FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 83-149
December 22, 1983

BANKERS' ACCEPTANCES

FINAL RULE

TO ALL MEMBER BANKS
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Board of Governors of the Federal Reserve System has issued a final rule, effective June 10, 1984, concerning the meaning of participations in bankers' acceptances in order to clarify the bankers' acceptance limitations of the Bank Export Services Act. This rule was originally proposed in Circular No. 83-85 dated July 8, 1983.

Attached are copies of the Board's press release and the material as submitted for publication in the Federal Register. Questions regarding the material contained in this circular should be directed to the Legal Department, Extension 6228.

Additional copies of this circular will be furnished upon request to the Public Affairs Department, Extension 6289.

Sincerely yours,

William H. Wallace

William H. Wallace
First Vice President

FEDERAL RESERVE press release

For immediate release

December 2, 1983

The Federal Reserve Board today clarified the meaning of participations in bankers' acceptances for purposes of the bankers' acceptance limitations of the Bank Export Services Act. The Board's final action becomes effective June 10, 1984.

The Bank Export Services Act (BESA) raised the limits on the aggregate amount of eligible[1]/ bankers' acceptances that may be created by a member bank of the Federal Reserve System. The Act also applied these limits to U.S. branches and agencies of foreign banks where the parent bank has, or is controlled by a company or companies with over $1 billion consolidated bank assets worldwide.

The BESA also provided that any portion of an eligible bankers' acceptance created by a member bank or by a U.S. branch or agency of a foreign bank covered by the BESA that is conveyed through a participation agreement to another covered[2]/ bank should not be included in the calculation of the creating banks' limits on bankers' acceptances. Instead, the amount of the acceptance conveyed through the participation is to be applied to the limitations applicable to the covered bank receiving the participation.

1/ "Eligible" bankers' acceptances are not subject to Federal reserve requirements. They must meet criteria in Section 13 of the Federal Reserve Act including requirements that the acceptance (1) grows out of a trade transaction involving exporting, importing or domestic shipment of goods or storage of readily marketable staples and (2) has a maturity of less than six months.

2/ "Covered banks" are those institutions subject to the BESA acceptance limits. All other institutions--"noncovered banks"--are not subject to BESA quantitative limits on eligible acceptances.

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Under the Act, the Board is authorized to define the term "participation" for purposes of the bankers' acceptances limitations of the BESA. In June 1983, the Board issued for comment a proposed definition of participations for purposes of the BESA acceptance limits.

In its final rule, the Board today determined that, for purposes of the BESA limits, a participation must satisfy the following two minimum requirements:

1. A written agreement entered into between the junior and senior bank 3/ under which the junior bank acquires the senior bank's claim against the account party to the extent of the amount of the participation that is enforceable in the event that the account party fails to perform in accordance with the terms of the acceptance; and

2. The agreement between the junior and senior bank provides that the senior bank obtains a claim against the junior bank to the extent of the amount of the participation that is enforceable in the event the account party fails to perform in accordance with the terms of the acceptance.

After reviewing comment received, the Board determined not to adopt the proposed requirement that the senior bank and the account party specifically agree that the senior bank's rights are assignable.

A copy of the Board's notice is available upon request.

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3/ The "senior bank" is the institution that creates the eligible bankers' acceptance and conveys the participation. The "junior bank" is the institution that receives the participation.

FEDERAL RESERVE SYSTEM

[12 CFR Part 250]

[Docket No. R-0474]

MISCELLANEOUS INTERPRETATIONS

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board has clarified the meaning of participations in bankers' acceptances for purposes of the bankers' acceptance limitations of the Bank Export Services Act.

EFFECTIVE DATE: June 10, 1984.

FOR FURTHER INFORMATION CONTACT: Gilbert T. Schwartz, Associate General Counsel (202/452-3625), or Robert G. Ballen, Attorney (202/452-3265), Legal Division, Board of Governors of the Federal Reserve System, Washington, D. C. 20551.

