

**FEDERAL RESERVE BANK  
OF NEW YORK**

[ Circular No. **10558**  
July 28, 1992 ]

**INTERBANK LIABILITIES**

**Proposed New Regulation F to Limit Exposure Risks to Insured Institutions**

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Comments Invited by September 18

*To All Insured Banks, Thrift Institutions, and Branches and Agencies of Foreign Banks  
in the Second Federal Reserve District, and Others Concerned:*

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System requesting comment on a proposal to issue a new Regulation F designed to limit the risks that the failure of a depository institution would pose to insured depository institutions:

The Federal Reserve Board has requested public comment on proposals to implement interbank liability provisions under Section 308 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

Comments should be received by September 18, 1992.

Section 308 of FDICIA requires the Board to prescribe standards that will have the effect of limiting the risks posed by an insured depository institution's exposure to another depository institution.

The proposed rule would apply to depository institutions insured by the Federal Deposit Insurance Corporation (FDIC), including banks, savings associations, and insured branches of foreign banks.

FDIC-insured depository institutions would be required to develop and implement internal procedures to evaluate and control exposure to the depository institutions with which they do business.

The proposed rule would also establish "benchmark" guidelines for daily overnight credit exposure to individual depository institutions.

Printed on the following pages is the text of the Board's proposals, which has been reprinted from the *Federal Register* of July 20. Comments thereon should be submitted by September 18, and may be sent to the Board, as indicated in the notice, or to our Domestic Banking Department.

E. GERALD CORRIGAN,  
*President.*

## FEDERAL RESERVE SYSTEM

### 12 CFR Part 206

[Regulation F; Docket No. R-0769]

#### Interbank Liabilities

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Proposed rule.

**SUMMARY:** The Board is publishing for comment a new Regulation F, Interbank Liabilities. The proposed rule would implement section 308 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which requires the Board to develop regulations designed to limit the exposure of insured depository institutions to other depository institutions. The proposed rule would apply to banks, savings associations, and branches of foreign banks with deposits insured by the Federal Deposit Insurance Corporation (FDIC)

The proposed rule would require insured banks, savings associations, and branches of foreign banks, referred to collectively as "banks," to develop and implement internal procedures to evaluate and control exposure to the depository institutions with which they do business, referred to as "correspondents." These procedures would be required to include limits on both credit and settlement exposure to each individual correspondent. The proposed rule also would establish "benchmark" guidelines for daily overnight credit exposure to individual correspondents within which a bank ordinarily would be expected to remain. The benchmarks are stated as a percentage of the exposed bank's capital. The benchmarks are intended to establish the maximum credit exposure that generally would be considered to be prudent, and are tiered based on the capital position of the correspondent with which the bank is dealing. The proposed rule provides for a two-year transition period after the effective date for implementation of the rule. The Board anticipates that the final rule would become effective on December 19, 1992.

**DATES:** Comments should be received by September 18, 1992.

**ADDRESSES:** Comments, which should refer to Docket No. R-0769, may be mailed to the Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551, to the attention of Mr. William W. Wiles, Secretary. Comments addressed to the attention of Mr. Wiles may be delivered to the Board's mail

room between 8:45 a.m. and 5:15 p.m., and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in room B-1122 between 9 a.m. and 5 p.m., except as provided in § 261.8 of the Board's Rules Regarding the Availability of Information, 12 CFR 261.8.

**FOR FURTHER INFORMATION CONTACT:** Oliver Ireland, Associate General Counsel (202/452-3625), or Lawranne Stewart, Attorney (202/452-3513), Legal Division; or Stephen Lovette, Manager (202/452-3622), or Derek L. Young, Senior Financial Analyst (202/452-2960), Division of Banking Supervision and Regulation. For the hearing impaired only, Telecommunications Device for the Deaf (TDD), Dorothea Thompson (202/452-3544).

**SUPPLEMENTARY INFORMATION:** Section 308 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) added a new section 23 to the Federal Reserve Act (FRA), which requires the Board to prescribe standards, by regulation or order, that will have the effect of limiting the risks posed by an insured depository institution's exposure to another depository institution. The Board believes that section 308 is intended to reduce the risks to insured depository institutions and to the deposit insurance funds by preventing situations where the failure of a single correspondent bank would trigger the failure of insured depository institutions with claims on the failed correspondent. Although the purpose of the section is stated in terms of the risks of the failure of large banks,<sup>1</sup> the provision directs the Board to prescribe standards to limit "the risks posed by an insured depository institution's exposure to any other depository institution." FRA section 23(b). Under section 23, insured depository institutions include all banks and savings associations that are insured by the Federal Deposit Insurance Corporation, as well as insured branches of foreign banks. FRA section 23(d).

The statute defines the "exposure" of an insured depository institution to include all extensions of credit to a depository institution, deposits or reverse repurchase agreements with a

<sup>1</sup> Section 308 states that "[t]he purpose of this section is to limit the risks that the failure of a large depository institution (whether or not that institution is an insured institution) would pose to the insured depository institutions." FRA section 23(a).

depository institution, guarantees, acceptances, or standby letters of credit on behalf of a depository institution, purchases or acceptance as collateral of securities issued by a depository institution, and "all similar transactions that the Board by regulation determines to be exposure for the purposes of this section." FRA section 23(c)(1). The Board is given authority to exempt transactions from the definition of exposure if the exemption is in the public interest and consistent with the purposes of the statute. FRA section 23(c)(2).

