FEDERAL RESERVE BANK OF NEW YORK

[Circular No. 8872
July 11, 1980]

ADOPTION OF RECOMMENDATIONS OF THE FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

—Standard Terminology for Competitive Factor Reports
—Uniform Guidelines for Internal Control of Commercial Banks' Foreign Exchange Activities

To All Member Banks, and Others Concerned, in the Second Federal Reserve District:

The Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation have announced the adoption of standard terminology for use in competitive factor reports prepared pursuant to the Bank Merger Act, and of uniform guidelines for internal control by commercial banks of their foreign exchange activities. The following is quoted from a joint statement issued by the three agencies in these matters:

The Federal bank supervisory agencies have adopted proposed recommendations made to them by the Federal Financial Institutions Examination Council regarding terms to be used in competitive factor reports and uniform guidelines for internal control of the foreign exchange activities of commercial banks.

The agencies adopted, as standard terminology to be used in their assessment of competitive factors in proposed bank mergers, the following terminology:

Monopoly (requiring disapproval).

Substantially Adverse (precludes approval unless anti-competitive effects of the proposed merger are outweighed by benefits to the public in meeting the convenience and needs of the community to be served).

Adverse (the proposed merger has anti-competitive effects material to the decision that would not preclude approval).

No Significant Effect (anti-competitive effects, if any, are not material to the decision).

The Agencies adopted recommended uniform guidelines for commercial banks on internal control of their foreign exchange operations covering policy documentation, internal accounting controls and audit documentation.

In a statement issued prior to adoption by the Federal bank supervisory agencies of the uniform guidelines for internal control of the foreign exchange activities of commercial banks, the Federal Financial Institutions Examination Council provided the following details regarding the guidelines:

The . . . Guideline is designed to help promote the safety and soundness of individual banks and of the nation's banking system as a whole.

In June 1979 the Council issued for comment a proposed Statement of Policy concerning minimum standards for documentation, accounting and auditing for foreign exchange operations. The principal changes made since that proposal are the change in characterization from policy statement to guideline, and deletion of proposed detailed provisions dealing with internal and external audit workpapers and reports.

In a Foreword to the Guideline, the Council said:

Most commercial banks already have adequate systems and procedures for monitoring and controlling their foreign exchange activities that meet or exceed these guidelines. In establishing systems, a bank considers the flexibility needed by traders to protect the bank, its size and organizational structure, the volume of activity and the costs associated with individual controls, as well as the differences in law and practice between trading markets. This guideline is a basis by which management, auditors, and supervisory authorities can evaluate a bank's internal control for foreign exchange activities. It should prove useful to bank management and supervisory authorities in promoting safety and soundness of individual banks and of the banking system as a whole.

The chief elements of the . . . Guideline are:

1. A statement that each bank engaged in foreign exchange trading should have written memoranda setting forth the goals and policies related to that activity adopted by senior management, a list of the internal guidelines and related guidance on documentation of foreign exchange operations, as well as a code of conduct for affected employees.

2. A statement setting forth standards for internal accounting controls with respect to foreign exchange operations.

3. A statement setting forth the need for documentation of internal and external audits in order that bank examiners can both judge the degree to which they can rely on internal controls and audits, and perform reviews of the banks' foreign exchange activities.

The texts of the joint notices issued by the Board, the Comptroller, and the FDIC regarding the standard terminology for competitive factor reports and the uniform guidelines on internal control of commercial banks' foreign exchange activities have been reprinted from the *Federal*

Register of June 24, 1980 on the following pages. Also, the text of a revised interpretation of the Board's Regulation Y, "Bank Holding Companies and Change in Bank Control," regarding the standard terminology for competitive factor reports has been reprinted from the *Federal Register* of July 3, 1980.

Questions regarding the standard terminology may be directed to our Banking Studies Department (Tel. No. 212-791-5797); questions regarding the uniform guidelines on internal control of commercial banks' foreign exchange activities may be directed to our Bank Examinations Department (Tel. No. 212-791-7934).

ANTHONY M. SOLOMON,
President.

FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

Joint Notice of Adoption of Standard Descriptive Terms To Be Used in Competitive Factor Reports Prepared Pursuant to the Bank Merger Act (12 U.S.C. 1828(c))

AGENCIES: Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency.

ACTION: Adoption by the three federal bank regulatory agencies represented on the Federal Financial Institutions Examination Council of Standard Descriptive Terms to be used in Competitive Factor Reports prepared in Response to Interagency Requests Made Under the Bank Merger Act (12 U.S.C. 1828(c)).

EFFECTIVE DATE: June 11, 1980.

SUMMARY: The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency have adopted standard terms to describe the competitive effects of mergers in competitive factor reports prepared in response to interagency requests made under the Bank Merger Act (12 U.S.C. 1828(c)).