SUPPLEMENTARY INFORMATION: a. The BESA. Section 207 of the Bank Export Services Act (Title II of Pub. L. 97-290)("BESA") provides that a member bank or a Federal or State branch or agency in the United States whose parent foreign bank has, or is controlled by a foreign company or companies that have, more than $1 billion in total worldwide consoliated bank assets,[1/] may create eligible bankers' acceptances ("BAs")[2/] in the aggregate up to 150 per cent of its paid up and unimpaired capital stock and surplus ("capital") and, with the permission of the Board, up to 200 per cent of its capital (12 U.S.C. § 372). Section 207 also prohibits these institutions from creating eligible BAs for any one person in the aggregate in excess of 10 percent of the institution's capital. Eligible BAs growing out of domestic transactions are not to exceed 50 percent of the aggregate of all eligible acceptances authorized for such an institution.

1/ The institutions subject to the BA limitations of BESA will hereinafter be referred to as "covered banks."

2/ An eligible BA includes a BA that meets the criteria of the seventh paragraph of section 13 of the Federal Reserve Act (12 U.S.C. § 372).

This section of the BESA also provides that any portion of an eligible BA created by a covered bank ("senior bank") that is conveyed through a "participation agreement" to another covered bank ("junior bank") shall not be included in the calculation of the senior bank's bankers' acceptance limits.[3/] However, the amount of the participation is to be included in the BA limits applicable to the junior bank.

The language of the statute does not define what constitutes a participation agreement for purposes of the applicability of the BESA limitations. The statute authorizes the Board to further define any of the terms used in section 207 of the BESA (12 U.S.C. § 372(g)).

b. The Board's proposal. The Board issued for public comment a proposed definition of a participation agreement for purposes of determining compliance with the BESA limits that included the following minimum requirements:

> 1. A written agreement entered into between the junior and senior bank under which the junior bank acquires the senior bank's claim against the account party to the extent of the amount of the participation that is enforceable in the event that the account party fails to perform in accordance with the terms of the acceptance. The agreement between the senior bank and the account party must indicate that the rights that the senior bank acquires under the agreement are assignable by the senior bank; and
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> 2. The agreement between the junior and senior bank provides that the senior bank obtains a claim against the junior bank to the extent of the amount of the participation that is enforceable in the event the account party fails to perform in accordance with the terms of the acceptance.

In its proposal, the Board stressed that both the junior bank's claim on the account party and the senior bank's claim on the junior bank involve risk. Accordingly, the Board proposed that the junior bank review the creditworthiness of each account party on a case-by-case basis before it acquires a participation and the senior bank review the creditworthiness

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3/ The use of the terms "senior bank" and "junior bank" has no implications regarding priority of claims. These terms merely represent a shorthand method of identifying the depository institution that has created the acceptance and conveyed the participation (senior bank) and the depository institution that has received the participation (junior bank).

of the junior bank. Similarly, the Board proposed that the actual assets acquired be included for purposes of assessing capital adequacy. 48 F.R. 29001 (June 24, 1983).

c. Discussion of comments. The Board received a total of 29 comments. Comments were received from 15 depository institutions, the American Bankers Association, the Bankers' Association for Foreign Trade, and 12 Reserve Banks. The commenters generally supported the Board's overall approach to the definition of participations.

Ten commenters opposed the requirement in the Board's proposal that the agreement between the senior bank and the account party indicate that the rights that the senior bank acquires under the agreement are assignable by the senior bank. These commenters believed that this requirement would interrupt the smooth flow of funds in the acceptance market in view of the fact that agreements between the senior bank and the account party often must be entered into rapidly and often are not formalized beyond tested telexes, powers of attorney, and simple letters. Nine of these commenters stated that this requirement was superfluous because, in the absence of a prohibition against assignment, the senior bank's rights would be assignable under general principles of commercial law. Finally, five of these commenters also suggested that this provision would restrict the use of participations, as those account parties that prefer to deal only with the senior bank would, upon being notified of the assignability, prohibit the senior bank from participating acceptances and thus disrupt the smooth functioning of the participation mechanism.

After consideration of the comments, the Board has determined not to include in the final rule the proposed requirement that the agreement between the senior bank and the account party indicate that the senior bank's rights are assignable. The Board is not requiring the senior bank and the account party specifically to agree that the senior bank's rights are assignable because the Board believes such rights to be assignable in the absence of an explicit agreement. In this regard, given the nature of the agreements between the senior bank and the account party and the speed with which these agreements often are required to be formed, the proposed requirement for assignability could have a disruptive effect upon the operations of the bankers' acceptance market.

