

# Trading and Capital-Markets Activities Manual

## Supplement 5—April 2001

---

### Nature of Changes

#### *Trading Activities*

Section 2120.1, "Accounting," has been revised to incorporate the following recent guidance from the Financial Accounting Standards Board: Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," and SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." (SFAS 140 supersedes SFAS 125, which had the same title). The accounting treatment for securitizations, repurchase agreements, derivative instruments, and foreign-currency instruments has been updated. The discussion on accounting for derivatives includes information on fair-value, cash-flow, and foreign-currency hedges. The examination objectives, examination procedures, internal control questionnaire, and appendix on financial statement disclosures, sections 2120.2, 2120.3, 2120.4, and 2120.5, respectively, have also been updated.

In section 2130.1, "Regulatory Reporting," references to the obsolete Monthly Consolidated Foreign Currency Report (FFIEC form 035) have been removed, and the guidance on institutions that are required to file the FR Y-20 report has been revised. The examination objectives, examination procedures, internal control questionnaire, and appendix on reports for trading instruments, sections 2130.2, 2130.3, 2130.4, and 2130.5, respectively, have also been updated.

The Gramm-Leach-Bliley Act (GLB Act), enacted in 1999, removed some restrictions that were formerly applicable to section 20 subsidiaries engaged in underwriting, dealing, and other related activities. Under the GLB Act, banking regulators are also required to rely to the greatest extent possible on the functional

regulator of securities firms. Section 2140.1, "Regulatory Compliance," has been revised to incorporate these provisions of the GLB Act.

#### *Capital-Markets Activities*

New information on the valuation of retained interests, including SR-99-37 and its related interagency guidance, has been added to section 3020.1, "Securitization and Secondary-Market Credit Activities." The subsection on internal controls has also been expanded to include the minimum requirements for management information systems reports on securitization activities.

A new section 3040.1, "Equity Investment and Merchant Banking Activities," has been added. The new section incorporates the supervisory letter on these activities (SR-00-9) that was formerly in section 4360.1. The section also provides new guidance on merchant banking activities of financial holding companies, including investment limitations, cross-marketing limitations, and special rules for private equity funds.

#### *Instrument Profiles*

The "Accounting Treatment" subsections in the instrument profiles have been revised to delete references to obsolete accounting standards and add references to SFAS 133 and SFAS 140. Section 4350.1, "Credit Derivatives," was further revised to expand the risk-based capital weighting guidance. In section 4353.1, "Collateralized Loan Obligations," more detailed information was provided on the risk-based capital weighting of three types of transactions for synthetic collateralized loan obligations.

### Filing Instructions

---

<i>Tab</i>	<i>Section</i>	<i>Title</i>	<i>Remove Pages</i>	<i>Insert Pages</i>
Contents		Table of Contents	1	1

<i>Tab</i>	<i>Section</i>	<i>Title</i>	<i>Remove Pages</i>	<i>Insert Pages</i>
2000				
	2120.1	Accounting	1–13	1–13
	2120.2	Accounting—Examination Objectives	1	1
	2120.3	Accounting—Examination Procedures	1	1
	2120.4	Accounting—Internal Control Questionnaire	1	1
	2120.5	Accounting—Related Financial Statement Disclosures	1–3	1–3
	2130.1	Regulatory Reporting	1	1
	2130.2	Regulatory Reporting—Examination Objectives	1	1
	2130.3	Regulatory Reporting—Examination Procedures	1	1
	2130.4	Regulatory Reporting—Internal Control Questionnaire	1	1
	2130.5	Regulatory Reporting—Reports for Trading Instruments	1–7	1–7
	2140.1	Regulatory Compliance	1–3	1–3
3000				
	3020.1	Securitization and Secondary-Market Credit Activities	3–4 7–10 53	3–4, 4.1 7–10 10.1–10.2 53–67
	3040.1	Equity Investment and Merchant Banking Activities		1–14
4000				
	4010.1	Commercial Paper	1–4	1–4
	4015.1	Repurchase Agreements	1–4	1–4
	4020.1	U.S. Treasury Bills, Notes, and Bonds	1–3	1–4
	4025.1	U.S. Treasury STRIPS	1–3	1–3