Section 23 provides that the rules developed by the Board are to be enforced by the appropriate Federal banking agency of an insured depository institution. FRA section 23(e). The amendments made by section 308 are effective on December 19, 1992, although the Board is authorized to provide transition rules to facilitate compliance with the rules under section 23. FDICIA section 308(b) and (c).

#### Interbank Exposure

The sources of the exposure of a bank to its correspondents tend to arise from two types of activity. First, banks may become exposed to their correspondents when obtaining banking services, such as check collection services, from their correspondents. Second, exposure may arise when banks engage in transactions with correspondents in the financial markets. Each type of exposure presents its own risks and characteristics.

Correspondent banking services are the primary source of interbank exposure for the majority of insured banks, particularly small- and medium-sized banks. In connection with check collection services and other trade- or payment-related correspondent services, banks often maintain balances with their correspondents in order to settle transactions and to compensate the correspondents for the services provided. These balances give rise to credit exposure to the correspondents. Although correspondent services are in some cases provided on a fee basis, many correspondents may prefer compensating balance arrangements, as these balances provide the correspondents with a stable source of funding. Similarly, banks may prefer to pay for services with "soft charges" in the form of balances instead of "hard charges" in the form of fees.

Exposure to a correspondent may be significant, particularly where a bank uses one correspondent for all of the bank's check collections and other payment services, sells excess reserve account balances ("Fed funds") to the correspondent, and engages in other

banking transactions with the correspondent.<sup>2</sup> This exposure may increase when interest rates fall, as higher levels of compensating balances may be required to provide adequate compensation to the correspondent.

Money center banks and large regional banks may have significant exposure to correspondents<sup>3</sup> through their activities in interbank markets, such as the securities, swap, and foreign exchange markets. Interbank transactions such as swaps, foreign exchange contracts and over-the-counter options that call for performance in the future give rise to exposure to the depository institutions that act as counterparties in such transactions. This exposure includes settlement risk, that is, the risk that a counterparty will fail to make a payment or delivery in a timely manner. Settlement risk may arise from transactions in the government securities, foreign exchange, or other markets, and may result from operational, liquidity, or credit problems.

There are currently no comprehensive statutory or regulatory limits on interbank exposure. National banks are subject to lending limits that prohibit national banks from lending amounts equal to more than 15 percent of the national bank's unimpaired capital and surplus to a single borrower on an unsecured basis, and an additional 10 percent on a secured basis. The national bank lending limits apply only to "loans and extensions of credit," and do not include most of the off-balance sheet

<sup>2</sup> Although a bank's primary correspondent often will buy Fed funds as principal directly from the bank, a correspondent may act as agent to place the funds with another institution. In such agency arrangements, a bank may provide its correspondent with a pre-approved list of institutions with which the correspondent may place the funds. Where a correspondent is acting as the bank's agent in placing Fed funds, the bank's exposure would be to the ultimate purchaser of the funds, not to the correspondent placing the funds on its behalf.

Fed funds sales generally are unsecured. A bank also may provide funds to a correspondent through transactions known as "reverse repurchase agreements," in which the bank provides funds to the correspondent by buying an asset, generally a government security. The correspondent agrees that it will repurchase the asset from the bank at the expiration of a set period, generally overnight, at a repurchase price calculated to compensate the bank for the use of its funds. Unlike Fed funds sales, these transactions are essentially secured transactions.

<sup>3</sup> Although the depository institutions that are parties to transactions in the interbank markets discussed above generally are referred to as "counterparties," the term "correspondent" generally will be used in this discussion to denote any depository institution to which an insured depository institution is exposed.

transactions that may provide significant sources of exposure to correspondents. Additionally, the national bank lending limits do not apply to overnight Fed funds sales, a significant source of short-term exposure to correspondents.

State-chartered banks generally are subject to similar lending limits under state law. Almost all states impose lending limits on the banks they charter. Most of these limits are patterned on the national bank lending limits, although the specific percentages or transactions covered vary. The state limits generally do not apply to a broader range of transactions than the national bank limits, although some states include Fed funds transactions within their limits. A number of states, however, exclude interbank transactions from their lending limits entirely.

Federal savings associations generally are subject to the same limitations on loans to one borrower as national banks, with exceptions for loans under \$500,000 and loans for residential real estate development. 12 U.S.C. 1464(u). In some states, state-chartered savings associations are subject to the same limitations as state-chartered banks, but a significant number of states have no lending limits that apply to savings associations or place no limits on deposits by a savings association with an insured depository institution.

#### Proposed Rule

The Board invites comment on all aspects of the proposed Regulation F, which would implement the provisions of section 38 of FDICIA. The Board's proposed rule is designed to ensure that banks adopt prudent limits on credit and liquidity risks in dealing with another depository institution. The proposed rule requires banks to establish limits on both credit and settlement exposure to each individual correspondent. Banks' assessments of the condition and operation of correspondents and their internal controls on exposure to correspondents are intended to operate as the principal safeguards against excessive exposure to individual correspondents.

The proposed rule also establishes "benchmark" guidelines on the overnight credit exposure to individual correspondents that ordinarily should not be exceeded. The benchmarks are stated as percentages of the exposed bank's capital. The levels of overnight credit exposure considered to be permissible under the benchmarks are tiered based on the capital of the correspondent with which the bank is

dealing, so that higher levels of a bank's capital may be exposed to better capitalized correspondents. These benchmark guidelines normally should not be exceeded, and are intended to establish the maximum credit exposure that ordinarily would be considered to be prudent with respect to a correspondent with a particular level of capital.

