
Introduction

Securities safekeeping operations include clearing securities trade settlements and operating as a trustee and custodian for securities pledged as collateral for either advances or derivative transactions. This module has applicability principally in the examinations of the Federal Home Loan Banks (FHLBanks) and, as noted below, may serve as a resource for the more limited securities safekeeping operations required by related Enterprise activities.

Securities Markets

The major securities markets in the United States include the government securities market, the corporate equities and bond market, the market for money market instruments, and the municipal bond market. The instruments in these markets are generally traded through organized exchanges or through the over-the-counter dealer markets. Major categories of financial instruments commonly traded include U.S. Treasury securities, government agency securities, securities issued by federal government-sponsored enterprises (GSEs), corporate equities and bonds, money market instruments such as commercial paper, and municipal (state and local) government securities. Participants in these markets include securities issuers, investment companies, non-financial corporations, and individuals.

The mechanisms for clearing and settling securities transactions vary by market and type of instrument, and generally involve two types of specialized financial intermediaries: clearing corporations and securities depositories. Clearing corporations provide trade confirmation and comparison services (where trade details are compared and matched as trades are submitted) and multilateral netting of trade obligations. Securities depositories transfer securities ownership on a gross or net basis against payment via book entry transfers.

Depository institutions play important roles in securities clearing and settlement. Not only do depository institutions participate in clearing and settlement arrangements for themselves, they also act as custodians, issuing and paying agents, and settling banks for their customers. In addition, depository institutions provide credit to clearing corporations, securities depositories, and clearing participants for routine and contingency purposes.

The primary participants in the securities settlement systems are:

1) U.S. Government Securities Market

The U.S. government securities market encompasses all primary and secondary market transactions in securities issued by the U.S. Treasury, certain federal government agencies, and federal GSEs. Trading in government securities is conducted over the counter between brokers, dealers, and investors. In over-the-counter trading, participants

trade with one another on a bilateral basis rather than on an organized exchange. Nearly all U.S. government securities are issued and transferred through a book-entry system operated by the Federal Reserve Banks.

In the primary market, Treasury securities are issued through regularly-scheduled auctions. The Federal Reserve Banks serve as conduits for the auctions, with the Federal Reserve Bank of New York coordinating much of the auction activity. Individuals, corporations, and financial institutions may participate in the auctions. Participation in Treasury auctions is typically concentrated among a small number of dealer firms known as primary dealers.

In the secondary market for government securities, trading activity takes place between primary dealers and non-primary dealers. Customers of these dealers are financial institutions, non-financial institutions, and individuals. The majority of transactions between primary dealers and other large market participants are conducted through inter-dealer brokers that provide price information to market participants. Approximately 2,000 securities brokers and dealers are registered in the U.S. government securities market.

2) Fixed Income Clearing Corporation (FICC)

The FICC started operations at the beginning of 2003 and was created when the Government Securities Clearing Corporation and the Mortgage-Backed Security Clearing Corporation merged. The FICC is divided into two sections, the government securities division (GSD) and the mortgage-backed securities division (MBSD). GSD clears and nets U.S. government securities and agency debt securities. Securities eligible for MBSD clearing are mortgage-backed securities issued by Ginnie Mae, Fannie Mae, and Freddie Mac.

FICC uses real-time trade matching: trade details are compared and matched upon submission of trade information. Successfully compared trades result in binding and enforceable obligations for settlement. Unmatched trades may be revised to achieve a trade match.

Successfully matched trades of eligible securities, for FICC netting service participants, are netted against offsetting net-receive or net-deliver obligations of the same security. Once the government securities net positions are determined, GSD interposes itself between the original trading parties and becomes the legal counter-party to FICC members for settlement purposes. Therefore, GSD members' net settlement obligations are delivered to or received from GSD. MBSD engages in multilateral position netting and does not stand in the middle of transactions. Final net settlement obligations of GSD and MBSD participants are settled through the Fedwire Securities Service via participants' settlement bank.

3) Fedwire Securities Service

As fiscal agents of the United States, the Federal Reserve Banks act as the securities depository for all marketable Treasury securities, many federal agency securities, and certain mortgage-backed securities issued by GSEs. U.S. government securities are issued in book-entry form through the Federal Reserve Bank's Fedwire[®] Securities Service (Fedwire Securities Service) using either an auction process or dealer syndicate mechanism. The Fedwire Securities Service provides for the safekeeping and transfer of these securities. The safekeeping function involves the records of securities balances, and the transfer and settlement function involves the transfer of securities between parties.