<i>Tab</i>	<i>Section</i>	<i>Title</i>	<i>Remove Pages</i>	<i>Insert Pages</i>
	4030.1	Treasury Inflation-Indexed Securities	1–3	1–3
	4035.1	U.S. Government Agency Securities	1–3	1–3
	4040.1	Structured Notes	9–10	9–10
	4045.1	Corporate Notes and Bonds	5–6	5–6
	4050.1	Municipal Securities	3–5	3–5
	4055.1	Eurodollar Certificates of Deposit	1–2	1–2
	4105.1	Asset-Baked Securities and Asset-Backed Commercial Paper	3–7	3–7
	4110.1	Residential Mortgage-Backed Securities	13–14	13–14
	4205.1	Australian Commonwealth Government Bonds	1–3	1–3
	4210.1	Canadian Government Bonds	3	3
	4215.1	French Government Bonds and Notes	3–4	3–4
	4220.1	German Government Bonds and Notes	3–4	3–4
	4225.1	Irish Government Bonds	1–3	1–3
	4230.1	Italian Government Bonds and Notes	3–4	3–4
	4235.1	Japanese Government Bonds and Notes	3–4	3–4
	4240.1	Spanish Government Bonds	3	3
	4245.1	Swiss Government Notes and Bonds	1–3	1–3
	4250.1	United Kingdom Government Bonds	3–4	3–4
	4255.1	Brady Bonds and Other Emerging-Markets Bonds	3–4	3–4
	4305.1	Foreign Exchange	7	7
	4310.1	Forwards	3–5	3–4
	4315.1	Forward Rate Agreements	3–4	3–4
	4320.1	Financial Futures	5–7	5–7

<i>Tab</i>	<i>Section</i>	<i>Title</i>	<i>Remove Pages</i>	<i>Insert Pages</i>
	4325.1	Interest-Rate Swaps	9–12	9–12
	4330.1	Options	7–9	7–9
	4335.1	Currency Swaps	5	5
	4340.1	Swaptions	3–4	3–4
	4345.1	Equity Derivatives	3–4	3–4
	4350.1	Credit Derivatives	9–10	9–10
	4353.1	Collateralized Loan Obligations	9–11	9–17
	4355.1	Commodity-Linked Transactions	5–6	5–6
	4360.1	Equity Investment and Merchant Banking Activities	1–11	
Index		Subject Index	1–6	1–7

# Trading and Capital-Markets Activities Manual

## Supplement 4—September 2000

### Equity Investments and Merchant Banking

The Federal Reserve’s supervisory letter SR-00-9, issued June 22, 2000, has been added as a new instrument profile, section 4360.1. The section provides guidance for managing the risks of equity investments and merchant banking activities, which have become important sources of earnings at some financial institutions. Furthermore, the recently enacted Gramm-Leach-Bliley Act provides additional

merchant banking authority to financial holding companies.

The new section outlines sound practices for equity investments and merchant banking, appropriate disclosure practices for institutions engaging in these activities, and additional risk-management issues for institutions engaging in transactions with portfolio companies. A final rule on the conduct of equity investment and merchant banking activities is forthcoming and will be included in a future update to this manual.

### Filing Instructions

<i>Tab</i>	<i>Section</i>	<i>Title</i>	<i>Remove Pages</i>	<i>Insert Pages</i>
Contents		Table of Contents	1	1
4000	4360.1	Equity Investment and Merchant Banking Activities		1–11
Index		Subject Index	1–7	1–6

# Trading and Capital-Markets Activities Manual

## Supplement 3—April 2000

---

### Capital Adequacy

A subsection on the capital treatment of synthetic collateralized loan obligations (CLOs) has been added to section 2110.1, “Capital Adequacy.” The use of credit derivatives to synthetically replicate CLOs has raised questions about how to calculate their leverage and risk-based capital ratios. The new material discusses supervisory and examination considerations for three types of synthetic CLO transactions in banking organizations: (1) the entire notional amount of the reference portfolio is hedged, (2) a high-quality senior risk position in the reference portfolio is retained, and (3) a first-loss position is retained.