The benchmarks, which are based on a measure of credit exposure that excludes certain relatively low-risk transactions, generally would permit a bank to have credit exposure to an individual correspondent in an amount up to 25 percent of the exposed bank's total capital. For a correspondent that a bank can demonstrate is "adequately capitalized," the bank could have credit exposure equal to 50 percent of the bank's total capital, but no more than 25 percent of the bank's capital could be exposed through transactions that have a term to maturity of more than thirty days. No specific benchmark is provided for credit exposure to a correspondent that the bank can demonstrate is "well capitalized."

In all cases, a bank would be expected to establish prudential credit limits internally, either within or in addition to the benchmark limits, and would be expected to place limits on settlement and other risks not addressed by the benchmarks. Although the primary emphasis of the proposed rule is on the prudential limits to be established internally by banks, the benchmarks for credit exposure are intended to prevent banks from undertaking levels of exposure that would not be considered to be prudent by the Board. Where a bank is exposed to a correspondent that is less than adequately capitalized and the correspondent fails, the bank could expect to lose a substantial portion of its credit exposure. Further, it would suffer protracted liquidity problems and uncertainty as to its ultimate loss. A correspondent that is adequately capitalized poses a lesser risk of imminent failure and therefore under the benchmarks banks would be permitted to take larger credit exposures that may be reduced quickly to the 25 percent limit if a correspondent's financial condition deteriorates. Well capitalized institutions generally pose a still lesser risk of failure, although risk is incurred in dealing with any institution. The Board believes that much of the current credit exposure of banks to their correspondents would fall within the benchmarks, although it anticipates that the benchmarks may be constraining in some cases.

**Section-By-Section Analysis**

The following is a section-by-section analysis of the proposed rule. A number of issues concerning the application of the rule are discussed in the context of the relevant section. An additional discussion of issues relating to monitoring, recordkeeping, and compliance is included in the Initial Regulatory Flexibility Analysis.

*Section 206.1 Authority, Purpose and Scope.*

This section states that Part 206 implements section 308 of FDICIA, and that part 206 is intended to limit the risks to insured depository institutions from the failure of depository institutions.

*Section 206.2 Definitions.*

**Bank.** "Bank" is defined to mean an insured depository institution, as defined in section 3 of the Federal Deposit Insurance Act (FDI Act), and therefore includes any bank, savings association, or other institution the deposits of which are insured by the FDIC. This term also includes state or Federal branches of foreign banks that are insured by the FDIC, but does not include credit unions. Although the provisions of the proposed regulation are applicable to depository institutions insured by the FDIC, the term "bank" is substituted in the regulation for clarity.

**Correspondent.** A "correspondent" is an institution to which a bank must limit its exposure under the proposed rule, and includes a "U.S. depository institution" or a "foreign bank" to which the bank has exposure. The capital adequacy guidelines permit a lower risk-weighting for most claims on these institutions.

Although section 23 of the FRA requires that standards be enacted to limit exposure to "depository institutions," that term is not defined in that section and no general definition of the term that would be applicable to section 23 is included in the Federal Reserve Act. With respect to domestic depository institutions, only insured depository institutions are included within the definition of "correspondent," as discussed further under the definition of "U.S. depository institution."

In addition to domestic institutions, the proposed definition of "correspondent" includes depository institutions that are "foreign banks." Insured depository institutions currently have significant exposure to foreign banks. Exposure to foreign banks involves risks to banks that are similar to exposure to domestic correspondents;

consequently, the proposed rule also would apply to exposure to correspondents that are foreign banks.

**Exposure.** The proposed rule defines "exposure" to mean the risks to a bank that its correspondent will not make a payment to complete a transaction in a timely manner, or will not pay an obligation. Exposure includes both the operational and liquidity risks related to the settlement of transactions and risk related to the creditworthiness of a counterparty. Under § 206.3 of the proposed rule, a bank is required to establish internal policies and limits relating to all types of exposure to its correspondents. Section 206.4 of the proposed rule establishes benchmarks for "credit exposure" to correspondents. Section 206.5 of the proposed rule defines "credit exposure." The definition of "credit exposure" does not include operational or liquidity risks or certain transactions that pose only a low credit risk.

**Foreign bank.** The definition of "foreign bank" is based on the criteria used in the risk-based capital guidelines for determining whether claims on a foreign institution may be considered to be claims on a bank, which carry a risk-weighting of 20 percent under the capital guidelines for claims with a remaining term to maturity of one year or less.<sup>4</sup> The criteria used in the capital-adequacy guidelines include foreign banks organized under the laws of any country. The definition is based primarily on whether the foreign institution is engaged in the business of banking, including the receipt of deposits as a substantial portion of its business, whether it has the authority to accept demand deposits, and whether the bank supervisory or monetary authorities of its home country recognize it as a bank.<sup>5</sup> The United States office of a foreign bank would be considered to be part of the foreign bank.

