FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 7440]
August 15, 1974

REGULATIONS H AND F

Limitations on the Use of Standby Letters of Credit and Ineligible Acceptances

*To All Member Banks, and Others Concerned,
in the Second Federal Reserve District:*

Following is the text of a statement issued August 9 by the Board of Governors of the Federal Reserve System:

The Board of Governors of the Federal Reserve System today announced the adoption of two regulatory amendments which require disclosure and limit the use of so-called standby letters of credit and ineligible acceptances by State banks that are members of the Federal Reserve.

Similar actions are being taken by other Federal bank regulatory agencies to include national banks and non-member State banks that are Federally insured.

The action by the Board adopts the substance of proposals for such limitations that were made in January. A number of language changes have been made for clarification.

The limitations on the use of standby letters of credit and ineligible acceptances, as adopted, apply to instruments issued, renewed, extended or amended on or after September 16, 1974.

In general, the revised regulations require that State member banks treat standby letters of credit and ineligible acceptances in the same manner as they treat ordinary loans. That is, the instruments will be subject to State restrictions on amounts of credit that may be provided to any one borrower and to Federal requirements on loans to affiliates.

The amendments—to Regulation H (Membership of State Banking Institutions in the Federal Reserve System) and Regulation F (Securities of State Member Banks)—will become effective September 16, 1974.

Standby letters of credit create an obligation of a bank that involves a credit risk and could result in an outflow of funds from the bank at a later date. Standby letters of credit are sometimes issued by a bank to businesses that use them to support their own notes — so-called documented discount notes — that are sold in money markets to raise funds. In addition, standby letters of credit may be issued by a bank to support a customer's obligation to perform under a construction contract.

An ineligible acceptance is a time draft, accepted by a bank, which does not meet the requirements for discount by a Federal Reserve Bank. Ineligible acceptances and standby letters of credit are similar in terms of credit risk because the timing, amount and degree of exposure can be about identical in the two types of transactions.

As defined in the Board's order, a "standby letter of credit" does not include (1) commercial letters of credit and similar instruments not involving a guaranty of payment of a money obligation, or (2) a guaranty or similar obligation issued by a foreign branch of a State member bank in accordance with and subject to the limitations of Regulation M (Foreign Activities of National Banks).

Restrictions, in addition to those already specified, include:

—Recipients of a standby letter of credit or an ineligible acceptance must be subject to credit analysis equivalent to that applicable to an ordinary borrower.

(OVER)

—Where several banks participate in issuing a standby letter of credit or ineligible acceptance the State member bank must report the entire amount of the letter of credit as an extension of credit unless there are provisions specifically limiting the exposure of individual participants, in which case only the amount of the participation need be reported.

Issuers must also adequately disclose the amount of outstanding letters of credit in their financial statements and keep records making it possible to determine readily the amount of potential liability of the issuer, and his compliance with the regulation.

The Board made two exceptions with respect to standby letters of credit. They will not be subject to the restrictions of the revised regulations if:

—The issuing bank is paid an amount equal to the bank's maximum liability under the letter of credit, or

—The issuer sets aside a clearly earmarked deposit account covering the issuer's liability.

Enclosed are copies of the amendments to Regulations H and F, referred to in the above statement. Additional copies of the enclosures will be furnished upon request.

Alfred Hayes,
President.

Board of Governors of the Federal Reserve System

MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM

AMENDMENT TO REGULATION H

Effective September 16, 1974, subsections (c) and (d) of §208.8 are amended to read as follows:

SECTION 208.8—BANKING PRACTICES

* * *

(c) **Effect on Other Banking Practices.** Nothing in this section shall be construed as restricting in any manner the Board's authority to deal with any banking practice which is deemed to be unsafe or unsound or otherwise not in accordance with law, rule, or regulation, or which violates any condition imposed in writing by the Board in connection with the granting of any application or other request by a State member bank, or any written agreement entered into by such bank with the Board. Compliance with the provisions of this section shall neither relieve a State member bank of its duty to conduct all operations in a safe and sound manner nor prevent the Board from taking whatever action it deems necessary and desirable to deal with general or specific acts or practices which, although perhaps not violating the provisions of this section, are considered nevertheless to be an unsafe or unsound banking practice.

