lenders to permit any withdrawal or substitution of cash or collateral by the customer if the withdrawal or substitution would not cause the credit to exceed the maximum loan value of the collateral or increase the amount by which the credit exceeds the maximum loan value of the collateral.

Margin stock has good faith loan value if it secures directly or indirectly credit extended by a plan lender under an eligible plan. Credit extended by plan lenders on the basis of eligible plans secured by margin stock is separate from other credit secured by margin stock, except for registration and reporting requirements. A plan lender includes any corporation (including any thrift organization whose members are employees and former employees of the organization) that extends or maintains credit to finance the acquisition of margin stock of the organization under an eligible plan. Any stockholder approved employee stock option, purchase or ownership plan adopted by a corporation that provides for the purchase of margin stock of the corporation, its subsidiaries or affiliates are eligible plans. Savings associations also may extend and maintain purpose credit to qualified ESOPs under Regulation U, subject only to the regulation's registration and reporting requirements.

Lenders other than broker-dealers may extend 50 percent loan value against listed options; such options qualify as margin stock. Except for options that qualify as margin stock, puts, calls and combinations thereof have no loan value. Regulation U permits savings associations to extend and maintain special purpose credit to brokers and dealers without regard to the general purpose credit requirements and maximum loan value of margin stock and other collateral restrictions. The types of special credit include: hypothecation loans, temporary advances in payment-against-delivery transactions, loans for securities in transit or transfer, intra-day loans, arbitrage loans, market maker

and specialist loans, underwriter loans, emergency loans, capital contribution loans and credit to clearing brokers or dealers.

Exempted Borrowers

Regulation U provides that certain borrowers are exempt. Exempted borrowers consist of national securities exchange members and certain brokers and dealers whose business consists of transactions with persons other than brokers or dealers. There are a number of accounts and dollar and percentage of gross revenue tests to determine eligibility of such borrowers for exemption.

Reporting and Regulatory Requirements

Registered lenders file with the Federal Reserve Bank an Annual Report, on Federal Reserve Form FR G-4 (OMB Control Number 7100-0011) (see Appendix E)¹ showing their lending activities secured by margin stock. Registered lenders file this form for the year ended June 30. This form contains the amount of such credit outstanding and extended during a calendar year. Registered savings associations file this report along with a copy of their balance sheet.

Federal Reserve Form FR G-3 entitled "Statement of Purpose for an Extension of Credit Secured by Margin Securities by a Person Subject to Registration Under Regulation G" must accompany each credit secured by margin securities. (OMB Control Number 7100-0018.) (See Appendix D)¹. Both the borrower and the lender complete the purpose statement for every margin-stock-secured loan extended, except for employee stock purchase plans. The lender obtains a current list of collateral that adequately supports all credit extended under the agreement. The collateral list remains with the executed FRB Form G-3. Neither OTS nor the FRB receives FRB Form G-3. Rather, the savings association keeps the form for three years after the credit is paid-off. The Office of Thrift Supervision is responsible for monitoring compliance with Regulation U by savings associations. The Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, National Credit Union Administration,

and Farm Credit Administration are responsible for Regulation U compliance by entities under their supervision.

Deregistration

A registered savings association may apply to terminate its registration, by filing Federal Reserve Form FR G-2 (OMB control number 7100-0011) (see Appendix C)¹, with its district Federal Reserve Bank, if the savings association has not, during the preceding six calendar months, had more than \$200,000 of margin-stock-secured credit outstanding. A savings association is deregistered upon approval by the FRB.

REFERENCES**Code of Federal Regulations (12 CFR)**

Part 221 Credit by Banks and Persons
Other Than Brokers or Dealers for the
Purpose of Purchasing or Carrying
Margin Stock (Regulation U)

United States Code (15 USC)

Part 78 Securities Exchange Act of 1934

Federal Reserve Board - Rulings and Interpretations of Regulation U

¹ OMB granted the FRB an extension of time to use this form beyond the printed expiration date.

Margin Securities (Regulation U) Program

Examination Objectives

To determine that the savings association has procedures in place to comply with Regulation U.

To determine that the savings association is in compliance with the registration, reporting, and lending requirements of the regulation.

Examination Procedures

Wkp.Ref.

Level I

1. Ascertain whether the savings association is subject to Regulation U. Determine whether the savings association has recently registered or deregistered.

2. Ascertain whether the savings association has procedures in place to maintain accurate records and ensure compliance with the reporting, lending limitation, and withdrawal requirements of the regulation.

