
Letters of Credit Program

Examination Objectives

To determine if the policies, procedures, and controls regarding letters of credit adequately ensure safety and soundness, profitability, and compliance with laws and regulations.

To determine if officers and employees are knowledgeable and qualified to perform their duties and responsibilities associated with letters of credit in a manner that ensures safety and soundness, profitability, and compliance with policies and procedures.

To determine if financial records and management reports provide accurate and necessary information to management and directors.

To determine the adequacy of the audit and internal loan review function(s) over letters of credit.

To evaluate the credit risk associated with the issuance of letters of credit and whether management is aware of those risks.

To evaluate the institution's documentation and underwriting of letters of credit, which should evidence the financial stability and credit quality of the borrower, collateral sufficiency, and collectibility.

To determine compliance with laws and regulations.

To initiate corrective action when deficiencies exist that could affect safety and soundness, or when violations of laws or regulations have been noted.

Examination Procedures

Level I

Wkp. Ref.

1. Review the institution's current policy on letters of credit. Verify that the board of directors has adopted the policy and that the guidelines adequately address safety and soundness (including internal controls), desirable and undesirable issuances, limits of authority, profitability, and compliance with laws and regulations.

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2. Obtain pertinent financial records (including the trial balance) and management reports that the institution has for this area. From these reports prepare a work paper on the following:

- a. List the dollar amount of the institution's total outstanding letters of credit (separately for both standby and commercial letters of credit).
- b. Compute the ratios of outstanding letters of credit issued to total loans, total assets, and regulatory capital. Contrast and note trends from the previous examination.
- c. Assess liquidity risk from LOCs and SBLOCs.

3. Scan the management reports for areas of concern and comment on these concerns in the work papers. Areas to consider are:

- a. Letters of credit issued for officers, directors, and their interests;
- b. Letters of credit issued for officers and directors of other financial institutions;
- c. Letters of credit criticized during the previous examination;
- d. Letters of credit that are in excess of percentage of asset limitations; and
- e. Payments made on standby letters of credit within the past year; status of the resultant loans.

4. Determine through discussions and other appropriate verification methods, if management has taken corrective action relative to:

- a. Prior examination report comments and prior examination exceptions;
 - b. External and internal audit and internal loan review exceptions; and
 - c. Any enforcement/supervisory actions and directives.
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5. Coordinate contingent liability and other information with examiners assigned to other loan areas. Add standby letters of credit to the borrowers' aggregate loans and determine if credits are in compliance with the loans to one borrower limits, §563.93 of the regulations.

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6. Complete the General Questionnaire.

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7. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.
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Level II

8. Review the trial balance that lists each outstanding letter of credit and review the institution's reconciliation of the account to the general ledger. Determine the reasonableness of reconciling items.

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9. Select and review a sample of the outstanding letters of credit, including import LOCs. Coordinate with the examiner assigned to lending risk assessment. (For details on sampling, refer to Section 209 of the Thrift Activities Regulatory Handbook.)
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10. Read and determine that each of the letters of credit selected for review complies with the requirements of § 545.48 of the regulations (if applicable) and constitutes a letter of credit rather than a guarantee.

- a. Each letter of credit should conspicuously state that it is a letter of credit.
- b. The issuer's undertaking must contain a specified expiration date or be for a definite term and must be limited in amount.

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- c. The issuer's obligation to pay must be solely dependent upon the presentation of conforming documents as specified in the letter of credit and not upon the factual performance or nonperformance by the parties to the underlying transaction.
- d. The account party must have an unqualified obligation to reimburse the issuer for payments made under the letter of credit.
- e. Check to see how verification for authenticity is performed prior to approving the release of funds.

11. Prepare regulator review sheets (215A.1) or line sheets for each selected sample and include the customer's aggregate letter of credit liability. The following detail should be noted on the review sheet of each outstanding letter of credit:

- Serial number
- Undrawn amount
- Date of issuance
- Expiration date of the credit
- Name of the beneficiary
- The manner in which the draft is to be drawn
- Purpose of the letter of credit

Note whether it is:

- Commercial or standby
- Issued or confirmed
- Revocable or irrevocable
- Negotiable or nonnegotiable

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- Revolving
- Transferable
- Assignable

Note whether the approval application is on file and whether the terms of the letter of credit are in agreement with it.

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12. Obtain loan files for all borrowers for whom review sheets were prepared. Complete the sheets from the information obtained from the file. Analyze the underwriting and quality of the letter of credit the same as for asset classification, and:
- a. Review compliance with provisions of letter of credit agreements.
 - b. Compare the amount of letters of credit outstanding with the lending officer's authority.
 - c. Ascertain compliance with the institution's established commercial loan policy.

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13. Ensure that the Objectives of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Level III

14. Compare fees charged with the fee schedule(s) and determine that terms are within established guidelines.

Examiner's Summary, Recommendations, and Comments

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