### Accounting

“Accounting,” section 2120.1, was revised in the “Netting or Offsetting Assets and Liabilities” subsection to clarify the conditions necessary for a master netting arrangement to exist and to add information from the Financial Accounting Standards Board’s Interpretation 41. A new subsection also provides guidance on accounting for derivative instruments under FASB Statement of Financial Accounting Standard No. 133 (SFAS 133), which is effective for fiscal years beginning after June 15, 2000. SFAS 133 requires banking organizations to recognize all derivatives on their balance sheets as assets or liabilities, and to report them at their fair value.

---

### FILING INSTRUCTIONS

---

<i>Tab</i>	<i>Section</i>	<i>Title</i>	<i>Remove Pages</i>	<i>Insert Pages</i>
2000	2110.1	Capital Adequacy	1–24	1–29
	2120.1	Accounting	11–12	11–13
Index		Subject Index	1–7	1–7

# Trading and Capital-Markets Activities Manual

## Supplement 2—September 1999

---

### Nature of Changes

This supplement reflects new or revised statutory and regulatory provisions and new or revised supervisory instructions or guidance issued by the Division of Banking Supervision and Regulation since the publication of the March 1999 supplement.

#### *Counterparty Credit Risk*

Section 2020.1, “Counterparty Credit Risk and Presettlement Risk,” has been revised to add a list of conditions examiners should use when evaluating credit-risk management in banking institutions, as provided in SR-99-3 (February 1, 1999). The guidance on collateral arrangements has been expanded to incorporate recent recommendations from the central banks of the Group of Ten countries on over-the-counter derivatives settlement procedures, as well as market-practice recommendations from the 1999 collateral review by the International Swaps and Derivatives Association. The examination objectives, examination procedures, and internal control questionnaire (sections 2020.2, 2020.3, and 2020.4, respectively) have also been updated.

### *Capital Adequacy*

A new subsection on assessing capital adequacy at large, complex banking organizations has been added to section 2110.1, “Capital Adequacy.” The new guidance outlines the fundamental elements of a sound internal analysis of capital adequacy, describes the risks that should be addressed in this analysis, and discusses the examiner’s review of an institution’s capital adequacy analysis. Other revisions were made to expand the guidance on market-risk measure, including the use of internal models and qualitative and quantitative requirements for market-risk management.

### *Accounting*

In section 2120.1, “Accounting,” the description of the Statement of Financial Accounting Standard No. 133, “Accounting for Derivative Instruments and Hedging Activities,” has been updated. The Financial Accounting Standards Board has delayed the statement’s effective date to fiscal years beginning after June 15, 1999.

A reference to an outdated Federal Reserve policy statement on securities activities has been removed. The appendix on financial-statement disclosures, section 2120.5, has also been updated.

---

### Filing Instructions

---

<i>Tab</i>	<i>Section</i>	<i>Title</i>	<i>Remove Pages</i>	<i>Insert Pages</i>
2000	2020.1	Counterparty Credit Risk and Presettlement Risk	1–8	1–8 8.1–8.2
	2020.2	Counterparty Credit Risk and Presettlement Risk—Examination Objectives	1	1
	2020.3	Counterparty Credit Risk and Presettlement Risk—Examination Procedures	1–2	1–2
	2020.4	Counterparty Credit Risk and Presettlement Risk—Internal Control Questionnaire	1–2	1–2

<i>Tab</i>	<i>Section</i>	<i>Title</i>	<i>Remove Pages</i>	<i>Insert Pages</i>
	2110.1	Capital Adequacy	1–16	1–24
	2120.1	Accounting	1–6 9–12	1–6 9–12
	2120.5	Accounting—Appendix: Related Financial-Statement Disclosures	3	3
Index		Subject Index	1–7	1–7



# Trading and Capital-Markets Activities Manual

## Supplement 1—March 1999

---

This supplement reflects new or revised statutory and regulatory provisions and new or revised supervisory instructions or guidance issued by

the Division of Banking Supervision and Regulation since the publication of the manual in February 1998.