3. Ascertain whether the savings association's internal audit program provides adequate coverage to monitor Regulation U. Ensure that the internal audit system regularly monitors data collection, reporting requirements, and lending restrictions.

4. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

5. If the savings association recently deregistered, verify that the savings association was eligible to deregister.

6. Ascertain the accuracy of the two most recent annual reports (FR G-4).

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Margin Securities (Regulation U) Program

Wkp.Ref.

7. Determine whether the savings association corrected previous violations.

8. Review a sample of loan files for margin-stock-secured credits to check that loan purpose statements exist and that the credits are within margin-stock-credit limitations. Review a sample of loans to savings association service corporations that serve as broker-dealers to determine if such loans qualify as *special purpose loans* to brokers and dealers (12 CFR 221.5).

9. Ensure compliance with the *Objectives* of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Level III

10. Determine if an improper registration or deregistration exists. Determine if all organizations required to register did so. Report exceptions to the regional director who will then contact the appropriate Federal Reserve Bank.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Federal Reserve Bank - Questions and Answers About Nonbank Lenders Under Regulation U

The following questions and answers on nonbank¹ lenders under Regulation U are intended to provide an introduction to the basic areas covered by the regulation. This is not a complete discussion of all the requirements of the regulation and is therefore not a substitute for the regulation itself.

1. *Q. What is Regulation U?*

A. Regulation U is a Federal Reserve Board regulation (12 CFR 221) that sets out certain requirements for lenders other than brokers and dealers extending credit secured by margin stock. (See question 9 for the definition of "margin stock.")

2. *Q. What types of lenders are typically covered by Regulation U?*

A. Regulation U covers not only commercial banks, but also savings and loan associations, federal savings banks, credit unions, production credit associations, insurance companies, and companies with employee stock option plans.

3. *Q. When does a lender become subject to Regulation U?*

A. A commercial bank is always subject to Regulation U when it extends credit secured by margin stock. A nonbank lender becomes subject to Regulation U when it meets either one of the following threshold tests for the amount of margin-stock-secured credit extended or outstanding.

Test 1: Has \$200,000 or more in credit secured directly or indirectly by margin stock been extended in the last calendar quarter? If the answer is yes, the lender is subject to Regulation U.

Test 2: At any time in the last quarter has the amount of margin-stock-secured credit outstanding equalled \$500,000 or more? If yes, then the lender is subject to Regulation U.

4. *Q. If margin stock is taken as additional collateral on a loan, is the loan considered in applying the two tests above?*

A. Yes.

5. *Q. What happens when one of these tests is met?*

A. The lender must register with the Federal Reserve Bank in whose District it is located by filling out and sending in Form G-1 (available by calling the local Federal Reserve Bank) within 30 days of the end of the calendar quarter in which one of the two tests is met. Sending in the registration statement Form G-1 is a one-time requirement.

6. *Q. Must such a lender register with the appropriate Federal Reserve Bank even though it is regulated by the Office of Thrift Supervision?*

¹ For purposes of Regulation U, the Federal Reserve Board classifies savings associations as nonbank lenders.

A. Yes, all nonbank, nonbroker lenders must register with the Federal Reserve. Compliance with Regulation U by savings and loans and federal savings banks has, since October 8, 1989, been monitored by the Office of Thrift Supervision.

7. Q. What is the Form G-1 and what information does it require to be disclosed?

A. The Form G-1 is a simple four-page form that must be filled out and submitted to the appropriate Federal Reserve Bank by a lender in fulfillment of its requirement to register as a nonbank lender whenever one of the tests mentioned above is met (see question 3). The Form G-1 requires the registrant-lender to provide the following information:

- name of registrant
- address of registrant
- principal lines of business
- form of business (corporation, partnership, etc.)
- names of personnel responsible for maintaining company records
- purpose of credit extended
- balance sheet

8. Q. What responsibilities does a lender take on once it registers with a Federal Reserve Bank as a nonbank lender?

A. Regulation U has three important postregistration requirements:

1. The nonbank lender must obtain from the borrower and complete a purpose statement (Form G-3) for each loan secured by margin stock.
2. The nonbank lender must adhere to margin requirements (currently 50 percent) for purpose loans secured by margin stock (see question 10 for the definition of "purpose loan").
3. The nonbank lender must file an annual report of stock-secured lending (Form G-4) as of each June 30.

9. Q. What is margin stock?

A. "Margin stock" is defined in Regulation U (§ 221.2(i)) and includes (1) any equity security registered on a national securities exchange, such as the New York Stock Exchange or American Stock Exchange; (2) any OTC security trading in the National Market System; (3) any warrant or right to purchase a stock described in 1, 2, or 3 above; (4) any debt security convertible into a stock described in 1, 2, or 3 above; or (5) most mutual funds.