Five commenters urged the Board not to prohibit the junior and senior bank from agreeing among themselves that the senior bank would be responsible for administration and enforcement of the entire obligation of the account party. In the absence of such an arrangement, these commenters argued that account party defaults would likely result in multiple enforcement actions. Such multiple actions, possibly in

different forums, could result in substantially increased litigation costs, inconsistent judgments, and administrative problems. One of these commenters indicated that permitting each junior bank to pursue its own enforcement action could result in minority interests impairing delicate workout negotiations that were in the best interests of the majority. Two of these commenters argued that junior banks should be able to benefit from senior bank expertise in recovering from a defaulting account party.

The Board has determined that, for the reasons set forth by the commenters, junior and senior banks may contract among themselves as to which party(ies) will have the responsibility for administering the arrangement, enforcing claims, or exercising remedies. In this regard, the Board believes that the parties should be aware of the risks inherent in such arrangements, such as the possibility that the bank with administration or enforcement responsibility would promote its own interests to the detriment of the others. If the parties do wish to contract among themselves as to administration and enforcement, the Board encourages that such arrangements clearly delineate the responsibilities of the relevant parties.

With regard to the Board's proposed requirements concerning credit reviews, two commenters indicated that they were unsure as to the meaning of the term "high credit standards." These commenters indicated that this term may cause confusion to those parties subject to the regulation. They suggested that the risks be reviewed in accordance with "prudent and sound banking practices" or "prudent banking practices." One of these commenters suggested that a junior bank be permitted to commit to purchasing all acceptance participations offered by a senior bank on an ongoing basis, subject to periodic review of the arrangement by the junior bank. This commenter also suggested that blanket agreements to purchase all participations from the senior bank be permitted between a parent bank and its Edge affiliates where the credit approval process for both organizations is handled by the parent bank. Another commenter argued that the junior bank should be required to make an independent evaluation of each account party and that blanket agreements probably do not display the degree of scrutiny of each arrangement that the phrase "participation" appears to contemplate. Finally, one commenter cautioned against a senior bank concentrating participations in particular junior banks.

In view of the potential confusion regarding the term "high credit standards," the Board has determined that the junior and senior banks be required to assess their respective risks in accordance with "prudent and sound banking practices." The examiners will in the normal course of the examination process review the risk assessment procedures

instituted by the banks. The Board continues to believe that the junior bank should review the creditworthiness of each account party when the junior bank acquires a participation and the senior bank should review on an ongoing basis the creditworthiness of the junior bank. Junior bank agreements to purchase from a senior bank all participations in BAs with specified account parties subject to periodic review of each specified account party will be reviewed by examiners to assure that the amounts are reasonable in relation to the two banks and that periodic reviews of each specified account party are made and are up to date. Junior bank agreements to rely exclusively upon the credit judgment of the senior bank and purchase on an ongoing basis from a senior bank all participations in BAs regardless of the identity of the account party are not appropriate in view of the risks involved. However, in those cases involving a participation between a parent bank and its Edge affiliate where the credit review for both entities is performed by the parent bank, the Edge Corporation should maintain documentation indicating that it concurs with the parent bank's analysis and that the acceptance participation is appropriate for inclusion in the Edge Corporation's portfolio.

Seven commenters stated that the amount of a BA conveyed through a participation should be excluded from the asset base of the senior bank for purposes of assessing capital adequacy. Six of these commenters argued that such an exclusion was necessary to avoid double counting of the asset. Two of these commenters noted that such an exclusion would be consistent with the treatment of loan participations. One of these commenters believed exclusion to be appropriate because the senior bank has transferred the risk of account party default to the junior bank through the participation.

After consideration of the comments, the Board has determined not to change its proposed position on this issue. As discussed above, the junior bank incurs the risk of account party default and the senior bank incurs the risk of junior bank default. Although the senior bank's ultimate risk may be less than its risk prior to conveyance of the participation, and may be less than the risk of the junior bank, the senior bank does incur the risk that both the account party and the junior bank will default. The Board believes that including the risks incurred by the senior bank in assessing the senior bank's capital and the risks incurred by the junior bank in assessing the junior bank's capital is not "double counting" but rather appropriate recognition of the risks involved.