When book-entry securities transfers are processed using the Fedwire Securities Service, the institution sending the transfer receives immediate credit in its Federal Reserve Bank funds account for the payment associated with the transfer, and a corresponding "debit" is made to its securities account. The Federal Reserve Bank funds the account of the institution receiving a book-entry securities transfer which is debited for the payment amount, and its securities account is credited. There are more than 9,000 participants in the system and they are largely depository institutions.

The Fedwire Securities Service is supported by a real-time, delivery-versus-payment gross settlement system that provides for the immediate, final, and simultaneous transfer of securities against the settlement of funds. This system, known as the National Book-Entry System, provides for the safekeeping and transfer of Treasury, government agency, and GSE securities. The safekeeping function involves the electronic storage of securities records in custody accounts, and the transfer and settlement function involves the transfer of securities between parties.

Financial institutions may access the Fedwire Securities Service via high-speed direct computer interface FedLine or with off-line telephone connectivity with a Federal Reserve Bank. The Federal Reserve Banks have replaced DOS-based FedLine terminals with its internet product, FedLine Advantage[®] (FedLine Advantage). This provides access to the Federal Reserve Banks' payment services in an on-line environment.

On-line participants using either a FedLine PC or internet connection to the Fedwire Securities Service require no manual processing by the Federal Reserve Banks. Off-line participants provide funds transfer instructions to their Federal Reserve Bank by telephone, and once authenticated, the Federal Reserve Bank enters the transfer instruction into the Fedwire Securities Service system for execution. The manual processing required for off-line requests makes them more costly and suitable only for institutions processing a small number of funds transfer payment orders.

4) Corporate and Municipal Securities

Corporate equities and bonds, commercial paper, and municipal bonds are traded on

various established exchanges and on over-the-counter markets. The primary securities exchanges in the United States are the New York Stock Exchange and the American Stock Exchange, and the primary over-the-counter dealer market is the National Association of Securities Dealers Automated Quotations.

The commercial paper market warrants special mention as it is an important source of short-term funding for financial corporations and municipal governments. Commercial paper is a money market instrument issued by prime-rated non-financial and financial companies with maturities ranging from one to 270 days. Commercial paper is issued through dealer placements or direct placements with investors. Although commercial paper is a negotiable instrument, secondary market trading is limited. Disruption in the issuance of commercial paper can cause significant liquidity and credit concerns for issuers, many of whom are depository institutions and other financial companies, and depository institutions that provide issuing and paying agent services to issuers.

5) National Securities Clearing Corporation (NSCC)

NSCC, established in 1976, provides clearing and settlement services for corporate equities, corporate debt, municipal securities, mutual funds, annuities, and unit investment trusts. NSCC is a registered clearing corporation regulated by the Securities and Exchange Commission (SEC). With roughly 250 full-service participants, NSCC handles all aspects of the clearing and settlement of trades between brokers and dealers in securities traded on the over-the-counter markets, the New York Stock Exchange, the American Stock Exchange, and other regional exchanges.

Executed trades are typically reported to NSCC on the trade date. Trades are either reported to NSCC by an established exchange as matched (irrevocable) trades or by brokers and dealers as unmatched trades. Trades submitted by brokers and dealers are compared and matched within NSCC's Continuous Net Settlement (CNS) system. Following the comparison process, NSCC becomes the legal central counterparty and guarantees completion of all securities trades following through CNS. CNS functions as an automated book-entry accounting system that centralizes the settlement of compared security transactions and maintains an orderly flow of securities and money balances.

Similar to the FICC netting process, successfully matched trades of eligible securities are netted against offsetting net-receive or net-deliver obligation of the same security. Settlement of securities takes place at the Depository Trust Company (DTC) and funds settlements occur over the Fedwire Funds Service through settlement banks.

6) Depository Trust Company (DTC)

DTC is a New York limited purpose trust company, a member of the Federal Reserve System, and a clearing agency registered with the SEC. DTC, the central securities depository for corporate equity securities and bonds, municipal government securities, and money market instruments, provides safekeeping and transfer of these securities.

DTC participants include securities brokers, dealers, institutional investors, and depository institutions acting on their own behalf as well as functioning as custodians, issuing and paying agents, and settling banks for their customers. Like the Fedwire Securities Service, the safekeeping function involves the electronic recordkeeping of securities balances for participants, and the transfer function involves the transfer of securities between parties. DTC transfers securities on a gross basis throughout the day, while settling funds obligations on a net basis at the end of the day.

During the transfer process, DTC will limit its credit exposure to participants. Debit positions incurred by the participants will require collateralization. End-of-day funds settlements occur over the Fedwire Funds Service through participants' settlement banks.