10. Q. What is a purpose loan?

A. A purpose loan is a loan whose proceeds are used to buy or carry margin stock. A loan to carry margin stock is one that enables borrower to maintain, reduce, or retire indebtedness originally incurred to purchase margin stock.

11. Q. What are the Regulation U requirements for purpose loans secured by margin stock?

A. The first requirement is that the borrower complete the Form G-3 statement of purpose, which must be signed by

the borrower and a representative of the lender. Second, a lender may not extend credit in excess of the maximum loan value as specified in Regulation U. The maximum loan value is now 50 percent of the current market value of the stock, except for plan-lender loans, which are discussed in question 15. In other words, the largest purpose loan a lender could extend would be one-half the current market value of the margin stock securing the loan (assuming the loan is secured only by margin stock). If a purpose loan is initially in compliance with Regulation U, no action is required by the lender if the market value of the stock changes or if the maximum loan value as prescribed by Regulation U changes. It should be noted that the stock securing the loan may be a different stock from the stock that is purchased.

Other rules in Regulation U cover situations such as withdrawals and substitutions of collateral, loan renewals, extensions of maturity, and loan transfers. For these requirements, a lender should consult the regulation or contact a Federal Reserve Bank.

12. *Q. What is a nonpurpose loan under Regulation U?*

A. A nonpurpose loan is a loan made for any purpose other than purchasing or carrying margin stock.

13. *Q. What are the requirements of Regulation U for nonpurpose loans?*

A. The only Regulation U requirement is that the borrower complete Form G-3 or Form U-1 if the loan is secured (directly or indirectly) by margin stock. Regulation U places no restriction on the amount of credit that may be extended on nonpurpose loans secured by margin stock.

14. *Q. What is Form G-3?*

A. Form G-3 is a two-page form wherein the borrower must disclose (1) the use to which the loan proceeds will be put, (2) the amount of the loan, and (3) the collateral for the loan. The form is signed by both the borrower and an authorized representative of the lender and must be kept in the lender's records for at least three years after the termination of the credit.

15. *Q. What is a plan-lender?*

A. A plan-lender is a corporation (including a wholly owned subsidiary, or a thrift organization whose membership is limited to employees and former employees of the corporation, its subsidiaries, or affiliates) that extends credit to its employees, under an employee stock option plan approved by the shareholders, to purchase stock of that corporation, its subsidiaries, or affiliates. Loans under such a plan may be for any amount up to 100 percent of the current market value of the stock. A G-3 purpose statement is not required for these loans.

16. *Q. Does Regulation U contain any special rules for employee stock ownership plans (ESOPs)?*

A. ESOPs qualified under section 401 of the Internal Revenue Code are entitled to exempt credit. A nonbank lender may extend purpose credit to an ESOP without regard to Regulation U, as long as the lender complies with the registration requirements and files annual reports.

17. *Q. Under Regulation U, what reports must be filed with the Federal Reserve Bank?*

A. The registration form, Form G-1, is discussed in question 7. An annual report, Form G-4, must be filed within 30 days of June 30. This form will be supplied by the Reserve Bank prior to June 30. The statement of purpose, Form G-3, should be maintained in each borrower's file. When a lender wants to register and is eligible to do so, Form G-2, the deregistration statement, must be filed with the Reserve Bank.

18. *Q. When is a lender eligible to deregister?*

A. A registered lender may deregister if, during the preceding six calendar months, no more than \$200,000 of credit secured by margin stock is outstanding.

19. *Q. What is the effect of deregistering?*

A. When a nonbank lender is eligible to deregister and does so by filing a Form G-2, it ceases to become subject to the requirements of Regulation U. Of course, if the lender extends margin-stock-secured credit above the threshold amount, it would again have to register with the Federal Reserve Bank.