One commenter suggested that the Board defer the effective date of its final rule one year to allow banks sufficient time to revise existing BA forms and to permit outstanding BA participation agreeements to mature. Another

commenter stated that the final rule should not apply to participations entered into before the effective date of the final rule or to renewals of such participations. A third commenter indicated that the Board may wish to consider "grandfathering" participation agreements entered into before the effective date of the final rule.

The Board has determined to delay the effective date of the rule for six months. The Board believes that six months should provide institutions sufficient time to prepare for the minimum requirements, particularly in view of the fact that the proposed requirement that the senior bank and the account party agree that the senior bank's rights are assignable has not been adopted. A six month delay will result in currently outstanding individual participations not being affected by this rule because of the maximum six month maturity of eligible BAs. The Board determined that the six month delayed effective date was preferable to grandfathering existing participations because the grandfathering approach would require examination of each individual participation to determine whether it was affected by this rule. Accordingly, the rule will apply to all participations in BAs created or renewed on or after the effective date of the rule.

One commenter indicated that a number of banks have deleted participated portions of BAs that they have created from their books of accounts. In this regard, the Report of Condition and Income currently provides that all acceptances created by a bank are to be reflected on that bank's balance sheet whether or not they are subject to participation agreements.

The impact of this rule on small entities has been considered in accordance with section 604 of the Regulatory Flexibility Act (Pub. L. 96-354; 5 U.S.C. § 604). The Board's rule will provide small member banks that are covered by the BESA limitations with increased flexibility with regard to the usage of eligible BAs. No new recordkeeping or reporting requirements will be imposed as a result of this action.

List of Subjects in 12 CFR Part 250

Federal Reserve System.

Pursuant to its authority under the seventh paragraph of section 13 of the Federal Reserve Act (12 U.S.C. § 372), the Board of Governors has amended, effective June 10, 1984, 12 CFR Part 250--Miscellaneous Interpretations--by adding a new section 250.165 to read as follows:

SECTION 250.165 -- BANKERS' ACCEPTANCES: DEFINITION OF PARTICIPATIONS

(a)(1) Section 207 of the Bank Export Services Act (Title II of Pub. L. 97-290) ("BESA") raised the limits on the aggregate amount of eligible bankers' acceptances ("BAs") that may be created by a member bank from 50 percent (or 100 per cent with the permission of the Board) of its paid up and unimpaired capital stock and surplus ("capital") to 150 percent (or 200 percent with the permission of the Board) of its capital. Section 207 also prohibits a member bank from creating eligible BAs for any one person in the aggregate in excess of 10 percent of the institution's capital. Eligible BAs growing out of domestic transactions are not to exceed 50 percent of the aggregate of all eligible acceptances authorized for a member bank. This section of the BESA applies the same limits applicable to member banks to U. S. branches and agencies of foreign banks that are subject to reserve requirements under section 7 of the International Banking Act of 1978 (12 U.S.C. 3105).1/

(2) This section of the BESA also provides that any portion of an eligible BA created by a covered bank ("senior bank") that is conveyed through a "participation agreement" to another covered bank ("junior bank") shall not be included in the calculation of the senior bank's bankers' acceptance limits established by section 207 of BESA.2/ However, the amount of the participation is to be included in the BA limits applicable to the junior bank. The language of the statute does not define what constitutes a participation agreement for purposes of the applicability of the BESA limitations. However, the statute does authorize the Board to further define any of the terms used in section 207 of the BESA (12 U.S.C. § 372(g)). The Board is clarifying the term participation for purposes of the BA limitations of the BESA.

(b) The legislative history of section 207 of the BESA indicates that Congress intended that the junior bank be obligated to the senior bank in the event that the account party defaults on its obligation to pay, but that the junior bank need not also be obligated to pay the holder of the acceptance at the time the BA is presented for payment. H. Rep. No. 97-629, 97th Cong., 2nd Sess. 15 (1982); 128

1/ The institutions subject to the BA limitations of BESA will hereinafter be referred to as "covered banks."