Prior to this action the three agencies used somewhat different terminology. The adoption of standard terms should facilitate analysis of merger applications by the agencies. Under the Bank Merger Act, the Federal bank regulator deciding the application must obtain reports on the competitive factors involved in the merger from the other two federal banking agencies and the Attorney General's Office.

The standard terms adopted by the three agencies to describe competitive effects are:

• *Monopoly.*—Means the proposed transaction must be disapproved in accordance with 12 U.S.C. 1828(c)(5)(A);

• *Substantially Adverse.*—Means that the proposed transaction would have anticompetitive effects which preclude approval unless the anticompetitive effects are clearly outweighed in the public interest by the probable benefit of the transaction in meeting the convenience and needs of the community to be served;

• *Adverse.*—Means that proposed transactions would have anticompetitive effects which would be material to the decision, but which would not preclude approval; and

• *No Significant Effect.*—Means that the anticompetitive effects of the proposed transaction, if any, would not be material to the decision.

Dated: June 13, 1980.

Griffith L. Garwood,
Deputy Secretary, Board of Governors of the Federal Reserve System.

Dated: June 13, 1980.

Hoyle L. Robinson,
Executive Secretary, Federal Deposit Insurance Corporation.

Dated: June 13, 1980.

John G. Heimann,
Comptroller of the Currency, Office of the Comptroller of the Currency.

[FR Doc. 80-18976 Filed 6-23-80; 8:45 am]

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Joint Notice of Uniform Guideline on Internal Control for Foreign Exchange Activities in Commercial Banks

AGENCIES: Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

ACTION: Adoption of uniform guideline on internal control for foreign exchange activities in commercial banks by the three Federal bank regulatory agencies represented on the Federal Financial Institutions Examination Council.

SUMMARY: This guideline sets forth minimum standards concerning internal control for foreign exchange activities in commercial banks. An internal control system is composed of administrative and accounting controls concerned with authorization and accounting for transactions and safeguarding of assets. This guidelines covers (a) policy documentation, (b) internal accounting controls, and (c) audit documentation.

EFFECTIVE DATE: June 11, 1980.

FOR FURTHER INFORMATION CONTACT: Mr. Hugh W. Conway, Review Examiner, Federal Deposit Insurance Corporation, 550 17th Street, NW., Room 668N, Washington, D.C. 20429, (202) 389-4431.

SUPPLEMENTARY INFORMATION: The Council published a proposed foreign exchange policy statement for comment in the **Federal Register** July 27, 1979 (44 FR 44267–44269). Since then the Council's Task Force on Supervision has analyzed the forty comments received and has made appropriate revisions. The final guideline endorsed by the Examination Council and adopted by the three federal banking agencies reflects two major revisions. First, the statement is now characterized as a guideline on minimum standards which allows flexibility to depart from such standards in certain circumstances. Second, most of the detailed provisions dealing with internal and external audit workpapers and reports have been deleted.

The Federal Financial Institutions Examination Council hereby announces adoption of the following uniform guideline by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency:

Uniform Guideline on Internal Control for Foreign Exchange Activities in Commercial Banks

Foreword

This guidelines represents the current judgment of the three federal bank regulatory agencies on minimum internal control for foreign exchange activities in commercial banks. An internal control system is composed of administrative and accounting controls concerned with authorization and accounting for transactions and safeguarding of assets. This guideline focuses on (a) the estalbishment and documentation of policy; (b) internal accounting controls; and (c) audit documentation. It reinforces existing procedures and practices widely utilized by commercial banks in monitoring and controlling their foreign exchange activities and in providing timely and accurate reports to bank boards of directors, senior management, supervisory authorities, and other interested parties. It also applies to those foreign exchange activities undertaken to fund loans or other extensions of credit through the money markets.

Most commercial banks already have adequate systems and procedures for monitoring and controlling their foreign exchange activities that meet or exceed these guidelines. In establishing systems, a bank considers the flexibility needed by traders to protect the bank, its size and organizational structure, the volume of activity and the costs associated with individual controls, as well as the differences in law and practice between trading markets. This guideline is a basis by which management, auditors, and supervisory authorities can evaluate a bank's internal control for foreign exchange activities. It should prove useful to bank management and supervisory authorities in promoting safety and soundness of individual banks and of the banking system as a whole.

Bank management is responsible for establishing an adequate audit function. The section on audit documentation below does not describe how audits should be conducted. Rather, that section is intended to facilitate identification and appraisal of the extent of internal and external audit work being performed.

