

FEDERAL RESERVE BANK OF NEW YORK

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CHRISTINE M. CUMMING  
SENIOR VICE PRESIDENT

AT-10898(a)  
November 20, 1996

To the Chief Executive Officers of all State-Chartered Branches and Agencies of Foreign Banks  
in the Second Federal Reserve District:

As you are aware, the Federal Reserve system has undertaken several recent initiatives to enhance the supervision of the operations of U.S. branches and agencies of foreign banking organizations. We believe that these initiatives have provided more effective oversight of these offices.

In the ongoing review of the supervision program, the Federal Reserve has determined that the use of internal or external audits to address certain significant supervisory concerns would enhance the supervisory process. The attached guidelines have been developed to assist in determining when special audit procedures should be implemented. The guidelines are intended to reduce the risk of losses due to misconduct or fraud and to promote prompt correction of situations that can cause an unsafe or unsound banking environment. The guidelines are consistent with supervisory policies applicable to all institutions supervised by the Federal Reserve.

Attached for your information is a copy of the guidelines. If you have questions about these guidelines, please call any member of your relationship management team in the Bank Supervision Group or Roseanne Farley, Supervising Examiner, Advisory and Technical Services Function, at (212) 720-2325.

Very truly yours,

*Christine M. Cumming*

Attachment



**BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM**

WASHINGTON, D. C. 20551

DIVISION OF BANKING  
SUPERVISION AND REGULATION

**SR 96-27 (SUP)**

**November 12, 1996**

**TO THE OFFICER IN CHARGE OF SUPERVISION  
AT EACH FEDERAL RESERVE BANK**

**SUBJECT:** Guidance on addressing internal control weaknesses in U.S. branches and agencies of foreign banking organizations through special audit procedures

### **INTRODUCTION**

This letter sets forth policy guidelines for special audit procedures that are to be implemented in situations where significant internal control weaknesses are detected in U.S. branches or agencies of foreign banking organizations (FBOs). The guidelines are intended to reduce the risk of losses due to misconduct or fraud in the U.S. operations of FBOs and to promote prompt correction of situations that can cause an unsafe and unsound banking environment. This guidance furthers overall supervisory goals and is consistent with supervisory policies applicable to all institutions supervised by the Federal Reserve System. However, the guidelines set forth below are designed specifically to deal with special considerations in supervising the U.S. operations of FBOs, which arise due to the fact that U.S. supervisors generally have authority for only a portion of an FBO--i.e., the offices located in the United States.

### **WHEN TO REQUIRE SPECIAL AUDIT PROCEDURES**

The supervisory evaluation of the adequacy of internal controls and operations of a branch or agency is reflected in the operational controls (i.e., "O") component of the ROCA rating system. The extent to which internal control problems alone or in conjunction with problems in other areas may adversely affect the overall condition of a branch or agency also is reflected in the composite rating. Therefore, both the "O" component and the composite rating should be used as guidelines in determining whether special audit procedures are required to be implemented in a branch or agency. The procedures outlined below should be required when both the "O" rating and the composite rating are "3" or worse, because such ratings indicate that the overall condition of the branch or agency is less than satisfactory, and that, at least in part, the problems are due to internal control weaknesses. The required procedures should be coordinated with Board staff. Any departures from the guidelines must be documented by the Reserve Bank responsible for coordinating the

supervision of the combined U.S. operations of the FBO (the "coordinating Reserve Bank") and discussed with Board staff.

In addition, significant internal control weaknesses in the operations of an FBO at one office may be an indication that similar weaknesses exist at other U.S. operations of the FBO, especially if other U.S. components of the foreign bank are conducting business of the type in which weaknesses were noted at a particular branch or agency. Therefore, the coordinating Reserve Bank, in consultation with other federal and state regulatory authorities, should determine whether the special audit procedures should be applied to the other U.S. operations of the FBO.<sup>1</sup> This decision must be documented and discussed with Board staff.

### **USE OF INTERNAL AUDITORS**

In some cases, it may be acceptable to have the special audit procedures performed by the internal audit staff of the branch or agency. However, if the adequacy of the internal audit function at a particular branch or agency is among the reasons why internal controls are considered to be less than satisfactory, the procedures must be conducted by regional or head office internal audit staff or by external auditors. In the situations cited below, the branch or agency will be required to engage external auditors to perform the procedures.

