

**1 Supporting Statement for the  
Recordkeeping Requirements Associated with the  
Interagency Statement on Complex Structured Finance Activities  
(FR 4022; OMB No. 7100-0311)**

**Summary**

The Board of Governors of the Federal Reserve System, under delegated authority from the Office of Management and Budget (OMB), propose to extend for three years, without revision, the Recordkeeping Requirements Associated with the Interagency Statement on Complex Structured Finance Activities (FR 4022; OMB No. 7100-0311).<sup>1</sup>

The guidance provides that state member banks, bank holding companies, and U.S. branches and agencies of foreign banks supervised by the Federal Reserve should establish and maintain policies and procedures for identifying, evaluating, assessing, documenting, and controlling risks associated with certain complex structured finance transactions (CSFTs). The Federal Reserve's total annual burden is estimated to be 230 hours for the 20 financial institutions that are likely to be subject to the guidance. There are no required reporting forms associated with the guidance.

**Background and Justification**

Financial markets have grown rapidly over recent decades and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers, and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, specialized financial conduits that manage pools of assets, and other types of structured finance transactions serve important purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. As a result, structured finance transactions, including the more complex variations of these transactions, now are an essential part of U.S. and international capital markets.

When a financial institution participates in a CSFT, it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, a financial institution involved in a CSFT may face heightened risk if the customer's regulatory, tax or accounting treatment for the CSFT, or disclosures concerning the CSFT in its public filings or financial statements, do not comply with applicable laws, regulations or accounting principles.

In some cases, certain CSFTs appear to have been used in illegal schemes that misrepresented the financial condition of public companies to investors and regulatory authorities. Those cases highlight the substantial legal and reputational risks that financial institutions may face when they participate in a CSFT that is used by the institution's customer to circumvent regulatory or financial reporting requirements or

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<sup>1</sup> Refer to SR letter 07-5 for the interagency statement.

further other illegal behavior. After conducting investigations, the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the Securities and Exchange Commission (SEC) took strong and coordinated civil and administrative enforcement actions in July 2003 against certain financial institutions that engaged in CSFTs that appeared to have been designed or used to shield their customers' true financial health from the public. These actions involved significant financial penalties on the institutions and required the institutions to take several measures to strengthen their risk management procedures for CSFTs. The complex structured finance relationships involving these financial institutions also sparked an investigation by the Permanent Subcommittee on Governmental Affairs of the United States Senate, as well as numerous lawsuits by private litigants.

Following these investigations from 2003 to 2004, the OCC, Federal Reserve, and SEC conducted special reviews of several large banking and securities firms that are significant participants in the market for CSFTs. These reviews were designed to evaluate the new product approval, transaction approval, and other internal controls and processes used by these institutions to identify and manage the legal, reputational and other risks associated with CSFTs. These assessments indicated that many of the large financial institutions engaged in CSFTs already had taken meaningful steps to improve their control infrastructure relating to CSFTs. Further, the agencies' supervisory staff monitor the complex structured finance activities of financial institutions during the normal course of the supervisory process.

To further assist financial institutions in identifying, managing, and addressing the risks that may be associated with CSFTs, the agencies developed the interagency guidance titled, "Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities" (the "Statement").

### **Description of Information Collection**

The Statement provides the following:

A financial institution engaged in CSFTs should maintain a set of formal, firm-wide policies and procedures that are designed to allow the institution to identify, evaluate, assess, document, and control the full range of credit, market, operational, legal, and reputational risks associated with these transactions. These policies may be developed specifically for CSFTs, or included in the set of broader policies governing the institution generally. A financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate to account for, and comply with, the applicable laws, regulations and standards of those jurisdictions.

A financial institution's policies and procedures should establish a clear framework for the review and approval of individual CSFTs. These policies and procedures should set forth the responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of CSFTs. A financial institution should define what constitutes a new

complex structured finance product and establish a control process for the approval of such new products. An institution's policies also should provide for new complex structured finance products to receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

### *Identifying Elevated Risk CSFTs*

As part of its transaction and new product approval controls, a financial institution should establish and maintain policies, procedures, and systems to identify elevated risk CSFTs. Because of the potential risks they present to the institution, transactions or new products identified as elevated risk CSFTs should be subject to heightened reviews during the institution's transaction or new product approval processes. The goal of each institution's policies and procedures should be to identify those CSFTs that warrant additional scrutiny in the transaction or new product approval process due to concerns regarding legal or reputational risks.