Financial institutions rely on internal funds transfer systems and networks to send payment instructions to their correspondents for the transfer of correspondent balances or to initiate Fedwire Funds Service or CHIPS (the Clearing House Inter-Bank Payment System) payments. Large financial institutions have either developed their own funds transfer systems or rely on off-the-shelf funds transfer systems. In either case, the internal financial institution funds transfer systems interface with Fedwire Funds Service and CHIPS, supporting the interface and transaction format specifications for the transmission of payment orders. Off-the-shelf funds transfer systems typically support a variety of treasury, cash management, and straight-through-processing modules, which automate payment order processing.

The Federal Reserve Banks provide the Computer Interface Protocol Specifications (CIPS) that funds transfer and book-entry securities systems need to adopt in order to implement a computer interface (CI) connection successfully. The Federal Reserve Banks provides a website with a list of vendors who have completed their protocol certification process. The Federal Reserve Banks do not endorse any specific software vendor or product. Nor do the Federal Reserve Banks make any warranties or representations with respect to any of the products offered by these vendors, except that communications-level software correctly executes systems network architecture commands as specified in the CIPS.

Regulatory Environment

The primary authorities governing, or relevant to, securities safekeeping activities of the FHLBanks are set forth below. The examiner should ensure that the application of such authorities to an FHLBank has been considered by the FHLBank and its legal counsel.

1) Rules and Regulations of the former Federal Housing Finance Board (Finance Board), which include the following parts and sections relevant to securities safekeeping activities:

12 CFR part 917 addresses powers and responsibilities of FHLBank boards of directors and senior management. In particular, 12 CFR 917.3, Risk Management, 12

CFR 917.4, Bank Member Products Policy, and 12 CFR 917.6, Internal Control System, are pertinent.

2) *Advisory Bulletins of the former Federal Housing Finance Board that provide supervisory guidance relating to the topic of securities safekeeping activities are:*

Advisory Bulletin 03-2, dated February 10, 2003 and Advisory Bulletin 02-3, dated February 13, 2002, offer guidance on specific attributes to be considered by FHLBanks in the formulation of their business continuity plans, and the establishment of bilateral agreements with other FHLBanks.

Advisory Bulletin 04-01, dated March 10, 2004, offers guidance on the evaluation of a service organization providing services to an FHLBank whose activities could affect the FHLBank's financial condition. This includes the performance of an assessment of the service organization's internal controls, such as the procurement of a service auditor's report in accordance with SAS 70 (which subsequently was effectively replaced by SSAE 16) or the performance of alternative methods necessary to gain confidence on the service organization's internal controls.

Advisory Bulletin 05-05, dated May 18, 2005, provides guidance on the risk management responsibilities of the board, senior management and risk management function.

3) *Regulation J of the Board of Governors (Board of Governors) of the Federal Reserve System (Regulation J), Collection of Checks and Other Items by Federal Reserve Banks (Subpart A) and Funds Transfer through Fedwire, incorporating Article 4A (Funds Transfers) of the Uniform Commercial Code (UCC) (Subpart B).*

Regulation J promotes efficient payment systems by establishing the respective responsibilities of sending and receiving banks and establishes incentives to ensure appropriate controls against unauthorized transactions. In the process, it allocates liability for failure of transaction participants to comply with their assigned responsibilities.

Regulation J allows the FHLBanks to offer their customers a "commercially reasonable security procedure" for wire transfer security which, if followed, will avoid legal liability for any wire transfer not authorized by the customer. A security procedure covered by Subpart B is one that:

- a) Verifies that a payment order or communication amending or canceling a payment order is that of the customer; or
- b) Detects errors in the transmission or the content of the payment order or communication.

The FHLBanks employ various security procedures to ensure the customer authorized the transaction. These include the issuance of personal identification numbers, testcodes, tokens, and the performance of callbacks.

Article 9 of the Uniform Commercial Code (UCC) applies to any transaction which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts, the sale of any accounts or chattel paper, and security interests created by contract including pledge, assignment, chattel mortgage, chattel trust, trust deed, factor's lien, equipment trust, conditional sale, trust receipt, other lien or title contract and lease or consignment intended as security.

Specific requirements that pertain to attachment and perfection of security interests, including the method of perfecting a security interest in specific types of collateral, the contents and filing of financing statements, changes in name and identity of debtors, rights and duties in connection with default, and enforcement, must be complied with in order to create and maintain a priority security interest in the collateral.

The UCC is a uniform nonbinding code which, to be effective in any domestic jurisdiction (i.e., a state), must be adopted into law by that jurisdiction. As a result, there are sometimes variations in the UCC's provisions in particular jurisdictions.

