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DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 96-36 (SUP.IB)
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TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Guidance on Evaluating Activities Under the Responsibility of U.S. Branches, Agencies and Nonbank Subsidiaries of Foreign Banking Organizations (FBOs)

Introduction and Background

This letter addresses the evaluation of activities of a U.S. branch, agency or nonbank subsidiary[See footnote 1] of a foreign banking organization that are functionally managed or operationally performed at the U.S. branch being examined but booked at another office of the FBO in the United States or offshore. U.S. branches usually have substantial interaction with other offices of the FBO, and it is not uncommon for a particular branch to generate or to be responsible for loans, trading assets, deposits, or other business that are ultimately booked at, sold, or otherwise transferred to related offices. Similarly, it is not uncommon for a U.S. branch to perform certain operations, such as electronic data processing, accounting, financial reporting, recordkeeping, credit administration, payments and collections, advisory services, treasury portfolio management, or other activities on behalf of another office of the FBO.

A U.S. branch may book business outside the United States in order to take advantage of pricing, funding, or other options not otherwise available at the U.S. branch. Such business commonly is booked at "shell" branches in offshore jurisdictions that may or may not be "managed or controlled"[See footnote 2] by the U.S. branch; however, business may also be booked at any other office of the FBO, including the head office.

Policies, Procedures, and Risk Management Processes

In reviewing the duties performed by a U.S. branch on behalf of another office of the FBO, examiners should evaluate policies, procedures and documentation provided by the U.S. branch to ensure their adequacy. These materials should clearly delineate the oversight, operational, and control responsibilities of the U.S. branch for inter-office transactions. The head office of the FBO should be aware of and in agreement with the delineation of responsibilities. This information should be maintained by the FBO in such a manner that it is accessible to the bank supervisory authorities in all three potentially affected jurisdictions -- the United States, the home country, and the host country of any non-U.S. foreign office.

The U.S. branch should have adequate risk management processes, operational controls, and compliance programs covering all activities booked at the U.S. office, as well as all activities for which it is effectively responsible, even if such assets are booked at another office of

the FBO. Even when a U.S. branch performs limited operational functions for a related office, examiners should assess whether the branch has sufficient records, reports, systems, and controls in place to execute the delegated responsibilities. In cases where insufficient documentation exists at the U.S. branch to discern adequately the nature and extent of the business relationship with another office of the FBO, as well as to assess the performance of the U.S. branch with respect to the relationship, examiners should cite this deficiency in the report of examination as a matter that requires immediate attention.

Supervisory Ratings

The examination treatment under the ROCA rating system for activities conducted by a U.S. branch on behalf of another office of the FBO should be the same as for activities conducted by the branch for its own book, except for the evaluation of asset quality as discussed below.

In evaluating risk management (the "R" component of the ROCA rating), the examiner should assess the ability of management at a U.S. branch to identify, measure, monitor, and control risk in the operations and activities under its responsibility. Special examination focus should be placed on the assessment of market, credit, and liquidity risk reporting to ensure that all relevant risk exposures are summarized clearly and reported to the appropriate level of local management and to the head office risk management function. In arriving at the risk management assessment, the examiner will need to review all elements of risk generated by *and* under the responsibility of branch management, regardless of where the financial transactions are ultimately booked.

In terms of the operational controls (the "O" component of the ROCA rating), the examiner should review the records, reports, systems, and controls that are in place at the U.S. branch to process, confirm, document, and account for transactions that are generated or executed by a U.S. branch, whether for the U.S. branch's own book or for the book of another office of the FBO. There should be robust financial and operational reporting to the head office of the FBO on activities performed by the U.S. branch on behalf of a related office.

A fully integrated risk-based audit process should be in evidence to test and confirm the range of transactions initiated by, recorded at, or otherwise managed by the U.S. branch, including transactions initiated by related offices. Audit programs should be updated regularly in line with industry best practices. Special attention should be directed to a determination of the adequacy of audit coverage over business activities that may transcend several jurisdictions. As part of the examination process, examiners should determine if audits are performed for the multi-jurisdictional businesses and should ensure, to the extent possible, that the audit programs are sufficiently rigorous to test adequately the full transaction process from initiation through closeout.

In evaluating compliance (the "C" component of the ROCA rating), all the activities conducted by the management of the U.S. branch should comply with U.S. laws and regulations, to the extent applicable, regardless of the booking location of the business. For example, if the U.S. branch accepts deposits on behalf of another office, branch management should ensure compliance with Bank Secrecy Act regulations and "know your customer" policies, even if the deposits are immediately transferred to a non-U.S. office of the FBO. Additionally, the U.S. branch should ensure compliance with the Regulation K requirement that a foreign bank not use its U.S. office to manage types of activities transacted through certain offshore offices that could not be managed by a U.S. bank at its foreign branches or subsidiaries. The review of regulatory

reporting should ensure that the records of the U.S. branch clearly differentiate between related and non-related party transactions and that the recordkeeping to support such reports is adequate.

In rating asset quality (the "A" component of the ROCA rating), the examiner only would evaluate assets that are on the books of the U.S. branch. Assets booked elsewhere should not be classified or listed as "special mention" or "other transfer risk problems" within the examination report. Further, examiners should not require any charge-off adjustments for loss assets not booked at the U.S. branch. However, examiners should be mindful of the general quality of assets being generated by the U.S. branch and booked elsewhere so as to be alert to any pattern of booking low quality assets outside the United States or any other situations that might indicate problems in risk management ("R") or operational controls ("O").

Summary

Examiners should evaluate all activities for which the U.S. branch has responsibility, regardless of where the business is booked. All responsibilities of U.S. branch management for FBO operations should be clearly documented in the policies and procedures of the U.S. branch. Such policies and procedures should document risk management methodologies, operational controls and compliance guidelines for all such activities. Examiners' assessments of these activities should be reflected in the risk management, operational controls, and compliance components of the U.S. branch's ROCA rating, and appropriately incorporated into its composite rating. The branch's asset quality component, however, should be based only on the quality of assets, including the credit risk element of off-balance sheet exposures, on the branch's books as of the examination date.

Please direct any comments or questions to Joel D. Shapiro, Manager - International Supervision Section (202/452-2056) or Betsy Cross, Manager - International Regulatory and Examination Policy Section (202/452-2574).

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Director

Cross Reference: SR 95-22 (SUP.IB) Attachment III

Footnote: 1 Referred to as a "U.S. branch" or collectively as "U.S. branches."

Footnote: 2 For purposes of the FFIEC 002s and Regulation K, a non-U.S. office is considered to be "managed or controlled" by a U.S. branch or agency of a foreign bank if a majority of the responsibility for business decisions, including but not limited to decisions with regard to lending or asset management or funding or liability management, or the responsibility for recordkeeping with respect to assets or liabilities of that non-U.S. office, resides at the U.S. branch or agency.