**Primary Federal supervisor.** "Primary Federal supervisor" is defined to have

<sup>4</sup> Long-term claims (claims with a term to maturity of more than one year) against foreign banks organized under the laws of countries that are members of the Organization for Economic Cooperation and Development (OECD) are also weighted at 20 percent. While the lower risk weighting is given to short term claims on any foreign bank, regardless of where the bank is organized, long-term claims against foreign banks that are organized under the laws of countries that are not part of the OECD-based group of countries are weighted at 100 percent. See, e.g., 12 CFR part 208, app. A.

<sup>5</sup> The central bank of a foreign country is not considered to be a "foreign bank" for the purposes of the risk-based capital guidelines, and would not be included within the definition of "foreign bank" for the purposes of the proposed rule.

the same meaning as "appropriate Federal banking agency" under section 3(q) of the FDI Act. The term "primary Federal supervisor" has been substituted for clarity. Under this definition, the primary Federal supervisor means (1) the Comptroller of the Currency for national or District banks and for insured Federal branches of foreign banks, (2) the FDIC for state nonmember banks and insured state-chartered branches of foreign banks,<sup>6</sup> and (3) the Office of Thrift Supervision for savings associations. The Board is the primary Federal supervisor for state member banks. Section 23(e) of the FRA provides that the primary Federal supervisor will be responsible for enforcing compliance with the rules implementing section 23 with respect to the institutions for which it is responsible.

**Quality asset.** The term "quality asset" includes assets that would be of sufficient quality to be used as collateral for transactions with affiliates under section 23A of the FRA. The definition is roughly the obverse of the term "low quality asset" in subsection (b)(10) of section 23A. Assets that are classified, on nonaccrual status, past due by more than thirty days, or that have been renegotiated are excluded, as are assets that have been compromised due to the deteriorating financial condition of the obligor. An asset also would not be considered to be a quality asset if other loans to the same obligor had been classified. This definition excludes from credit exposure an asset on which a correspondent is a secondary obligor, or which results in secondary exposure to the correspondent, as long as the asset would be considered to be a quality asset even in the absence of recourse to the correspondent.

**Subsidiary.** "Subsidiary" has the same meaning that term is given under section 23A of the FRA (12 U.S.C. 371c), and therefore includes any company in which a bank owns or controls 25 percent or more of any class of voting securities. A company in which the election of a majority of directors is controlled by the bank, or a company which the Board has found to be controlled by the bank for the purposes of section 23A of the FRA, also will be considered to be a subsidiary.

**Total capital.** "Total capital" is defined as the total of Tier 1 and Tier 2 capital under the risk-based capital guidelines of a bank's primary Federal supervisor. Tier 1 capital includes core capital elements such as common

<sup>6</sup> The FDIC also may have overlapping responsibilities for insured Federal branches of foreign banks.

stockholder's equity, qualifying noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries, minus goodwill and ineligible intangibles. Tier 2 capital includes perpetual preferred stock and related surplus, hybrid capital instruments, mandatory convertible debt instruments, term subordinated debt and intermediate-term preferred stock and related surplus, and a portion of the bank's allowance for loan and lease losses. "Total capital" is used in section 206.4 of the proposed regulation as the base for calculating the maximum credit exposure that a bank should have to a correspondent.

As noted above, insured branches of foreign banks are "banks" under the proposed rule and are therefore subject to the section 206.4 guidelines on credit exposure. Consistent with the approach of the OCC in applying the national bank lending limits to Federal branches of foreign banks, the § 206.4 guidelines on credit exposure in the proposed regulation would be based on the capital of the entire foreign bank. For foreign banks organized in countries that subscribe to the principles of the Basle Capital Accord, total capital under the proposed rule would include total Tier 1 and Tier 2 capital as calculated under the standards of that country. For foreign banks that are organized in countries that do not subscribe to the principles of the Basle Capital Accord, total capital under the proposed rule would be calculated based on the provisions of the Accord. In either case, a foreign bank would be permitted to apply the accounting conventions permitted by its country of organization in calculating total capital.

*U.S. depository institution.* Under the proposed rule, the term "correspondent" is defined to include both a "foreign bank" and a "U.S. depository institution." As is the case for the term "foreign bank," the definition of "U.S. depository institution" covers only institutions that are considered to be depository institutions for the purposes of the capital adequacy guidelines. "U.S. depository institution" is limited to institutions insured under the FDI Act that are chartered under Federal or state law. "U.S. depository institution" does not include Federal Reserve Banks, Federal Home Loan Banks, or other domestic depository institutions that are not federally insured. The term also does not include insured branches of a foreign bank, as the foreign bank itself is considered to be the correspondent.

Although section 23 of the FRA refers

to exposure to "depository institutions," whether insured or not, application of the proposed rule to exposure to uninsured domestic institutions would provide little benefit in risk reduction while adding significantly to the complexity of the proposed rule. For example, banks may have exposure to uninsured trust companies that are registered clearing agencies. These trust companies are subject to a separate supervisory scheme under the Securities Exchange Act of 1934. This supervisory scheme is intended to control the risk to users of the trust company's services. In some cases these companies are subject to supervision by the Board as member banks. Little benefit would be gained by applying the limits of section 23 to the transactions of insured depository institutions with such uninsured trust companies or similar entities. Further, the purposes and consequently the levels of capital for uninsured trust companies are not comparable to those of insured institutions. For these reasons, the Board finds that it is in the public interest and consistent with the purposes of section 23 to exclude exposure to uninsured domestic institutions from the coverage of the proposed rule, as permitted under section 23(c)(2).