4) *Issuances by the Federal Reserve Banks and Federal Financial Institutions Examination Council (FFIEC) that address specific controls and procedures as to Fedwire and privately operated payment systems. Specifically:*

- a) Federal Reserve Banks' FedLine Advantage References;
- b) FFIEC Information Technology Examination Handbooks such as Information Security, Business Continuity Planning, and Wholesale Payment Systems; and
- c) FFIEC Guidance-Authentication in an Internet Banking Environment.

5) *Federal Reserve Bank Operating Circulars and Appendices that set forth the terms for maintaining accounts with and obtaining other services from the Federal Reserve Banks. Specifically:*

- a) Operating Circular No. 1-Account Relationships, Agreements and Forms;
- b) Operating Circular No. 4-Automated Clearing House Items;
- c) Operating Circular No. 5-Electronic Access, Certification Practice Statement, and Password Practice Statement;
- d) Operating Circular No. 6-Funds Transfers Through The Fedwire Funds Service;
- e) Operating Circular No. 7-Book-Entry Securities Account Maintenance and Transfer Services;
- f) Operating Circular No. 8-Collateral; and

g) Operating Circular No. 12-Multilateral Settlement.

6) *Issuances of the Board of Governors that address Intraday Liquidity Management and Payment System Risk Policy.*

In July 2006, the Board of Governors implemented changes in its daylight overdraft policy for GSEs and certain international organizations. The changes required these organizations to eliminate their daylight overdrafts at the Federal Reserve Banks relating to their interest and redemption payments and to pay a penalty fee and post collateral if daylight overdrafts occur in their accounts as a result of their general corporate payment activity.

7) *The Bank Secrecy Act (BSA), as amended by the USA Patriot Act, and the regulations and interpretations of the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) thereunder.*

The BSA was enacted to safeguard the U.S. financial system from illicit use and combat money laundering and other illegal activity. Specific requirements under the BSA that may apply to financial institutions engaged in securities safekeeping services include, but are not limited to, the establishment of an anti-money laundering (AML) program reasonably designed to prevent the financial institution from being used to facilitate money laundering or the financing of terrorist activities. Additional information may be found on FinCEN's website at <http://www.fincen.gov>.

Failure by an institution to comply with BSA requirements may result in the imposition of civil and criminal penalties and damage the institution's reputation in the marketplace.

8) *Statutes and Regulations administered by the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC).*

OFAC, an agency of the U.S. Department of the Treasury, administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy of the United States.

All U.S. persons must comply with OFAC regulations, including all U.S. citizens and permanent resident aliens regardless of where they are located, all persons and entities within the United States, all U.S. incorporated entities and their foreign branches.

As part of its enforcement efforts, OFAC publishes a list of individuals and companies owned or controlled by, or acting for or on behalf of, targeted countries. It

also lists individuals, groups, and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific. Collectively, such individuals and companies are called "Specially Designated Nationals" or "SDNs." Their assets are blocked and U.S. persons are generally prohibited from dealing with them. Prohibited transactions are defined broadly and may include payments or transfers to a designated country or national thereof. Financial institutions are generally required to conduct screening to identify transactions involving any counterparty that has been designated by OFAC and to follow specific procedures such as blocking or freezing such counterparty's assets and providing reports to OFAC and the institution's board of directors.

OFAC maintains and periodically updates the SDN List, which may be viewed and/or searched on its website at

<http://www.treasury.gov/resource-center/sanctions/Pages/regulations.aspx>

For more information on OFAC's sanctions programs OFAC has produced a brochure titled "Foreign Assets Control Regulations For The Financial Community," which is available on OFAC's website.

Failure by an institution to comply with OFAC requirements may result in the imposition of severe civil and criminal penalties and damage the institution's reputation in the marketplace.

9) State privacy laws that address providing disclosure to customers when conversations are being recorded.

Specific requirements may vary, from state to state. FHLBanks should be aware of the laws in all the states in which any party to the conversation is located.

Issues Specific to the FHLBanks

The FHLBanks provide a secure and convenient method for clearing and safekeeping securities for the FHLBank and their members. Specific legal agreements and forms are developed and reviewed by the FHLBank's legal counsel to address the duties, responsibilities, and liabilities of the FHLBank, the custodian(s), the member, the member's customer, the applicable transactions that are processed, and compliance with applicable state law and UCC requirements.

Examples of specific services include, but are not limited to, the following:

- 1) Providing securities trade settlement, income collection, maturity and called bond payment processing, monthly reporting, online access to securities information, payment inquiries processing, market valuation, and bond ratings.
- 2) Pledging securities to a third party where the FHLBank operates as trustee and

custodian for collateral held for repurchase agreements that have been sold by the member to their customer. Under these situations, the FHLBank internally codes these securities as pledged collateral for the repurchase transactions.