### LIST OF CHANGES

---

#### Counterparty Credit Risk

Section 2020.1, Counterparty Credit Risk and Presettlement Risk, has been revised to incorporate the supervisory guidance on counterparty credit risk management provided in SR-99-3 (February 1, 1999). Specific guidance on the calculation of potential future exposure, exposure-monitoring and limit systems, the importance of stress testing and scenario analysis, and the interrelationship between credit and market risk, is included. Additional guidance on credit enhancements, including collateral, close-out provisions, and margining requirements, is provided. The section discusses in detail the need for robust counterparty credit risk management policies and internal controls to ensure that existing practice conforms to stated policies. The unique risks posed by institutional investors and hedge funds are detailed in a separate subsection, which includes a discussion of the January 1999 report of the Basle Committee on Banking Supervision on the risks posed by hedge funds to creditors and the accompanying sound practices standards for interactions with hedge funds. The examination objectives, examination procedures, and internal control questionnaire (sections 2020.2, 2020.3, and 2020.4, respectively) have also been updated.

In section 2021.1, Counterparty Credit Risk and Settlement Risk, a discussion of the Board's June 1998 Policy Statement on Privately Operated Multilateral Settlement Systems provides guidance on the additional settlement risks posed by these systems.

#### Legal Risk

Section 2070.1, Legal Risk, has been updated to include a discussion on the importance of properly and accurately defining the trigger events that provide for payments between counterparties, in light of experiences during the market

disruptions of 1998. A subsection on nondeliverable forwards and the need for explicit documentation of these contracts is also added. The examination objectives and examination procedures (sections 2070.2 and 2070.3, respectively) have been updated.

#### Capital Adequacy

Section 2110.1, Capital Adequacy, has been updated to reflect regulatory changes to the definition of tier 1 and tier 2 capital and to include a revised discussion of the regulatory treatment of credit derivatives.

#### Accounting

In section 2120.1, Accounting, a brief description of the Statement of Financial Accounting Standards No. 133 (SFAS 133) for derivatives has been added. SFAS 133 is effective for fiscal years beginning after June 15, 1999, with an effective date of January 1, 2000, for most banks. The description of SFAS 133 will be expanded in subsequent revisions to the manual.

#### Securities

Section 3000.1, Investment Securities and End-User Activities, has been revised to reflect the Policy Statement on Investment Securities and End-User Derivatives Activities, published by the Federal Financial Institutions Examination Council, and the rescission of the high-risk test for mortgage-derivative products.

#### Interest-Rate Risk

In section 3010.1, Interest-Rate Risk Management, a discussion of an examination scope for noncomplex institutions has been revised to

delete specific criteria previously used to identify institutions in which only baseline examination procedures were necessary. The revised focus is on the overall risk profile of the individual institution in lieu of dependence on strict quantitative criteria.

obligations (CLOs) has been added as section 4353.1. CLOs are securitizations of portfolios of commercial and industrial loans through a bankruptcy-remote special-purpose vehicle that issues asset-backed securities in one or more classes (or tranches). Alternatively, CLOs may be synthetically created through the use of credit derivatives.

## Collateralized Loan Obligations

A new product profile on collateralized loan

## FILING INSTRUCTIONS

<i>Tab</i>	<i>Section</i>	<i>Title</i>	<i>Remove Pages</i>	<i>Insert Pages</i>
		Preface	1–2	1–2
Contents		Table of Contents	1	1
2000				
	2020.1	Counterparty Credit Risk and Presettlement Risk	1–9	1–13
	2020.2	Counterparty Credit Risk and Presettlement Risk—Examination Objectives	1	1
	2020.3	Counterpart Credit Risk and Presettlement Risk—Examination Procedures	1–2	1–2
	2020.4	Counterparty Credit Risk and Presettlement Risk—Internal Control Questionnaire	1–2	1–2
	2021.1	Counterparty Credit Risk and Settlement Risk	1–4	1–5
	2070.1	Legal Risk	1–2 5–6	1–2, 2.1 5–6
	2070.2	Legal Risk—Examination Objectives	1	1
	2070.3	Legal Risk—Examination Procedures	1–3	1–3
	2100.1	Financial Performance	7–8	7–8
	2110.1	Capital Adequacy	1–4 7–16	1–4 7–16
	2120.1	Accounting	11–12	11–12