#### *Section 206 General Guidelines Prudential Limits*

The proposed rule requires banks to have policies and procedures to limit the risks posed by transactions with correspondents, taking into account both credit risk and settlement risk. This subsection emphasizes the importance of safe and sound banking practices in transactions with correspondents. Under this subsection, a bank would be required to establish limits on its exposure for each correspondent with which the bank does business, and to review periodically the condition of each correspondent and revise as necessary the limits on exposure to each correspondent. A bank would be required to structure its relations with its correspondents to avoid undue concentrations of exposure to an individual correspondent. A bank should address issues relating to both intraday and overnight exposure in its policies and procedures.

In establishing limits on exposure to a correspondent, the proposed rule requires the bank to evaluate the overall condition and creditworthiness of its correspondent. The bank should not rely solely on the capital ratios of its correspondent, but should assess other factors that can affect a correspondent's

condition and operations.

#### *Monitoring of Exposure*

Under this subsection of the proposed rule, a bank would be required to ensure that its exposure to a correspondent remains within the internal limits the bank has established for exposure ordinarily does not exceed the benchmark guidelines on interday credit exposure established under § 206.4. A bank can meet the requirements concerning monitoring of its limits and guidelines either by structuring its relations with its correspondents so that the limits and guidelines are not exceeded, or by monitoring actual exposure to correspondents.

For example, if the aggregate of the credit facilities approved for a correspondent is less than the benchmark established under § 206.4, then the bank generally would not need to monitor actual outstandings under each facility, as long as it had procedures to ensure that the facilities are not exceeded. If total actual outstandings under the facilities available to a correspondent are likely to exceed the benchmark limit, frequent monitoring would be necessary. If aggregate credit facilities approved for a particular correspondent exceed the limits of § 206.4, but actual outstandings under the facilities are almost always below the limits, monitoring on an *ex post* basis may be adequate.

#### *Section 206.4 Guidelines for Credit Exposure*

In addition to the general requirements for the establishment of internal limits concerning credit risks under § 206.3, § 206.4 of the proposed rule establishes benchmark guidelines on interday credit exposure within which banks ordinarily should remain. The benchmarks established in this section are tiered based on the capitalization of the correspondent. These guidelines would not be rigid limits, such as the national bank lending limits, violations of which may result in director liability for losses attributable to loans exceeding the lending limits. Unlike limits that apply to lending transactions, in which total exposure can be determined at the time the transaction is done, the proposed rule applies to a variety of transactions under which credit exposure cannot be determined or limited readily. For example, credit exposure resulting from many off-balance sheet transactions may increase without any action on the part of the bank as a result of moves in the relevant markets. Because exposure

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under these transactions changes frequently, actual credit exposure is difficult to monitor on a contemporaneous basis. Similarly, credit exposure related to the collection of checks and other cash items also cannot be measured with precision on a contemporaneous basis, as the bank does not have sufficient information to determine whether particular items have been finally paid.<sup>7</sup>

Rigid limits on credit exposure effectively would require a bank to target a much lower level of credit exposure in order to enable the bank to stay within the limits at all times. Such limits also would lend a false sense of precision to the measures of credit exposure used in the proposed rules. For these reasons, the proposed guidelines are structured as benchmarks that would be considered prudent outside limits on credit exposure.

Credit exposure ordinarily should remain within the guidelines, but occasional or inadvertent excesses would not be considered to be a violation of the regulation, provided that credit exposure generally is managed in a manner consistent with the regulation's prudential requirements. For example, occasional excesses resulting from market disturbances, market movements favorable to the bank, unexpected surges in activity in particular areas, or operational difficulties would not be considered to be violations of the regulation. Further, the benchmarks are intended to serve as the outer limits for exposure to correspondents, and are not intended to endorse levels of credit exposure that otherwise would not be considered prudent based on the condition and operations of the correspondent. For example, credit exposure to a correspondent qualifies as adequately capitalized, but that has weaknesses in its management, operations, or loan portfolio, should be at a level below that permitted under the benchmark for credit exposure to an adequately capitalized correspondent.

Many banks already have sophisticated risk management systems that they use to measure exposure. If a bank can demonstrate that its system produces a measurement of risk exposure that is essentially equivalent to the measure of credit exposure used in this rule, it may be able to rely on its systems to demonstrate compliance with

<sup>7</sup> Under FDIC receivership proceedings, checks sent for collection through a bank that fails are not treated as claims on the failed bank unless the checks have been finally paid.

§ 206.4. Additionally, the guidelines apply to credit exposure on an interday basis, that is, overnight credit exposure. The Board recognizes that determining overnight credit exposure may be difficult for banks that have global branch networks and that engage in transactions at almost all times of the day. For such institutions, any reasonable method for determining "interday" credit exposure that is applied on a consistent basis would be sufficient.

#### Well Capitalized Correspondents

No numerical benchmark is established for credit exposure to a correspondent that the bank can demonstrate is "well capitalized," as that term is defined under § 206.6(a)(1) of this part. Although no specific numerical limit would apply to exposure to such institutions, the bank would still be required to meet the general prudential standards under § 206.3 with respect to credit exposure to such correspondents.