- 3) Pledging securities to a third party where the FHLBank operates as trustee and custodian for collateral held on behalf of various public entities whose deposits held by the member exceed the maximum standard insurance amount set by the FDIC. Usually, the secured deposits are public funds. A tri-party agreement is executed among the member, the member's customer, and the FHLBank. Under these circumstances, the FHLBank internally codes these securities as pledged collateral for the deposits.
- 4) Operating as a custodian of securities pledged as collateral by members to protect the FHLBank in the event of default on the repayment of outstanding advances and standby letters of credit. Under these circumstances, the securities safekeeping function coordinates with the credit and collateral functions to ensure that the FHLBank has physical possession of the securities that are pledged as collateral and sufficient in value. The securities are coded internally as pledged collateral for advances and/or standby letters of credit.

In addition, the securities safekeeping function coordinates with the capital markets or treasury functions to facilitate the cash management of repurchase agreement transactions that have been executed on behalf of the FHLBank. Securities that are pledged as collateral are transferred to the counterparty's custodian.

The FHLBanks use the appropriate Federal Reserve Bank to process book-entry wireable securities such as those issued by the U.S. Treasury, Freddie Mac, and Fannie Mae and use a correspondent bank custodian relationship to process securities for which DTC is serving as a custodian. Vendor software is utilized to provide current market valuation information.

Dual Control

Dual control is a process requiring the approval of more than one individual to complete certain activities. By having more than one individual responsible for completing transactions, a regulated entity reduces the possibility of error or fraud. Dual controls should be in place for all activities related to the review, verification, receipt, input, release, adjustments, and reconciliation processes for all securities safekeeping activities. Examples of specific transactions are as follows:

- 1) *Delivery-versus-payment*: a transaction in which the buyer's payment for securities is due at the time of delivery (usually to the FHLBank acting as agent for the buyer) upon receipt of the securities;
- 2) *Receive-versus-payment*: an instruction accompanying sell orders that only cash will

be accepted in exchange for delivery of the securities;

- 3) *Free delivery*: securities are delivered without an offsetting receipt of funds; and
- 4) *Free receive*: securities are received without an offsetting receipt of funds.

Segregation of Duties

Critical access controls and segregation of duties that relate to system access, authorization, processing, recording, and reconciliation of transactions must be in place to prevent the processing of erroneous and fraudulent transactions. A material erroneous or fraudulent transaction could have a significant effect on the financial condition of the FHLBank and result in attendant reputational risk.

Recording and Reconciliation

Securities transactions are processed and recorded to applicable general ledger accounts such as the “Federal Reserve Bank” and “correspondent” and to the member’s accounts such as the demand deposit account, safekeeping account, and pledge account. The responsibility for the review and reconciliation of entries should be segregated from that of the processing of the daily transactions.

On the safekeeping system, the customer’s securities should be identifiable where the securities are assigned a unique receipt number and linked to the member’s accounts and a distinction is made to segregate securities that are pledged. A reconciliation of securities held at each custodian and pledged as collateral should be completed at least monthly.

Trade activity should be identified by a receipt and confirmation advice that is mailed the following day of the settlement, and detailed in the member’s accounts. Periodic statements that pertain to demand deposit, safekeeping portfolio totals, and safekeeping transactions are generated and sent to the members.

Credit and Collateral Administration

The development and maintenance of sound and effective credit and collateral administration are critical elements in the identification, management, and monitoring of the risk exposures associated with securities that are securing advances and standby letters of credit.

Daylight and Customer Deposit Overdrafts

The Federal Reserve Banks provide the unsecured intraday credit needed to support clearing of the large transactional volumes. Such credit extensions occur when a Federal Reserve Bank allows institutions to initiate transactions that exceed, at a given moment,

the balance in their reserve or clearing accounts, which leaves the institution in a net debit position with the Federal Reserve Bank. These intraday overdrafts of accounts are referred to as "daylight overdrafts."

The amount of credit available to any institution is usually limited by "net debit sender caps," which establish the maximum unsecured exposure that a Federal Reserve Bank is willing to accept. As the FHLBanks do not have any net debit sender caps, they must monitor their position with the Federal Reserve Bank continuously.

The Federal Reserve imposes penalties on any institution incurring a daylight overdraft above a pre-determined amount agreed to by the institution. Repeated daylight overdrafts may result in discontinuation by the Federal Reserve Bank of services such as wires, automated clearing house (ACH), securities, and access to capital markets, which could limit an institution's ability to meet its financial obligations and provide services to its customers. FHLBanks are prohibited from incurring daylight overdrafts with the Federal Reserve Banks.