<i>Tab</i>	<i>Section</i>	<i>Title</i>	<i>Remove Pages</i>	<i>Insert Pages</i>
3000				
	3000.1	Investment Securities and End-User Activities	5–6 17–19	5–6, 6.1 17–19
	3010.1	Interest-Rate Risk Management	17	17
	3020.1	Securitization and Secondary-Market Credit Activities	1–2	1–2
4000				
	4010.1	Commercial Paper	1–2	1–2
	4040.1	Structured Notes	1–2	1–2
	4353.1	Collateralized Loan Obligations		1–11
Index		Subject Index	1–5	1–7

## USING THIS MANUAL

This manual seeks to provide the examiner with guidance for reviewing capital-markets and trading activities at all types and sizes of financial institutions. The manual will be updated periodically as products and activities evolve.

The manual codifies current procedures used in the review of capital-markets and trading activities. It discusses the risks involved in various activities, risk-management and -measurement techniques, appropriate internal controls, and the examination process from the following perspectives:

- *Global applicability.* The manual is not directed at trading at any one type of institution (commercial bank, branch/agency, other) but is meant to apply to capital-markets and trading activities at all financial institutions to be examined.
- *Portfolio.* The manual attempts to broaden our review of trading operations from a product-by-product approach to a portfolio and functional-activity approach. This method better reflects the multiple uses of financial instruments by institutions, their relationship to other instruments and activities on or off the balance sheet, and attendant correlations.
- *Types of risk.* The manual identifies the range of risks—market, credit, liquidity, operational, legal, and other risks—relevant to the review of capital-markets and trading activities, and discusses their management on a functional and legal-entity basis.

The manual is divided into four basic sections. The first section consists of broad introductory remarks regarding the examination of most capital-markets and trading activities, including important considerations in preparing for the examination and review of capital-markets activities. It also discusses the importance of examiner review of the management organization of the activity to be examined.

The second section presents supervisory guidance regarding trading and dealer operations at banking organizations and specifically details certain aspects of the examination process for these operations. In general, the discussion of each topic has the following four subsections:

- discussion of the general topic

- examination objectives
- examination procedures
- internal control questionnaire

The focus of the examination objectives, examination procedures, and internal control questionnaires is to provide examiners with a practical guide to examining the core areas of any trading operation. Examination objectives describe the goals that should be of primary interest to the examiner and determine the scope of the examination for the specific area of interest. The examination procedures include procedures to be performed during a comprehensive examination. In some instances, not all the procedures may apply to all financial institutions. Thus, examiners have the flexibility, depending on the characteristics of the particular institution under examination, to determine the examination scope and procedures. The materiality and significance of a given area of operations are an examiner's primary considerations when deciding the scope of the examination and the procedures to be performed. Examiner flexibility results in examinations tailored to the operations of the banking institution. After determining the proper objectives and procedures, the examiner will have an organized approach to examining the institution's trading processes. Core topics include the following:

- market risk
- credit risk
- settlement risk
- liquidity risk
- operations and systems risk
- legal risk
- financial performance
- capital adequacy of trading activities
- accounting
- regulatory reporting
- regulatory compliance
- ethics

The third section of this manual offers supervisory guidance regarding various banking activities and functions that are not trading-related but are directly linked with capital-markets and Treasury operations. While targeted primarily at larger institutions, the general principles identified in this section are applicable to activities at institutions of all sizes. This section presents the latest Federal Reserve