2/ The use of the terms "senior bank" and "junior bank" has no implications regarding priority of claims. These terms merely represent a shorthand method of identifying the depository institution that has created the acceptance and conveyed the participation (senior bank) and the depository institution that has received the participation (junior bank).

Cong. Rec. H 4647 (daily ed. July 27, 1982) (remarks by Rep. Barnard); and 128 Cong. Rec. H 8462 (daily ed. October 1, 1982) (remarks by Rep. Barnard). The legislative history also indicates that Congress intended that eligible BAs in which participations had been conveyed not be required to indicate the name(s) (or interest(s)) of the junior bank(s) on the acceptance in order for the BA to be excluded from the BESA limitations applicable to the senior bank. 128 Cong. Rec. S 12237 (daily ed. September 24, 1982) (remarks of Senators Heinz and Garn); and 128 Cong. Rec. H 4647 (daily ed. July 27, 1982) (remarks of Rep. Barnard).

(c)(1) In view of Congressional intent with regard to what constitutes a participation in an eligible BA, the Board has determined that, for purposes of the BESA limits, a participation must satisfy the following two minimum requirements:

> 1. A written agreement entered into between the junior and senior bank under which the junior bank acquires the senior bank's claim against the account party to the extent of the amount of the participation that is enforceable in the event that the account party fails to perform in accordance with the terms of the acceptance; and
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> 2. The agreement between the junior and senior bank provides that the senior bank obtains a claim against the junior bank to the extent of the amount of the participation that is enforceable in the event the account party fails to perform in accordance with the terms of the acceptance.

(2) Consistent with Congressional intent, the minimum requirements do not require the junior bank to be obligated to pay the holder of the acceptance at the time the BA is presented for payment. Similarly, the minimum requirements do not require the name(s) or interest(s) of the junior bank(s) to appear on the face of the acceptance.

(3) An eligible BA that is conveyed through a participation that does not satisfy these minimum requirements would continue to be included in the BA limits applicable to the senior bank. Further, an eligible BA conveyed to a covered bank through a participation that provided for additional rights and obligations among the parties would be excluded from the BESA limitations of the senior bank provided the minimum requirements were satisfied.

(4) A participation structured pursuant to these minimum requirements would be as follows: Upon the conveyance of the participation, the senior bank retains its entire obligation to pay the holder of the BA at maturity. The senior bank has a claim against the junior bank to the extent of the amount of the participation that is enforceable in the event the account party fails to perform in accordance with the terms of the acceptance. Similarly, the junior bank has a corresponding claim against the account party to the extent of the amount of the participation that is enforceable in the event the account party fails to perform in accordance with the terms of the acceptance.

(d)(1) The Board is not requiring the senior bank and the account party specifically to agree that the senior bank's rights are assignable because the Board believes such rights to be assignable even in the absence of an explicit agreement.

(2) The junior and senior banks may contract among themselves as to which party(ies) have the responsibility for administering the arrangement, enforcing claims, or exercising remedies.

(e) The Board recognizes that both the junior bank's claim on the account party and the senior bank's claim on the junior bank involve risk. Therefore, it is essential that these risks be assessed by the banks involved in accordance with prudent and sound banking practices. The examiners will in the normal course of the examination process review the risk assessment procedures instituted by the banks. The junior bank should review the creditworthiness of each account party when the junior bank acquires a participation and the senior bank should review on an ongoing basis the creditworthiness of the junior bank. Junior bank agreement to rely exclusively upon the credit judgment of the senior bank and purchase on an ongoing basis from the senior bank all participations in BAs regardless of the identity of the account party is not appropriate in view of the risks involved. However, in those cases involving a participation between a parent bank and its Edge affiliate where the credit review for both entities is performed by the parent bank, the Edge Corporation should maintain documentation indicating that it concurs with the parent bank's analysis and that the acceptance participation is appropriate for inclusion in the Edge Corporation's portfolio.

(f) Similarly, the Board has determined that it is appropriate to include the risks incurred by the senior bank in assessing the senior bank's capital and the risks incurred by the junior bank in assessing the junior bank's capital.

(g) In view of this clarification of the issues relating to participations in BAs, the Board encourages the private sector to develop standardized forms for BAs and participations therein that clearly delineate the rights and responsibilities of the relevant parties.

By order of the Board of Governors, December 2, 1983.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board