20. *Q. Where can a lender get more information?*

A. Copies of Regulation U and Forms G-1, G-2, G-3, and G-4 may be obtained by writing or calling the Federal Reserve Bank offices listed below:

1. Atlanta:
Consumer Affairs Section
Federal Reserve Bank of Atlanta
104 Marietta Street
Atlanta, Georgia 30303
(404) 589-7200

4. Cleveland:
Division of Supervision & Regulation
Federal Reserve Bank of Cleveland
1455 East Sixth Street
Cleveland, Ohio 44101
(216) 293-8000

2. Boston:
Regulations Unit
Federal Reserve Bank of Boston
600 Atlantic Avenue
Boston, Massachusetts 02106
(617) 973-3000

5. Dallas:
Supervision and Regulation Department
Federal Reserve Bank of Dallas
2200 N Pearl St.
Dallas, Texas 75201
(214) 744-7484

3. Chicago:
Division of Consumer and Community
Affairs
Federal Reserve Bank of Chicago
230 South LaSalle Street
Chicago, Illinois 60690
(312) 322-5322

6. Kansas City:
Division of Bank Supervision & Structure
Federal Reserve Bank of Kansas City
925 Grand Avenue
Kansas City, Missouri 64198
(816) 881-2000

7. Minneapolis:

Division of Supervision & Regulation
Federal Reserve Bank of Minneapolis
90 Hennepin Avenue
Minneapolis, Minnesota 55401
(612) 340-2345

8. New York:

Compliance Examinations Division
Federal Reserve Bank of New York
33 Liberty Street
New York, New York 10045
(212) 720-5000

9. Philadelphia:

Community and Consumer Affairs
Department
Federal Reserve Bank of Philadelphia
Ten Independence Mall
Philadelphia, Pennsylvania 19106
(215) 574-6000

10. Richmond:

Bank Supervision and Regulation
Federal Reserve Bank of Richmond
P.O. Box 27622
Richmond, Virginia 23261
(804) 697-8000

11. San Francisco

Consumer Affairs Section
Federal Reserve Bank of San Francisco
101 Market Street
San Francisco, California 94105
(415) 974-2000

12. St. Louis:

Division of Supervision & Regulation
Federal Reserve Bank of St. Louis
P.O. Box 442
St. Louis, Missouri 63166
(314) 444-8444

FR G-1
 OMB No. 7100-0011
 Approval expires July 31, 1998

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Registration Statement For Persons Who Extend Credit Secured by
 Margin Stock (Other Than Banks, Brokers or Dealers)
 (Federal Reserve Form G-1)

This registration statement is required by law (15 U.S.C. 78g and 78w; 12 C.F.R. 207).

Public reporting burden for this collection of information is estimated to average 2.5 hours per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0011), Washington, D.C. 20503.

The Federal Reserve Board regards the information provided by each respondent as confidential. If it should be determined subsequently that any information collected on this form must be released, respondents will be notified.

Name of registrant: _____
 IRS Identification No.*

Name under which business is conducted, if different from above: _____

Address of principal place of business: _____
 (Do not use P.O. Box No.)
 Street County
 City State ZIP Code

Mailing address, if different from above: _____
 Street
 City State ZIP Code

GENERAL INSTRUCTIONS

Who must file: Section 207.3(a) of Federal Reserve Regulation G requires that FR Form G-1 be completed by every person (other than commercial banks, brokers or dealers) who during any calendar quarter extends a total of \$200,000 or more, or has outstanding a total of \$500,000 or more, in credit secured directly or indirectly, in whole or in part, by collateral that includes any margin stock.

When and where to file: The form should be filed *in duplicate* with the Federal Reserve Bank of the district in which the principal office of subject person is located within 30 days following the end of such quarter in which credit has been extended or is outstanding in accordance with Section 207.3(a). This registration statement will remain in effect until a FR Form G-2 (deregistration statement) is approved by the Board of Governors of the Federal Reserve System.

What to file: All persons subject to the registration requirements of Section 207.3(a) should (i) supply the background information specified below; (ii) complete Schedule A; and (iii) submit *two copies* of a balance sheet, certified by an independent public accountant, for the registrant's latest fiscal year. If the registrant is subject to supervision by a State or Federal regulatory authority, a copy of the latest balance sheet filed with such authority may be used. If neither is available, the registrant should complete Schedule B on page 4.

*A registrant who is an individual is not required to disclose his or her Social Security number.

Registration forms will be returned to registrants for corrections if all items have not been answered in the manner required or if the forms are otherwise unacceptable for filing.

DEFINITIONS

Terms used in this form are explained below. Precise definitions may be found in Section 207.2 of Regulation G.

Person: Any individual, corporation, partnership, association, joint stock company, business trust, or unincorporated organization.

Purpose credit: Credit extended for the purpose of purchasing or carrying margin stock, or to reduce or retire indebtedness previously incurred for that purpose.

In the ordinary course of business: Occuring or reasonably expected to occur from time to time in the course of any activity of a person for profit or the management and preservation of property or, in the case of a person other than an individual, carrying out or in furtherance of any business purpose.