### *Due Diligence, Approval, and Documentation Process for Elevated Risk CSFTs*

Having developed a process to identify elevated risk CSFTs, a financial institution should implement policies and procedures to conduct a heightened level of due diligence for these transactions. The financial institution should design these policies and procedures to allow personnel at an appropriate level to understand and evaluate the potential legal or reputational risks presented by the transaction to the institution and to manage and address any heightened legal or reputational risks ultimately found to exist with the transaction.

If a CSFT is identified as an elevated risk CSFT, the institution should carefully evaluate and take appropriate steps to address the risks presented by the transaction with a particular focus on those issues identified as potentially creating heightened levels of legal or reputational risk for the institution. In general, a financial institution should conduct the level and amount of due diligence for an elevated risk CSFT that is commensurate with the level of risks identified.

To appropriately understand and evaluate the potential legal and reputational risks associated with an elevated risk CSFT that a financial institution has identified, the institution may find it useful or necessary to obtain additional information from the customer or to obtain specialized advice from qualified in-house or outside accounting, tax, legal, or other professionals. As with any transaction, an institution should obtain satisfactory responses to its material questions and concerns prior to consummation of a transaction.

In conducting its due diligence for an elevated risk CSFT, a financial institution should independently analyze the potential risks to the institution from both the transaction and the institution's overall relationship with the customer. Moreover, a financial institution should carefully consider whether it would be appropriate to rely on

opinions or analyses prepared by or for the customer concerning any significant accounting, tax or legal issues associated with an elevated risk CSFT.

A financial institution's policies and procedures must provide that CSFTs identified as having elevated legal or reputational risk are reviewed and approved by appropriate levels of control and management personnel. The institution's control framework should have procedures to deliver the necessary or appropriate information to the personnel responsible for reviewing or approving an elevated risk CSFT to allow them to properly perform their duties. Such information may include, for example, the material terms of the transaction, a summary of the institution's relationship with the customer, and a discussion of the significant legal, reputational, credit, market and operational risks presented by the transaction.

The documentation that financial institutions use to support CSFTs is often highly customized for individual transactions and negotiated with the customer. A financial institution should create and collect sufficient documentation to allow the institution to:

- Document the material terms of the transaction,
- Enforce the material obligations of the counterparties,
- Confirm that customers have received any required disclosures concerning the transaction, and
- Verify that the institution's policies and procedures are being followed and allow the internal audit function to monitor compliance with those policies and procedures.

When an institution's policies and procedures require an elevated risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation that reflect management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the reasons for such action. The institution should retain documents created for elevated risk CSFTs in accordance with its record retention policies and procedures as well as applicable statutes and regulations.

#### *Other Risk Management Principles for Elevated Risk CSFTs*

The board and senior management of a financial institution also should, through both actions and formalized policies, send a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. In appropriate circumstances, financial institutions may also wish to consider implementing mechanisms allowing personnel to confidentially submit concerns about the institution's CSFT activities to senior management. As in other areas of financial institution management, compensation and incentive plans should be structured, in the context of elevated risk CSFTs, so that they provide personnel with appropriate incentives to have due regard for the legal, ethical, and reputational risk interests of the institution.

Financial institutions should conduct periodic independent reviews of their CSFT activities to verify that their policies and controls relating to elevated risk CSFTs are being implemented effectively and that elevated risk CSFTs are accurately identified and receive proper approvals. Such monitoring may include more frequent assessments of the risk arising from elevated risk CSFTs, both individually and within the context of the overall customer relationship, and the results of this monitoring should be provided to an appropriate level of management in the financial institution.

An institution should identify relevant personnel who may need specialized training regarding CSFTs to be able to effectively perform their oversight and review responsibilities. Appropriate training on the financial institution's policies and procedures for handling elevated risk CSFTs is critical. Financial institution personnel involved in CSFTs should be familiar with the institution's policies and procedures concerning elevated risk CSFTs, including the processes established by the institution for identification and approval of elevated risk CSFTs and new complex structured finance products and for the elevation of concerns regarding transactions or products to appropriate levels of management. Financial institution personnel should be trained to identify and properly handle elevated risk CSFTs that may result in a violation of law.