#### Adequately Capitalized Correspondents

Under the proposed rule, a bank should limit its total interday credit exposure to a correspondent that the bank can demonstrate is "adequately capitalized," as that term is defined under § 206.6(a)(2) of this part, to 50 percent of the exposed bank's total capital. Within this overall guideline, a separate benchmark for longer term credit exposure would apply, under which a bank should not have credit exposure with a remaining term to maturity of more than thirty days in amounts equal to more than 25 percent of the bank's total capital. For a bank with 50 percent of its capital exposed, therefore, only half of its exposure should have a remaining term to maturity of more than thirty days. This structure recognizes that exposure with a remaining term of thirty days or less can be reduced fairly readily if the condition of a correspondent changes. As with exposure to well capitalized correspondents, credit exposure that meets these guidelines is subject to the general prudential standards.

#### Other Correspondents

The general limit for interday credit exposure to an individual correspondent is 25 percent of a bank's total capital. Except where a bank can demonstrate that its correspondent is adequately or well capitalized, the 25 percent benchmark would apply to a bank's credit exposure to any correspondent. To the extent that a bank can obtain adequate information to demonstrate

that its correspondent is adequately or well capitalized, the higher benchmarks described above would apply. As with exposure to correspondents that the bank can demonstrate are adequately capitalized or well-capitalized, exposure under this guideline is subject to the general prudential standards of § 206.3.

#### Commonly Controlled Depository Institutions

Except for the general prudential standards in § 206.3, a bank need not adhere to the benchmark guidelines for credit exposure to correspondents that are commonly controlled with the bank, and for which the bank would be subject the cross-guarantee provisions of section 206 of the Financial Institution Reform, Recovery, and Enforcement Act (12 U.S.C. 1815(e)). Because an insured depository institution is potentially liable to the FDIC for losses resulting from the failure of a commonly controlled insured depository institution under the cross-guarantee provisions, there is no effective way for a bank that is subject to the proposed rule to limit its credit exposure to an FDIC-insured depository institution that is commonly controlled with the bank.

For the purposes of this section, "commonly controlled" is given a definition similar to but somewhat narrower than that used for the purposes of the cross-guarantee provisions of the FDI Act. Under the FDI Act, banks are commonly controlled if they are controlled by the same holding company or if one bank controls the other. Control exists where there is ownership of 25 percent or more of the voting stock of an entity.<sup>8</sup> Under the cross-guarantee provisions, control also may exist based on ownership interests of less than 25 percent under certain circumstances. For the purposes of the proposed rule, however, banks will be considered to be commonly controlled only if a holding company owned 25 percent or more of the voting stock of each bank, or if one institution owned 25 percent or more of the voting stock of the other.<sup>9</sup>

<sup>8</sup> The standard for "control" under the FDI Act is the standard provided by the Bank Holding Company Act, 12 U.S.C. 1813(w) and 1841.

<sup>9</sup> Although the proposed rule would not apply the benchmark limits on exposure to depository institutions with common ownership of 25 percent or more, depository institutions with common ownership of more than 25 percent would continue to be subject to the limits on transactions with affiliates under sections 23A and 23B of the FRA (12 U.S.C. 371c and 371c-1). Under section 23A, transactions between banks with common ownership of 80 percent or more may be exempt from the section 23A limits on transactions, although these limits continue to apply to

### Exposure of Subsidiaries

A bank must include the credit exposure of its subsidiaries in calculating its credit exposure to a correspondent. "Subsidiary" is defined to include companies in which the bank owns or controls 25 percent or more of the company. A bank may prorate the credit exposure of the subsidiary to reflect the bank's ownership of companies in which it has less than 100 percent ownership.

### Transition Provisions

Where a bank is no longer able to demonstrate that a correspondent is adequately capitalized or well capitalized, including where the bank cannot obtain adequate information concerning the capital ratios of the correspondent, the bank should bring its credit exposure into line with the appropriate benchmark guideline within 30 days of the date when updated information normally would be obtained on the capital ratios of the correspondent. In most instances, this normally would be the date when new Call Report data are available.

### Section 206.5 Computation of Credit Exposure

#### Transactions Generally Included in Credit Exposures

The Board proposes to base the computation of credit exposure for the purposes of the guidelines of § 206.4 on the claims on a correspondent that qualify as assets and off-balance sheet items subject to capital requirements under the capital adequacy guidelines. These assets and off-balance sheet items are given a weighting of 100 percent for the purposes of calculating credit exposure.

The claims covered would include direct extensions of credit, such as demand deposit balances, other deposits, Fed funds sales, and other loans to a depository institution, as well as other transactions that involve the credit risk of a correspondent, such as stand-by letters of credit issued by the bank for the account of a correspondent. Off-balance sheet transactions such as interest rate and foreign exchange rate contracts are included in credit exposure, but only to the extent of the current replacement value. The "add-ons" required for the purposes of risk-

transactions such as those between savings associations that are not owned by a bank holding company or between a bank and its foreign bank parent.

based capital calculations in order to reflect potential future increases in the value of the claims would not be required in determining credit exposure to a correspondent for the purposes of the proposed regulation. Only the market-to-market value of these transactions therefore will be included in the credit exposure calculation.

Settlement risk and other sources of exposure that are not covered by the risk-based capital guidelines are not included in the calculation of credit exposure for the purposes of § 206.4, although these sources of exposure must be addressed under the general prudential standards in § 206.3.