Margin stock: Includes (1) stocks registered on a national securities exchange, stocks on the Federal Reserve Board's List of Marginable OTC Stocks, or any OTC security designated for trading in the National Market System, (2) debt securities that are convertible into, or carry a warrant or right to subscribe to or purchase margin stock, (3) any such warrant or right, and (4) shares of most mutual funds.

Indirectly secured: In general, credit is indirectly secured by margin stock if there is an understanding between the borrower and the lender (1) which is designated to make the margin stock more available to the lender in case of default than to the borrower's other creditors, or (2) which limits the borrower from exercising full dominion over the margin stock to sell, pledge, or donate them, or determining where they shall be placed physically.

Background Information

1. Principal lines of business:

2. Registrant is: (check one)

- | | |
|--|---|
| <input type="checkbox"/> Sole proprietorship | <input type="checkbox"/> Private investor |
| <input type="checkbox"/> Partnership | <input type="checkbox"/> Other (specify) |
| <input type="checkbox"/> Corporation | |

a. If registrant is a sole proprietor, private investor, or other, state full residence address:

b. If registrant is a corporation, state date and place of incorporation:

Date: _____ Place: _____

c. Person responsible for maintaining records in connection with Regulation G:

Name: _____ Title: _____

Telephone Number (include area code): _____

3. If any of the accounts or records of registrant are kept or maintained by anyone other than the person named in 2(c), furnish the name and address of the other individual, firm, or organization:

4. a. Does any person not named in items 2(c) or 3 above exercise or have power to exercise a controlling influence over the management or policies of registrant, directly or indirectly, through stock ownership, agreement, or otherwise?

- Yes No

b. If "yes", state the name of such person and describe the agreement, arrangement, or nature of the controlling influence:

5. a. Does the registrant extend credit in connection with an employee stock option or stock purchase plan pursuant to the special "plan-lender" provision set forth in Section 207.5(a) of Regulation G? If so, submit two copies of documents establishing the plan, a prospectus, and other information which supports adherence to plan-lender limitations.

- Yes No

5. b. Does the registrant extend credit to an employee stock ownership plan (ESOP) qualified under section 401 of the Internal Revenue Code (26 U.S.C. 401), as set forth in Section 207.5(c) of Regulation G? If so, submit two copies of documents establishing the plan and any other pertinent supporting information.

- Yes No

Schedule A — Securities Credit
As of _____, 19____

	I ¹ Total credit outstanding as of June 30, ____ (dollars)			II ² Credit extended during reporting period (dollars)		
	Mil	Thou	Dollars	Mil	Thou	Dollars
A. Credit to purchase or carry margin stock (Purpose Loans):						
1. Secured directly by margin stock:						
a. Listed stocks and OTC margin stocks						
b. Debt securities convertible into margin stock						
c. Mutual funds and other margin stock						
2. Secured indirectly by margin stock						
3. TOTAL (Purpose Credit)						
B. Other credit (Nonpurpose Loans)						
1. Secured directly by margin stock:						
a. Listed stocks and OTC margin stocks						
b. Debt securities convertible into margin stock						
c. Mutual funds and other margin stock						
2. Secured indirectly by margin stock						
3. TOTAL (Nonpurpose Credit)						

¹ "Credit outstanding: (Column I) includes credit extended by the registrant during the year covered by this report, and during previous years, that has not been extinguished before the end of the year covered by this report.

² "Credit extended" (Column II) is credit extended at any time during the year covered by this report. Column II includes all new credit extended during the year regardless of whether such credit was extinguished at the end of the year. An increase in an existing loan is new credit.

Schedule B—Balance Sheet

As of _____, 19____

This schedule is to be completed only by lenders not submitting corporate balance sheets certified by an independent public accountant or used to meet reporting requirements of a State or Federal regulatory authority.

(\$ Thousands)

ASSETS	LIABILITIES AND NET WORTH
Cash and bank deposits _____	Short-term bank borrowings _____
Trade accounts and notes receivable (net allowance for bad debts of _____) _____	Other notes and accounts payable _____
Other accounts and notes receivable (include credit to executives and employees) _____	Long-term debt _____
Marketable securities _____	All other liabilities _____
Inventories _____	TOTAL LIABILITIES _____
Investments in non-consolidated subsidiaries _____	Capital stock _____
Fixed assets (net of depreciation) _____	Additional paid-in capital _____
All other assets _____	Retained earnings/undivided profits _____
TOTAL ASSETS _____	Total Equity Capital ¹ _____
	TOTAL LIABILITIES AND EQUITY CAPITAL _____

1. Registrants not reporting capital stock, additional paid-in-capital or retained earnings/undivided profits must nevertheless indicate total equity capital.