### **USE OF EXTERNAL AUDITORS**

External auditors are required to be used:

(a) when there are extremely serious deficiencies in internal controls, as reflected in an "O" rating of "4" or worse, and the composite rating is also "4" or worse;

(b) in cases where internal auditors had performed the special audit procedures following the previous examination, and the current examination still demonstrates that the branch or agency is in less than satisfactory condition (i.e., rated composite "3" or worse) and internal controls are again rated "3" or worse; or

(c) in other situations, if the coordinating Reserve Bank, after consultation with Board staff, other federal and state regulatory authorities, and the home country supervisor, is of the opinion that the use of an external auditor is necessary. This would usually occur when there are significant concerns about the competence or independence of head office internal audit staff.

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<sup>1</sup> This would include coordination with the OCC and FDIC if the foreign banking organization also has a national or state non-member bank subsidiary.

In instances where it is determined that the use of an external auditor is needed, it is the responsibility of the FBO to engage a qualified independent public accountant and enter into a contract to perform the necessary work. The scope of the audit should be agreed upon between the FBO and the Federal Reserve. In this connection, in its engagement letter with the FBO, the accountant would be expected to acknowledge that all substantive information, including work papers, programs and procedures related to the audit would be provided to the Federal Reserve upon request. Prior to the commencement of the engagement, the coordinating Reserve Bank should receive a copy of the engagement letter indicating its terms.

### **SCOPE OF SPECIAL AUDIT PROCEDURES**

A fundamental purpose of a special audit is to determine whether the internal control weaknesses have already led to unreported losses and the extent of any such losses. The other principal objective is to identify the degree of internal control deficiencies and the risks posed to the branch or agency so that management can implement appropriate corrective action on both an interim and longer-term basis.

In order to determine if unreported losses have occurred, it is expected that in all cases auditors will perform direct verification, usually on an appropriate sample basis. These procedures may include direct observations, interviews, confirmations with third parties, or other forms of direct verification. While direct verification efforts should be focused principally on those areas identified by the examiner as having significant internal control weaknesses, there also should be some verification of key accounts in other areas of the branch or agency that may have been affected by these weaknesses.

The auditors also must determine the accuracy of reports filed by the branch or agency with U.S. bank regulatory authorities. In all cases, the auditors would perform sufficient tests to verify the items from the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002) designated in the engagement letter, to related schedules or source documents. These would include items related to the areas where significant deficiencies in internal controls existed. For example, if weaknesses were noted in internal controls in the letter of credit department, the auditors would verify the relevant line items in Schedule L of the FFIEC 002 report to source documents.

The auditors also will be expected to report on the type, nature and extent of any significant internal control weaknesses found during the audit. This should include a discussion of the interim steps management has taken to minimize the risks to the branch or agency until comprehensive improvements in the internal control environment can be implemented. The review would be concentrated within the areas specifically criticized by examiners; however, there should also be some review of internal controls in other significant branch or agency operations.

The engagement letter for the audit should contain target dates for interim and final reports. The coordinating Reserve Bank should monitor the general progress of the audit and obtain a copy of the final report upon its completion. The coordinating Reserve Bank should review the report and discuss with the Board staff any additional steps that should be taken. In addition, the coordinating Reserve Bank should prepare a brief report of actions taken.

## RELATED MATTERS

The guidelines outlined in this letter, when relevant, should be implemented as part of a supervisory action undertaken with an FBO. This guidance is effective immediately and should be applied to all branches and agencies currently under examination and in cases in which the Reserve Bank is in the process of formulating a supervisory action resulting from a recently completed examination. In addition, while this letter discusses the guidelines in terms of branches and agencies of foreign banks, the procedures outlined in this letter are applicable to all U.S. financial operations of FBOs. The Federal Reserve is developing further guidance as to the appropriate use of internal and external auditors in conducting reviews of U.S. banking organizations when similar situations arise.

A copy of this SR letter should be provided to the senior management of each U.S. branch and agency of a foreign banking organization. Attached is a draft transmittal letter that may be used for that purpose.

If you have any questions, please contact Joel Shapiro, Manager, International Supervision Section at 202-452-2056 or Betsy Cross, Manager, International Regulatory and Examination Policy Section at 202-452-2574.



Richard Spillenkothen  
Director

### Cross Reference:

SR 96-3 (SUP.IB) (March 29, 1996)  
SR 95-22 (SUP.IB)(March 31, 1995)