### Netting

Banks may give effect to netting contracts in calculating credit exposure, provided that the netting contracts are valid and enforceable under applicable law. This generally would include transactions under a netting contract between two depository institutions organized in the United States. Netting contracts between financial institutions in the United States generally are valid under the netting provisions of Title IV of FDICIA, sections 401-407.

Other netting contracts also may be considered valid and enforceable. Transactions subject to netting contracts that meet the minimum legal standards recommended in the November 1990 Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries ("Basle Netting Report") for the recognition of cross-border netting contracts may be netted under this subsection. Under the standards established by the Basle Netting Report, a bank must have reasoned legal opinions that the contracts are valid and enforceable under the law of the countries in which the exposed institution and its correspondent are chartered, and where any branches of the institutions that engage in transactions covered by the netting contract are located, as well as the laws that govern the individual transactions subject to the netting contract or any contract or agreement necessary to effect the netting. Such opinions would have to be reviewed periodically to ensure their continued validity.

### Exclusions

Under the proposed rule, "credit exposure" does not include exposure to a correspondent from transactions that the Board believes present little risk to the bank. Consequently, the Board finds

that these exclusions are in the public interest and consistent with the purpose of section 308. The exclusions include certain secured transactions, cash items in the process of collection, and obligations that result in secondary exposure to the correspondent or for which a second obligor in addition to the correspondent is available, as well as the portion of exposure that is covered by Federal deposit insurance.

### Secured Transactions

"Credit exposure" does not include transactions that are fully secured by United States government or agency securities or other readily marketable collateral having a current market value equal to 100 percent of the transactions. As banks do not have the power to pledge collateral generally to cover deposit obligations, the exclusion for secured transactions will result primarily in the exclusion of reverse repurchase agreements, that is, transactions in which the exposed bank has provided funds in exchange for a security which the user of the funds promises to repurchase.

For the purposes of the exclusion, "government security" is defined to include a security that is an obligation of or guaranteed by the United States government or any of its departments, agencies, bureaus, boards, commissions, establishments, or corporations owned by the government. The definition is the same as that used for the purposes of the national bank lending limits. As with the national bank lending limits, transactions secured by government securities of the types listed will be excluded from calculation of exposure.

The definition of "readily marketable collateral" is based on the definition of that term in the Comptroller's lending limits for national banks, and includes financial instruments and bullion that may be sold under ordinary circumstances with reasonable promptness of a fair market value based on actual market transactions. This definition covers instruments of the type listed in the OCC regulation, including stocks, notes, bonds, and debentures traded on a national securities exchange, "OTC margin stocks," commercial paper, negotiable certificates of deposit, bankers' acceptances, and shares in money market and mutual funds in which a security interest may be perfected. Other financial instruments that meet the criteria of the definition also would be covered. Although transactions secured by "readily marketable

collateral" are subject to a 10 percent limit under the national bank lending limits, such transactions would be excluded from the definition of credit exposure for the purposes of the proposed rule.

Although the definition of "government security" used in the national bank lending limits does not include obligations issued or guaranteed by certain United States government-sponsored enterprises such as the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Student Loan Marketing Association (SLMA), such obligations generally would be included within the definition of "readily marketable collateral." In addition to obligations of United States government-sponsored enterprises, such as FNMA, FHLMC, and SLMA, "readily marketable collateral" would include obligations of foreign governments, multilateral lending institutions or regional development banks that may be sold under ordinary circumstances with reasonable promptness at a fair market value based on actual market transactions.

#### Cash Items in the Process of Collection

Banks commonly use correspondents as intermediaries for the collection of checks and other cash items, and typically maintained balances with their correspondents as part of their check collection relationships. The proceeds of a bank's check deposits to an account at a correspondent generally are made available for withdrawal in accordance with an availability schedule of the correspondent. Under the proposed rule, the portion of the balance that has not yet been made available for withdrawal would be excluded from the calculation of exposure.

This treatment reflects the FDIC's treatment of checks and other cash items collected through institutions for which the FDIC is acting as liquidator or receiver. Checks and other cash items on which final payment has not been made at the time of the collecting institution's closure are not treated as deposits subject to the insurance limitation. The FDIC treats the closed correspondent as the agent of the bank with respect to the collection of items that have not been finally paid and passes the proceeds back to the bank.<sup>10</sup>

A bank collecting checks through a correspondent does not have sufficient

information to determine with precision the value of the checks deposited with a correspondent that have not yet been finally paid. This section permits a bank to exclude the portion of its cash letter that its correspondent has not yet made available for withdrawal by that bank from the calculation of credit exposure. The Board believes that the portion of a cash letter that is not yet available to the bank for withdrawal would provide a reasonable estimate of the portion of the bank's deposit that is represented by checks sent for collection that would not have been finally paid, and thus should be excluded from the calculation of credit exposure.

#### Secondary Obligations

Under the purposes of the proposed rule, credit exposure does not include quality assets on which the correspondent is secondarily liable or that result in secondary credit exposure to the correspondent. This exclusion covers transactions such as loans to third parties secured by stock or debt obligations of the correspondent, as well as "two-name paper," such as loans to third parties purchased from the correspondent with recourse or loans or obligations of third parties backed by stand-by letters of credit issued by the correspondent. The asset must be of sufficient quality, based on the credit of the primary obligor without the backing of the correspondent, that the asset generally would be acceptable as collateral based on the standards for transactions with affiliates under section 23A of the FRA. If the quality of an asset or the financial condition of the primary obligor on an asset deteriorates, the asset must be included as credit exposure to the correspondent.