The responsibility for monitoring the FHLBank's position with a Federal Reserve Bank is usually assigned to cash management/treasury personnel. Such personnel customarily have inquiry access to the wire system, which allows them to monitor large incoming/outgoing wire activity. In addition, the automated wire system has software controls that establish internal dollar limits and mitigate daylight overdraft possibilities. Securities safekeeping personnel coordinate with wire and cash management/treasury personnel on the current cash position with the relevant Federal Reserve Bank and the correspondent bank relationship, and anticipated purchase and matured securities activity.

Customer deposit overdrafts represent an unsecured credit exposure, and should require the approval of credit personnel and line management.

Legal

In connection with securities safekeeping services, FHLBank legal staff reviews applicable regulatory requirements, vendor contracts, and other FHLBank documentation to protect the FHLBank's interests. In addition, the business units coordinate a periodic review with legal staff to ensure current operating practices comply with regulatory requirements.

Business Continuity and Recovery

The FHLBank should have written procedures for operations at its designated hot-site. Back-up tapes should be stored off-site and be easily retrievable. If the automated wire system is not available at the hot-site, FedLine Advantage terminals, off-line trade settlement processing with the relevant Federal Reserve Bank can be accomplished by telephonic instructions through the wholesale area of the Federal Reserve Bank. Bilateral agreements with one or more FHLBanks and the correspondent bank custodian

relationship may need to be used to effect the FHLBank's securities requests.

Documentation of business continuity testing performed by the correspondent bank relationship and the market valuation vendor is requested at least annually. Each FHLBank must have at least one back-up system and must test it periodically to ascertain its reliability.

Issues Specific to the Enterprises

The Enterprises do not have similar securities safekeeping functions to that of the FHLBanks, instead they engage a third-party custodian when securities are pledged as collateral for derivatives transactions or repurchase agreements. With respect to securities issued by the Enterprises, principal and interest payments are passed through a DTC to the owner-of-record. Although the Enterprises don't engage in securities safekeeping activities, they must ensure that adequate controls are in place with third-party custodians. For further information about third-party relationships, refer to FHFA's supplemental guidance "Third-Party Relationship Management" at M:\Examination Manual and Supplemental Guidance\Supplemental Examination Guidance.

This examination module deals primarily with issues pertaining to the FHLBanks and has been developed accordingly. Nonetheless, the guidance included in the document may be used as a source of reference for examiners completing an evaluation of practices at the Enterprises.

Examination Guidance

The workprogram for the Securities Safekeeping Operations (securities safekeeping or safekeeping) examination module is detailed below. If this module is included in the examination scope, the examiner must perform worksteps sufficient in coverage to document the basis for conclusions on the quantity of risk and quality of risk management pertaining to this area. Transaction testing is mandatory and the examiner must document sufficient worksteps from Section 4, *Testing*, to support the findings and conclusions from this examination module.

In determining the extent of review and testing to be conducted in completing each examination, the examiner should take into account any applicable FHFA off-site monitoring or analysis reports, such as analyses of the quality and effectiveness of corporate governance practices, financial condition and performance, economic and housing industry conditions, internal controls, and audit coverage relating to the institution's safekeeping activities.

NOTE: Text in (*italics*) referenced in a workstep represents illustrative guidance that serves as suggestions for specific inquiry.

1. Scope of Examination Work Performed

- 1) Review past reports of examination for outstanding issues or previous problems related to securities safekeeping operations.
- 2) Review applicable FHFA off-site monitoring or analysis reports, and workpapers produced as part of on-going monitoring related to securities safekeeping operations.
- 3) Assess the status of outstanding examination findings pertaining to securities safekeeping operations.
- 4) Review internal audit reports for outstanding issues relating to securities safekeeping operations.
- 5) Review minutes of meetings of the board of directors and relevant board and management committees for any issues regarding securities safekeeping operations.
- 6) Identify and evaluate the FHLBank's strategy for safekeeping services offered and the risks and benefits of that business model.

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- 7) Determine if the business model used by the FHLBank for securities safekeeping is consistent with the FHLBank's broader strategic objectives and the needs of its members.

Summarize the work performed in the examination of securities safekeeping operations. To the extent there were modifications to the originally planned scope based on concerns identified during the examination, document those changes and the reasons for such changes.