(d) **Letters of Credit and Acceptances**

(1) *Definitions.* For the purpose of this paragraph, "standby letters of credit" include every letter of credit (or similar arrangement however named or designated) which represents an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party, or (2) to make payment on account of any evidence of indebtedness undertaken by the account party, or (3) to make payment on account of any default by the account party in the performance of an obligation.[6a] An "ineligible acceptance" is a time draft accepted by a bank, which does not meet the requirements for discount with a Federal Reserve Bank.

(2) *Restrictions.* (A) A State member bank shall not issue, renew, extend or amend a standby letter of credit (or other similar arrangement, however named or described) or make an ineligible acceptance or grant any other extension of credit if, in the aggregate, the amount of all standby letters of credit and ineligible acceptances issued, renewed, extended, or amended on or after the effective date of this amendment, when combined with other extensions of credit issued by the bank would exceed the legal limitations on loans imposed by the State (including limitations to any one customer or on aggregate extensions of credit) or exceed legal limits pertaining to loans to affiliates under Federal law (12 U.S.C. 371(c)); provided that, if any State has a separate limitation on the issuance of letters of credit or acceptances which apply to a standby letter of credit or to ineligible acceptances respectively, then the separate limitation shall apply in lieu of the standard loan limitation.

(B) No State member bank shall issue a standby letter of credit or ineligible acceptance unless the credit standing of the account party under any letter of credit, and the customer of

6a As defined, "standby letter of credit" would not include (1) commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer and which do not "guaranty" payment of a money obligation or (2) a guaranty or similar obligation issued by a foreign branch in accordance with and subject to the limitations of Regulation M.

(OVER)

PRINTED IN NEW YORK

an ineligible acceptance, is the subject of credit analysis equivalent to that applicable to a potential borrower in an ordinary loan situation.

(C) If several banks participate in the issuance of a standby letter of credit or ineligible acceptance under a *bona fide* binding agreement which provides that, regardless of any event, each participant shall be liable only up to a certain percentage or certain amount of the total amount of the standby letter of credit or ineligible acceptance issued, a State member bank need only include the amount of its participation for purposes of this section; otherwise, the entire amount of the letter of credit or acceptance must be included.

(3) *Disclosure; Recordkeeping.* The amount of all outstanding standby letters of credit and ineligible acceptances, regardless of when issued, shall be adequately disclosed in the bank's published financial statements. Each State member bank shall maintain adequate control and subsidiary records of its standby letters of credit comparable to the records maintained in connection with the bank's direct loans so that at all times the bank's potential liability thereunder and the bank's compliance with this section (d) may be readily determined.

(4) *Exceptions.* A standby letter of credit is not subject to the restrictions set forth above in the following situations: (A) prior to or at the time of issuance of the credit, the issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit or,

(B) prior to or at the time of issuance, the bank has set aside sufficient funds in a segregated, clearly earmarked deposit account to cover the bank's maximum liability under the standby letter of credit.

Board of Governors of the Federal Reserve System

SECURITIES OF MEMBER STATE BANKS

AMENDMENT TO REGULATION F

Effective September 16, 1974, §206.7 is amended to read as follows:

SECTION 206.7—FORM AND CONTENT OF FINANCIAL STATEMENTS

* * *

(c) **Provisions of general application** * * *

(9) **General notes to balance sheets** * * *

(viii) Standby letters of credit. State the amount of outstanding "standby letters of credit." For the purpose of this paragraph, "standby letters of credit" include every letter of credit (or similar arrangement however named or designated) which represents an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party, or (2) to make payment on account of any evidence of indebtedness undertaken by the account party, or (3) to make payment on account of any default by the account party in the performance of an obligation,[2] *except that,* if prior to or at the time of issuance of a standby letter of credit, the issuing bank (1) is paid an amount equal to the bank's maximum liability under the standby letter of credit, or (2) has set aside sufficient funds in a segregated, clearly earmarked deposit account to cover the bank's maximum liability under the standby letter of credit, then the amount of that standby letter of credit need not be stated.

[2] As defined, "standby letter of credit" would not include (1) commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer and which do not "guaranty" payment of a money obligation, or (2) a guaranty or similar obligation issued by a foreign branch in accordance with and subject to the limitations of Regulation M.

PRINTED IN NEW YORK