Certification

The registrant filing this registration form and any attachments thereto and the person by whom it is executed represent hereby that all information contained therein is true and complete.

Date

Signature of sole proprietor, general partner, managing agent, or principal officer

Telephone number (including area code)

Print or type name

Title

This mandatory report is needed to elicit certain background and financial information about a Regulation G lender and the types and amount of credit activities engaged in that are secured by margin stock.

**Honest, accurate, and timely statements are required by law
(15 U.S.C. §78ff; 18 U.S.C. §1001)**

FR G-2
OMB No. 7100-0011
Approval expires July 31, 1998

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
Deregistration Statement For
Persons Registered Pursuant to Regulation G
(Federal Reserve Form G-2)
A. For use by Noncorporate Registrants

This deregistration statement is required by law (15 U.S.C. 78g and 78w: 12 C.F.R. 207).

Public reporting burden for this collection of information is estimated to average 15 minutes per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed,

and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0011), Washington, D.C. 20503.

Certificate

I (We), doing business under the name _____

_____ IRS Identification No.*

hereby certify that I (we) have not, during the preceding six calendar months, had a total of \$200,000 or more of credit outstanding secured directly or indirectly by margin stock.

I (We) understand that if I (we), in the future, extend a total of \$200,000 or more during any calendar quarter, or have

outstanding at any time during a calendar quarter a total of \$500,000 or more, in credit that is secured directly or indirectly by collateral that includes any margin stock, I (we) shall within 30 days following the end of such calendar quarter reregister and remain registered for at least six months with the Board of Governors of the Federal Reserve System by filing Federal Reserve Form G-1 with the Federal Reserve Bank of the district in which my (our) principal office is located.

This certification is given in connection with an application for termination of registration pursuant to Section 207.3(a) of Regulation G of the Board of Governors of the Federal Reserve System.

Signature(s)

Date

Print or type name(s) and title(s)

Name of firm

Telephone number (including area code)

*A registrant who is an individual is not required to disclose his or her Social Security number.

Honest, accurate, and timely statements are required by law
(15 U.S.C. §78ff; 18 U.S.C. §1001)

FR G-2
OMB No. 7100-0011
Approval expires July 31, 1998

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
Deregistration Statement For
Persons Registered Pursuant to Regulation G
(Federal Reserve Form G-2)
B. For use by Corporate Registrants

This deregistration statement is required by law (15 U.S.C. 78g and 78w; 12 C.F.R. 207).

Public reporting burden for this collection of information is estimated to average 15 minutes per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed,

and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0011), Washington, D.C. 20503.

Officer's Certificate

I hereby certify that _____
Name of corporation

IRS Identification No.

quarter, or has outstanding at any time during a calendar quarter a total of \$500,000 or more, in credit that is secured directly or indirectly by collateral that includes any margin stock, the Corporation shall within 30 days following the end of such calendar quarter reregister and remain registered for at least six months with the Board of Governors of the Federal Reserve System by filing Federal Reserve Form G-1 with the Federal Reserve Bank of the district in which the principal office of the corporation is located.

("Corporation") has not, during the preceding six calendar months, had a total of \$200,000 or more of credit outstanding secured directly or indirectly by margin stock.

This certification is given in connection with an application for termination of registration pursuant to Section 207.3(a) of Regulation G of the Board of Governors of the Federal Reserve System.

It is understood that if the Corporation shall, in the future, extend a total of \$200,000 or more during any calendar

Signature of duly authorized officer

Print or type name

Title

Telephone number (including area code)

Date

Honest, accurate, and timely statements are required by law
(15 U.S.C. §78ff; 18 U.S.C. §1001)

FR G-3
OMB No. 7100-0018
Approval expires July 31, 1998

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Statement of Purpose for an Extension of Credit Secured by Margin
Stock by a Person Subject to Registration Under Regulation G
(Federal Reserve Form G-3)

Name of Lender

This form is required by law (15 U.S.C. 78g and 78w; 12 C.F.R. 207).

Public reporting burden for this collection of information is estimated to average 10 minutes per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed,

and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0011), Washington, D.C. 20503.

Instructions

1. This form must be completed when a lender subject to registration under Regulation G extends credit secured directly or indirectly, in whole or in part, by any margin stock.
2. The term "margin stock" is defined in Regulation G (12 CFR 207) and includes, principally: (1) stocks that are registered on a national securities exchange, stocks that are on the Federal Reserve Board's List of Marginable OTC Stocks, or any OTC security designated for trading in the National Market System; (2) debt securities (bonds) that are convertible into margin stock; and (3) shares of most mutual funds.
3. Please print or type (if space is inadequate, attach separate sheet).