2. Description of Risks

- 1) Evaluate any significant changes related to securities safekeeping that have been implemented since the last examination or are being considered that may affect the FHLBank's risk profile.
- 2) Evaluate the effectiveness of the annual risk assessment and determine if it reasonably identifies and evaluates all material risks, both quantitative and qualitative aspects, of the FHLBank's securities safekeeping operations. *(Are there any action plans arising from the assessment? Check corrective actions for effectiveness.)*

3. Risk Management

Organizational Structure

- 1) Identify the key personnel and their primary duties, responsibilities, and technical expertise to determine if resources are effectively deployed to execute the FHLBank's securities safekeeping strategies.
- 2) Evaluate the staffing and skill level, segregation of duties, and cross-training of personnel to determine if resources are sufficient to execute the FHLBank's securities safekeeping operations. *(Does staff have appropriate training and experience to carry-out their responsibilities within the organization? What steps has the regulated entity taken to address any identified deficiencies in staff expertise? Are such steps appropriate?)*
- 3) Evaluate coordination between departments such as risk management, information technology, treasury and cash management, and accounting to determine if the FHLBank's safekeeping services are processed in an efficient and effective manner. *(Do different departments within the organization coordinate efforts to limit the risk)*

exposure to the regulated entity resulting from safekeeping operations? How are these efforts coordinated?)

Policy and Procedure Development

- 1) Review departmental policies and procedures and determine if they are current, relevant, sufficiently detailed, and consistent with the FHLBank's policies and regulations.
- 2) Evaluate the process for mitigating risks and liability with the purchase of specific insurance and bond coverage such as directors' and officers' liability, errors and omissions, computer cyber-crime policies and fidelity bond coverage, and establishing compensating procedures and controls to address any exclusion in the policies.

Risk Metrics

- 1) Review the FHLBank's Risk Management Policy (RMP), or similar policy, to determine and identify what, if any, risk limits are established and how they are monitored.
- 2) Review and evaluate the FHLBank's practices for limiting/controlling risk through the establishment of risk tolerances. *(Do the risk tolerances appropriately consider all potential risks?)*

Reporting

- 1) Evaluate the reporting to the board of directors of RMP and Member Products Policy exceptions/waivers and periodic reporting to the board on the status of the strategic business plan goals and objectives as it relates to securities safekeeping.

Internal/External Audit

- 1) Evaluate the adequacy of the scope, testing, and workpapers completed by internal audit. *(Do procedures include testing for cases of fraud? Do pertinent audits consider the effect of risks emanating from the securities safekeeping operations to all areas of the organization?)*
- 2) Evaluate the adequacy of the scope and testing completed by external audit and determine the status of corrective actions for findings. *(Are all areas of potential risk considered? If not, why not? Are reasons for not including certain areas within the scope of the audit work reasonable and supported?)*
- 3) Evaluate the adequacy of the objectives and scopes of reviews performed by outside consultants and determine the status of management's actions regarding

recommendations. *(Review the actions taken in response to consultant recommendations.)*

Information Technology

- 1) Identify and assess the automated and manual systems and applicable controls for processing securities safekeeping services, including:
 - a) Authorized users;
 - b) Vendor technical support and access to the automated wire system;
 - c) Utilization of spreadsheets or other user developed applications;
 - d) Business continuity and recovery; and
 - e) Exception tracking, escalation, and reporting.
- 2) Determine if physical security has been established over the securities safekeeping terminals.
- 3) Review the system controls applicable to the automated securities safekeeping system(s). Specific attributes include, but are not limited to, the following:
 - a) The process for the review and establishment of employees' system capabilities such as the initial review and approval by line management and coordination with the system administrator (if not line management), who establishes access to the automated securities safekeeping system;
 - b) Access and function capabilities (all transactions should require dual control);
 - c) System defaults pertaining to user identifications, password composition and length, number of attempts before being locked-out, expiration, and timeout;
 - d) Dollar limitations for securities safekeeping transactions; and
 - e) Managerial review and override capabilities.
- 4) Evaluate the adequacy of the business continuity plan for this line of business. *(Are systems specific to safekeeping operations considered in the business continuity plan? Does the regulated entity have appropriate actions in place to ensure that securities safekeeping operations continue despite unexpected interruptions? What additional steps are needed to ensure the FHLBank's operations are not adversely affected?)*

Compliance

- 1) Perform a compliance review of FHFA and Finance Board regulations that are relevant to securities safekeeping. See the "Regulatory Environment" section above for relevant regulations. *(For instances of violations, identify the cause of the violation. Determine how internal controls should be strengthened to ensure there are no future regulatory violations.)*