This document is not intended to be all encompassing as to policies and procedures expected to be found in the most active market participants. It is essential that each bank's system of control be commensurate with the risks to which it is exposed. In certain situations, these minimum guidelines may specify greater internal control than is appropriate to a specific bank's activity. In such case, if the bank does not meet these minimum guidelines, the bank should stand ready to demonstrate that risks attendant to its activities are adequately controlled. Such a bank should discuss its situation with its federal supervisory authority.

Documentation of Policy

Each bank engaged in foreign exchange trading should have written memoranda setting forth the goals and policies established for that activity by senior management. The memoranda should describe the scope of trading activity authorized, the lines and delegation of authority and responsibility, the types of services offered, trading limits, reporting requirements, internal accounting controls, and other instructions to trading personnel at each office of the bank.

The bank's trading policy should include guidelines or required reports with respect to the following:

(1) Net overnight positions by currency, including US dollars;

(2) Maturity distribution by currency of foreign currency assets, liabilities, and foreign exchange contracts;

(3) Outstanding contracts with individual customers and banks;

(4) Credit approval procedures for delivery or settlement risk either in the form of settlement limits or through other specified management controls; and

(5) Total value of outstanding contracts, spot and forward, to allow for review of the bank's general involvement in exchange markets or changes in trading patterns.

The policy should provide for reporting procedures adequate to properly inform management of trading activities and to facilitate detection of lack of compliance with policy directives. Each bank's head office should maintain current and complete records of exceptions to directives, policies, or controls pertaining to individual trading offices. Some very large banks have delegated substantial senior management review responsibility to major regional offices. Head office records referred to in this paragraph may be maintained at major regional offices where such records are accessible to examination personnel.

There should be periodic review and approval of established policies and controls. Consideration should be given to actual and projected trading, particularly of those offices where activity is not consistent with existing guidelines or limits.

Whether a bank sets customer delivery limits or weighs delivery risk in determining individual customer limits for outstanding contracts, the bank should have documentary evidence that a customer's delivery exposure is being reviewed by responsible account and trading officials. Every bank should have the capability to readily report delivery exposure with customers and banks.

The bank should, either in its overall code of conduct for employees or in its foreign exchange policy, set written standards covering:

(1) Trading with entities affiliated with the bank or with members of the board of directors;

(2) Foreign exchange and deposit transactions with other employees;

(3) Personal business activities of the bank's dealers involving foreign exchange; and

(4) Personal business relationships with foreign exchange and money brokers with whom the bank deals.

Management should ensure that these written policies are periodically reviewed with all dealers. The terms and conditions of any such transactions should not vary materially from similar transactions with nonrelated parties. The policy should cover any arrangements whereby a bank trading office holds positions or executes contracts either for the account of other offices of the bank or for the account of outside parties.

Internal Accounting Controls

Each trading office should have available a written description of the organization and procedures used to account for and control both foreign exchange and those transactions involving foreign exchange to fund loans or other extensions of credit through the money markets. The organization and procedures should be adequate to give reasonable assurance that (a) reports on trading and funding activities are current and complete and (b) the possibility of misappropriation of funds or concealment of unauthorized transactions is minimized.

The following is a list of eleven internal controls that should be considered minimum for most systems. It is possible that a bank may address a risk area in a manner which is adequate although different from that listed below. In such case, the bank should stand ready to justify the omission.

(1) A chart of accounts and descriptions of the use of the accounts and the operation of the books of account.

(2) Segregation of duties between trading personnel and those performing trade-related accounting or disbursement functions.

(3) A procedure to allow reconstruction of the date and the approximate order or time trading personnel entered into individual contracts. Contract forms shoud be controlled and should bear a preparation date, if different from transaction date.

(4) Clear descriptions of the types of interest arbitrage transactions (financial swaps/treasury swaps/internal contracts) in a bank's foreign exchange accounting system together with descriptions of the accounting entries and bookkeeping methods for each type of interest arbitrage transaction.

(5) A procedure under which contract confirmations are sent and received by staff independent of the trading operation. Outgoing confirmations should include the following:

(a) Date of transaction, date of preparation if different from transaction date, and date of value or maturity date;

(b) Amounts of the currencies traded, accepted, or placed, and the applicable rate;

(c) Name of counterparty; and

(d) Liquidation instruction, if known, and reference number.

Incoming confirmations should be verified by comparison with contracts. The bank should maintain a confirmation exception log or other record of every exception between an incoming confirmation and the bank's own records regardless of disposition. This exception record should be reviewed by a supervisor or official independent of the trading function. Some banks do not confirm spot contracts on the theory that the need for comfirmation is quickly obviated by the settlement of such contracts. Any bank which omits such confirmation should be satisfied that alternate internal controls are sufficient.

(6) A holdover register to record trades made but not posted to the bank's ledgers at the end of the day, the identification of such contracts as "holdover" items, and their inclusion in the trader or trading office day-end position reports to management.