Part I To be completed by borrower(s)

1. What is the amount of the credit being extended? _____

2. Will any part of this credit be used to purchase or carry margin securities? Yes No

If the answer is "no," describe the specific purpose of the credit _____

I (We) have read this form and certify that to the best of my (our) knowledge and belief the information given is true, accurate, and complete.

Signed:

Signed:

Borrower's signature

Date

Borrower's signature

Date

Print or type name

Print or type name

This form should not be signed if blank.

A borrower who falsely certifies the purpose of a credit on this form or otherwise willfully or intentionally evades the provisions of Regulation G will also violate Federal Reserve Regulation X, "Borrowers of Securities Credit".

Part II To be completed by lender only if the purpose of the credit is to purchase or carry margin securities (Part I(2) answered "yes")

1. List the margin stock securing this credit; do not include debt securities convertible into margin stock. The maximum loan value of margin stock is 50 per cent of its current market value under the current Supplement to Regulation G.

No. of shares	Issue	Market price per share	Date and source of valuation (See note below)	Total market value per issue

2. List the debt securities convertible into margin stock securing this credit. The maximum loan value of such debt securities is 50 per cent of the current market value under the current Supplement to Regulation G.

Principal amount	Issue	Market price	Date and source of valuation (See note below)	Total market value per issue

3. List other collateral including non-margin securities securing this credit.

Describe briefly	Market price	Date and source of valuation (See note below)	Good faith loan value

Note: Lender need not complete "Date and source of valuation" if the market value was obtained from regularly published information in a journal of general circulation or automated quotation system.

Part III To be signed by an authorized representative of the lender in all instances

I am a duly authorized representative of the lender and understand that this credit secured by margin stock may be subject to the credit restrictions of Regulation G. I have read this form and any attachments, and I have accepted the customer's statement in Part I in good faith as required by Regulation G*; and I certify that to the best of my knowledge and belief, all the information given is true, accurate, and complete.

Signed:

* To accept the customer's statement in good faith, the authorized representative of the lender must be alert to the circumstances surrounding the credit and, if in possession of any information that would cause a prudent person not to accept the statement without inquiry, must have investigated and be satisfied that the statement is truthful. Among the facts which would require such investigation are receipt of the statement through the mail or from a third party.

This form must be retained by the lender for three years after the credit is extinguished.

FR G-4
 OMB No. 7100-0011
 Approval expires July 31, 1998

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Annual Report
 (Federal Reserve Form G-4)

For the year ended June 30, 19 _____

This report is required by law (15 U.S.C. 78g and 78w; 12 C.F.R. 207).

The Federal Reserve Board regards the information provided by each respondent as confidential. If it should be determined subsequently that any information collected on this form must be released, respondents will be notified.

Public reporting burden for this collection of information is estimated to average 2 hours per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0011), Washington, D.C. 20503.

Name of registrant: _____
 IRS Identification No.*

Address of principal office: _____
 Street

 City County

 State ZIP Code

GENERAL INSTRUCTIONS

Who must file: Section 207.3(o) of the Federal Reserve Regulation G requires a report on Form G-4 to be filed by every person subject to the registration requirement of Section 207.3(a) of the rule. Any person registered under the regulation may apply for termination of registration by filing FR Form G-2 [see Section 207.3(a)], if such person has not, during the preceding six calendar months, had a total of \$200,000 or more of credit outstanding secured directly or indirectly by margin stock.

When and where to file: Form G-4 shall be filed, *in duplicate*, with the Federal Reserve Bank of the district in which the registrant's principal place of business is located, within 30 days following June 30 of each calendar year.

What to file: The registrant is required to file with this report two copies of the registrant's balance sheet, certified by an independent public accountant, as of the end of its most recent fiscal year. If a certified balance sheet is not available, registrant should file with this report a balance sheet in the form prescribed by Schedule B on FR Form G-1, or if subject to supervision by a State or Federal regulatory agency, the latest balance sheet filed with such agency.

*A registrant who is an individual is not required to disclose his or her Social Security number.

DEFINITIONS

Terms used in this form are explained below. Precise definitions may be found in Section 207.2 of Regulation G.

Person: Any individual, corporation, partnership, association, joint stock company, business trust, or unincorporated organization.

Registrant: Any person who is subject to the registration requirement of Section 207.3(a).