4. Testing

- 1) Assess and test the adequacy of the FHLBank's procedures and controls that pertain to authentication such as agreements, personal identification numbers, tokens and callback procedures, and processing, recording, and confirmation of securities safekeeping requests that are received from the members and FHLBank personnel for the following transactions (if applicable):
 - a) Delivery-versus-payment;
 - b) Receive-versus-payment;
 - c) Free delivery;
 - d) Free receive;
 - e) Member pledges securities as collateral for FHLBank advances and/or standby letters of credit;
 - f) Member pledges securities as collateral for third-party repurchase transactions;
 - g) Member pledges securities as collateral for third-party public deposits in excess of the standard maximum deposit insurance amount set by the FDIC; and
 - h) FHLBank pledges securities as collateral for its repurchase transactions (delivery transaction-securities are transferred to the counterparty's custodian).
- 2) Observe the processing of a securities safekeeping transaction. Assess dual control constraints where the systems prevent a single employee from performing the input and verify/release functions for transactions.
- 3) Review and evaluate a sample of agreements executed between the safekeeping custodian(s) such as the relevant Federal Reserve Bank and the correspondent bank relationship and the FHLBank.
- 4) Review the securities safekeeping reconciliations that pertain to general ledger, demand deposit account(s), securities held by each custodian, and securities pledged as collateral as of the examination date. In addition, review the adequacy of the following attributes:
 - a) Segregation of duties;
 - b) Reconciliation of accounts by another employee in the event the assigned employee is absent;
 - c) Timely review of applicable accounts by appropriate staff, including the reconciliation of balances and rejected items and the resolution of differences;
 - d) Managerial review of reconciliations; and
 - e) Periodic reporting of line management's review of the general ledger reconciliations to accounting staff.

5. Conclusions

- 1) Summarize conclusions for all examination work performed, including work performed by other FHFA staff as it relates to the regulated entity's securities safekeeping operations function. Develop a memorandum articulating the risks to the institution resulting from securities safekeeping practices and the regulated entity's management of those risks. The memorandum should clearly and articulately describe the basis of conclusions reached and summarize the analysis completed. Within the memorandum, discuss the types of risk the regulated entity is exposed to (e.g., market, credit, operational); the level of risk exposure; the direction of risk (stable, decreasing, increasing); and the quality of risk management practices (strong, adequate, weak). A memorandum must be prepared irrespective of whether the examiner's assessment is positive or negative.
- 2) Conclude on the responsiveness to previous examination findings. Evaluate the adequacy of the regulated entity's response to previous examination findings and concerns.
- 3) Develop findings and prepare findings memoranda, as appropriate. Based on examination work performed, develop findings communicating concerns identified during the examination. Findings should identify the most significant risks to the institution and the potential effect to the regulated entity resulting from the concerns identified. Such documents should describe a remediation plan specifying the appropriate corrective action to address examination concerns and establish a reasonable deadline for the regulated entity to remediate the finding. Communicate preliminary findings to the EIC. Discuss findings with regulated entity personnel to ensure the findings are free of factual errors or misrepresentations in the analysis.
- 4) Develop a list of follow-up items to evaluate during the next annual examination. In addition to findings developed in the steps above, include concerns noted during the examination that do not rise to the level of a finding. Potential concerns include issues the regulated entity is in the process of addressing, but require follow-up work to ensure actions are completed appropriately. In addition, potential concerns should include anticipated changes to the institution's practices or anticipated external changes that could affect the institution's future oversight of securities safekeeping practices.

Workprogram

1. Scope of Examination Work Performed

Workpapers must document the examination activities undertaken to evaluate potential risks related to securities safekeeping.

2. Description of Risks

- Identify areas of concern related to securities safekeeping
- Assess current risks and trends in the risk to the organization emanating from the regulated entity's security safekeeping function
- Evaluate changes within the organization or industry affecting risk
- Evaluate the entity's own risk-identification practices and conclude on their adequacy

3. Risk Management

- Assess and conclude on the adequacy of the organization's risk identification process
- Assess and conclude on the overall adequacy of internal controls, including an evaluation of:
 - The FHLBank's organizational structure
 - Policy and procedure development for securities safekeeping
 - Appropriateness of risk metrics established for securities safekeeping
 - Reporting by management and the board
- Assess and conclude on the internal and external audit of risks
- Assess and conclude on the adequacy of information technology and controls related to securities safekeeping
- Assess and conclude on the adequacy of the organization's efforts to ensure:
 - Compliance with laws, regulations and other supervisory guidance
 - Compliance with the organization's policies and procedures

4. Testing

- Complete testing, as appropriate, to assess adherence with examination standards

5. Conclusions

- Summarize conclusions for all examination work performed related to securities safekeeping
 - Conclude on the level of risk to the organization
 - Include an assessment of the adequacy of an organization's monitoring of risk and establishment of internal controls to mitigate risk
- Conclude on responsiveness to examination findings from previous examinations
- Develop examination findings as appropriate
- Identify areas requiring follow-up examination activities or monitoring