The internal audit department of a financial institution should regularly audit the financial institution's adherence to its own control procedures relating to elevated risk CSFTs, and further assess the adequacy of its policies and procedures related to elevated risk CSFTs. The internal audit should periodically validate that business lines and individual employees are complying with the financial institution's standards for elevated risk CSFTs and appropriately identifying any exceptions. This validation should include transaction testing for elevated risk CSFTs.

A financial institution's policies and procedures should provide for the appropriate levels of management and the board of directors to receive sufficient information and reports concerning the institution's elevated risk CSFTs to perform their oversight functions.

### **Time Schedule for Information Collection**

The Statement includes the provisions discussed above, which may require some financial institutions to implement, adopt or revisit CSFT policies and procedures on a one-time basis. Subsequent changes to the policies and procedures would be on-occasion.

### **Consultation Outside the Agency and Discussion of Public Comments**

On April 2, 2009, the Federal Reserve published a notice in the *Federal Register* (74 FR 14988) requesting public comment for 60 days on the extension, without revision, of the Recordkeeping Requirements Associated with the Interagency Statement on Complex Structured Finance Activities. The comment period for this notice expired on

June 1, 2009. The Federal Reserve did not receive any comments. On June 9, 2009, the Federal Reserve published a final notice in the *Federal Register* (74 FR 27319).

### **Sensitive Questions**

This collection of information contains no questions of a sensitive nature, as defined by OMB guidelines.

### **Legal Status**

The Board's Legal Division has determined that the FR 4022 is authorized by sections 11(a), 11(i), 21, and 25 of the Federal Reserve Act (12 U.S.C. 248(a), 248(i), 483, and 602), section 5 of the Bank Holding Company Act (12 U.S.C. 1844), and section 13(a) of the International Banking Act (12 U.S.C. 3108(a)) and is voluntary guidance for supervised institutions. However, the Federal Reserve expects to use the Statement in reviewing the internal controls and risk management systems of those financial institutions engaged in CSFTs as part of the Federal Reserve's supervisory process. Since the Federal Reserve does not collect any information, no issue of confidentiality normally arises. However, in the event records generated under the guidance are obtained by the Federal Reserve during an examination of a state member bank or U.S. branch or agency of a foreign bank, or during an inspection of a bank holding company, confidential treatment may be afforded to the records under exemption 8 of the Freedom of Information Act (FOIA), 5 U.S.C. 552(b)(8). FOIA exemption 8 exempts from disclosure matters that are contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.

### **Estimate of Respondent Burden**

The total annual burden for the guidance is 230 hours, as shown in the table below. Since CSFTs are typically conducted by a limited number of large financial institutions, the Federal Reserve estimates that only 20 of the institutions it supervises will be affected by the guidance. The Federal Reserve estimates that it will take two new respondents 25 hours each year to create and maintain their CSFT policies and procedures. Also, the Federal Reserve estimates that it will take the 18 existing respondents 10 hours each year to maintain their CSFT policies and procedures. Based on the Federal Reserve's experience in supervising the CSFT activities of financial institutions, the Federal Reserve believes that the information collections included in the Statement are generally consistent with the types of policies and procedures that large financial institutions actively involved in CSFTs already have developed and implemented and are consistent with usual and customary business practices. The total annual burden represents less than 1 percent of the total Federal Reserve System paperwork burden.

	<i>Number of respondents</i>	<i>Estimated annual frequency</i>	<i>Estimated response time</i>	<i>Estimated annual burden hours</i>
New respondents (Establish compliance program)	2	1	25 hours	50
Existing respondents (Maintain compliance program)	<u>18</u>	1	10 hours	<u>180</u>
<i>Total</i>	20			230

The total cost to the public for this information collection is estimated to be \$19,159.<sup>2</sup>

### **Estimate of Cost to the Federal Reserve System**

Since the Federal Reserve does not collect any information, the cost to the Federal Reserve System is negligible.

<sup>2</sup> Total cost to the public was estimated using the following formula. Percent of staff time, multiplied by annual burden hours, multiplied by hourly rate: (1) 10% - Administrative and Junior Analyst @ \$25, (2) 40% - Managerial and Technical @ \$55, (3) 30% - Senior Management @ \$100, and (4) 20% Legal Counsel @\$144. Hourly rate estimates for each occupational group are averages using data from the Bureau of Labor and Statistics (BLS), Occupational Employment and Wages 2007, <http://www.bls.gov/news.release/ocwage.nr0.htm>. Occupations are defined using the BLS Occupational Classification System. <http://www.bls.gov/soc/>.