Purpose credit: Credit extended for the purpose of purchasing or carrying margin stock, or to reduce or retire indebtedness previously incurred for that purpose.

Margin stock: Includes (1) stocks registered on a national securities exchange, stocks on the Federal Reserve Board's List of Marginable OTC Stocks, or any OTC security designated for trading in the National Market System, (2) debt securities that are convertible into, or carry a warrant or right to subscribe to or purchase margin stock, (3) any such warrant or right, and (4) shares of most mutual funds.

Indirectly secured: In general, credit is indirectly secured by margin stock if there is an understanding between the borrower and the lender (1) which is designated to make the margin stock more available to the lender in case of default than to the borrower's other creditors, or (2) which limits the borrower from exercising full dominion over the margin stock to sell, pledge, or donate them, or determining where they shall be placed physically.

Instructions for Completing Schedule of Securities Credit

- A. Report all Purpose Credit secured by margin stock extended during the reporting period, as well as all purpose credit secured by margin stock outstanding as of June 30, on Part A of the Schedule of Securities Credit.
- B. Registrants reporting Purpose Credit secured by margin stock in Part A must also complete Part B if any nonpurpose credit was extended during the reporting period or is outstanding as of June 30.
- C. Registrants *not* reporting Purpose Credit in Part A must complete Part B if any nonpurpose credit was extended during the reporting period or is outstanding as of June 30.
- D. Registrants who maintain records based upon fiscal quarters that do not coincide with calendar quarters have an option of reporting credit outstanding and extended in a slightly different manner. These registrants may report the annual data required by FR Form G-4 as of the year ended on either April 30 or May 31. A registrant reporting in this manner should change the date in Column I of the Schedule of Securities Credit to reflect the year end date used.

Employee Stock Option, Purchase, and Ownership Plan Credit

1. Is part or all of the credit extended pursuant to an employee stock option, purchase, or ownership plan?
 - Yes
 - No

2. A. If "yes," does the credit qualify under the special provisions set forth in Section 207.5 of Regulation G?
 - Yes
 - No
 - B. If credit reported in Column I of the Schedule of Securities Credit includes outstanding employee stock option, purchase, or ownership plan credit, please report the following:
 - i. Outstanding "Plan-Lender" credit pursuant to Section 207.5(a) \$ _____
 - ii. Outstanding credit to an ESOP pursuant to Section 207.5(c) \$ _____

3. Has any of the credit reported above been extended pursuant to a plan adopted since the submission of the last annual report?
 - Yes
 - No

If yes, please submit two copies of the plan and any supporting documents.

Schedule of Securities Credit

	I ¹ Total credit outstanding as of June 30, ____ (dollars)			II ² Credit extended during reporting period (dollars)		
	Mil	Thou	Dollars	Mil	Thou	Dollars
A. Credit to purchase or carry margin stock (Purpose Loans):						
1. Secured directly by margin stock:						
a. Listed stocks and OTC margin stocks						
b. Debt securities convertible into margin stock						
c. Mutual funds and other margin stock						
2. Secured indirectly by margin stock						
3. TOTAL (Purpose Credit)						
B. Other credit (Nonpurpose Loans)						
1. Secured directly by margin stock:						
a. Listed stocks and OTC margin stocks						
b. Debt securities convertible into margin stock						
c. Mutual funds and other margin stock						
2. Secured indirectly by margin stock						
3. TOTAL (Nonpurpose Credit)						

¹ "Credit outstanding: (Column I) includes credit extended by the registrant during the year covered by this report, and during previous years, that has not been extinguished before the end of the year covered by this report.

² "Credit extended" (Column II) is credit extended at any time during the year covered by this report. Column II includes all new credit extended during the year regardless of whether such credit was extinguished at the end of the year. An increase in an existing loan is new credit.

Changes in Background Information

For material included in background information, see the second page of FR Form G-1 Registration Statement

Have there been any changes in background information since the previous G-4 report (G-1 report for a registrant filing its first G-4 report)?

Yes

No

If yes, describe any such changes pertaining to name, address, IRS Identification No., organizational structure (e.g., a sole proprietorship becoming incorporated), name of person responsible for maintaining Regulation G records, control, or location of records.

Certification

The registrant filing this annual report and any attachment thereto and the person by whom it is executed represent hereby that all information contained therein is true and complete.

Telephone number (including area code)

Print or type name

Title

This mandatory report is needed to elicit certain background and financial information about a Regulation G lender and the types and amount of credit activities engaged in that are secured by margin stock.

**Honest, accurate, and timely statements are required by law
(15 U.S.C. §78ff; 18 U.S.C. §1001)**