(7) A daily reconciliation of the dealers' position sheets with the bank trading positions as recorded in books and records of the bank.

(8) Information on all overdraft charges and brokerage bills and on authorizations for such payments within the last 12 months; and retention of all foreign exchange telex tapes or copies for at least 90 days.

(9) Procedures for revaluing positions

including independent verification of rates.

(10) Documentation of review and approval of limits and sublimits should evidence that consideration is given to actual and projected trading—particularly of offices where existing limits have consistently exceeded actual activity.

(11) Procedures to insure prompt identification and reporting of exceptions to limits and non-delivery upon settlement date.

Audit Documentation

Federal bank examiners in reviewing foreign exchange activities increasingly rely on the work done by bank internal and external auditors. Adequate documentation of internal audit work and ready access to external auditors' reports will facilitate the judgment by bank examiners of the degree to which they may rely on internal controls and internal audits.

Significant exceptions disclosed in internal audits of foreign exchange activities should be reported in writing to the board of directors or a committee thereof. Such exceptions would include any significant uncorrected weakness in the system of internal accounting control; any significant unsatisfactory level of compliance with the existing internal control system; or any significant inadequacy in information supplied management regarding activity and positions.

Internal audit reports, workpapers and files should be readily available for review by examination personnel at the bank's head office or elsewhere but need not be present at the site of every facility examined.

The internal auditor's files should contain evidence that the following steps have been taken.

(1) The auditor has determined that the accounting system in use is adequately documented and that it conforms to bank policy.

(2) The auditor has identified the internal controls incorporated in the accounting system and has determined whether they are sufficient to control risks related to the activity. The basis for decisions that it is not feasible or cost-effective to control certain risks should be assessed by the auditor. Findings of insufficient controls should be set out in audit files. Files should indicate the specific controls, if any, recommended by regulatory guidelines but omitted from the system, and should discuss the reasons for such omission.

(3) The auditor has tested the internal controls to ascertain that they are, in fact, operative. Tests should include (a) tests of the accuracy of financial statements, reports to management and reports to regulatory agencies and (b) tests of trading personnel compliance with bank policies and directives applying to foreign exchange.

It is essential that the internal auditor be alert to detect changed conditions which would affect the auditor's earlier determinations relating to the adequacy and effective operation of controls. Therefore, audit files should evidence the steps taken by the auditor to identify changed conditions. However, a comprehensive detailed evaluation of internal control is not necessary at every audit of foreign exchange activity.

Any external audit reports, management letters, engagement letters, and other descriptions of audit scope, procedures, or findings provided to a bank by its external auditor should be readily available to examiners.

Dated: June 13, 1980.

Griffith L. Garwood,

Deputy Secretary, Board of Governors of the Federal Reserve System.

Dated: June 13, 1980.

Hoyle L. Robinson

Executive Secretary, Federal Deposit Insurance Corporation.

Dated: June 13, 1980.

John G. Heimann,

Office of the Comptroller of the Currency.

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FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Reg.Y, Docket No. R-0312]

Terms Defining Competitive Effects of Proposed Mergers; Revised Interpretation

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Revision of interpretation.

SUMMARY: The Bank Merger Act (12 U.S.C. 1828(c)) requires the Federal banking agency responsible for deciding a merger application to request reports on competitive factors from the Department of Justice and from the other two banking agencies. The Board is revising an interpretation that defined terms used to describe the competitive effects of proposed mergers. The revision standardizes descriptive terms used by the Board in competitive factor reports with those used by the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.

EFFECTIVE DATE: June 11, 1980.

FOR FURTHER INFORMATION CONTACT: Jack M. Egertson, Assistant Director, Division of Banking Supervision and Regulation (202-452-3408), Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

The Board is revising § 250.182 to read as follows:

§ 250.182 Terms defining competitive effects of proposed mergers.

Under the Bank Merger Act (12 U.S.C. 1828(c)), a Federal Banking agency receiving a merger application must request the views of the other two banking agencies and the Department of Justice on the competitive factors involved. Standard descriptive terms are used by the Board, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency. The terms and their definitions are as follows:

(a) The term "*monopoly*" means that the proposed transaction must be disapproved in accordance with 12 U.S.C. 1828(c)(5)(A).

(b) The term *"substantially adverse"* means that the proposed transaction would have anticompetitive effects which preclude approval unless the anticompetitive effects are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served as specified in 12 U.S.C. 1828(c)(5)(B).

(c) The term "*adverse*" means that proposed transaction would have anticompetitive effects which would be material to the decision but which would not preclude approval.

(d) The term *"no significant effect"* means that the anticompetitive effects of the proposed transaction, if any, would not be material to the decision.

Board of Governors of the Federal Reserve System, June 27, 1980.

Griffith L. Garwood,

Deputy Secretary of the Board.

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