#### FDIC-Insured Deposits

Under the proposed rule, credit exposure does not include the portion of the bank's exposure that is covered by Federal deposit insurance. This exclusion would permit the bank to deduct the \$100,000 deposit insurance coverage from credit exposure relating to deposit account balances at a correspondent that also is insured. This exclusion may not be used to offset credit exposure due to Fed funds sales and other transactions that are not insured.

#### Section 206.6 Capital Level of Correspondents

The benchmark guidelines on credit exposure provided in § 206.4 are tiered based on the level of capitalization of the correspondent, with higher levels of credit exposure permitted for

correspondents that a bank can demonstrate are "adequately capitalized" or "well capitalized." The determination of whether a correspondent is considered "well capitalized" or "adequately capitalized" generally will be based on the risk-based capital and leverage capital ratios of the correspondent. The capital ratios required to meet these classifications are based on the minimum capital ratios proposed for the purposes of the prompt corrective action standards under section 131 of FDICIA,<sup>11</sup> with the exception of the minimum leverage ratio required to be considered "adequately capitalized."

For the purpose of this proposed rule, a correspondent will be considered "adequately capitalized" if the correspondent has a total risk-based capital ratio of 8 percent or greater, a Tier 1 risk-based capital ratio of 4 percent or greater, and a leverage ratio of 4 percent or greater. Although the proposed prompt corrective action standard also permit a bank to be considered "adequately capitalized" with a leverage ratio of only 3 percent if the bank has a composite 1 CAMEL rating and is not experiencing or anticipating significant growth, a bank is not permitted to disclose its CAMEL rating. For this reason, correspondents must meet the 4 percent leverage ratio requirement to be considered "adequately capitalized" for the purposes of this proposed rule.

For the purposes of this proposed rule, a correspondent will be considered "well capitalized" if the correspondent has a total risk-based capital ratio of 10 percent or greater, a Tier 1 risk-based capital ratio of 6 percent or greater, and a leverage ratio of 5 percent or greater. The proposed prompt corrective action standard also requires that the bank not be subject to any final order or directive concerning the bank's capital. This condition is not imposed for the purposes of this regulation, as such information concerning a correspondent may not be available to a bank.

Although the section 23 does not require that exposure to foreign banks be limited under the rule, the proposed rule has included foreign banks as correspondents for prudential reasons. A correspondent that is a foreign bank may be considered "well capitalized" or "adequately capitalized" under this section if it meets the respective capital levels established under the proposed rule, as calculated under the risk-based capital system established by the Basle

<sup>10</sup> 12 CFR 330.4; FDIC Advisory Opinion Nos. 91-75 (Aug. 28, 1991) and 86-28 (October 10, 1986).

<sup>11</sup> 12 U.S.C. 1831o; 57 FR 29226, July 1, 1992.

Capital Accord. It is anticipated that use of these measures will reduce the burden on banks in complying with the standards established by the proposed rule. This treatment also is consistent with the Capital Adequacy Report recently submitted to Congress by the Board and the Department of the Treasury. As discussed in the Report, the risk-based capital measure of capital established under the Basle Capital Accord are generally the most meaningful measure of capital for a foreign bank.

For a correspondent that is a U.S. depository institution, the required ratios generally are calculated in accordance with the capital adequacy guidelines of the correspondent's primary Federal supervisor. For a correspondent that is a foreign bank organized in a country that has adopted the risk-based framework of the Basle Capital Accord, the required risk-based capital ratios are to be calculated in accordance with the capital adequacy guidelines of the supervisory authority of the country in which the correspondent is chartered. For a correspondent that is a foreign bank organized in a country that has not adopted the risk-based framework of the Basle Capital Accord, the required risk-based capital ratios are to be calculated in accordance with the provisions of the Basle Capital Accord.

As calculated under the capital adequacy guidelines of the appropriate Federal regulator, "Leverage ratio" means the ratio of Tier 1 capital to average total consolidated assets. As calculated under the capital adequacy guidelines of the appropriate foreign or domestic supervisory authority or the Basle Capital Accord, "total risk-based capital ratio" means the ratio of qualifying total capital to weighted risk assets. Similarly, "Tier 1 risk-based capital ratio" means the ratio of Tier 1 capital to weighted risk assets. Although the calculation of these ratios and the definitions of the components of the ratios may vary slightly among the capital adequacy guidelines established by the various supervisory authorities, the differences generally are not significant.

The Board understands that banks generally are able to obtain financial information, including risk-based and leverage capital ratios, either from the Call Report or Thrift Financial Report, directly from the depository institutions with which they do business, or from secondary sources, such as bank rating agencies.

For example, the risk-based capital

ratios for domestic banks with assets of over \$1 billion can be calculated from data provided in Schedule RC-R of the Call Report. Domestic banks with assets of less than \$1 billion also are required to complete a portion of Schedule RC-R, which provides a test for determining whether the rest of the Schedule also must be completed. For institutions with assets of less than \$1 billion that are required to complete Schedule RC-R, the institution's risk-based capital ratios can be calculated from the data provided. Additionally, risk-based capital ratios for savings associations may be calculated from the data provided in Schedule CCR of the Thrift Financial Report.

For domestic banks with assets of under \$1 billion that meet the test provided in Schedule RC-R and therefore are not required to complete the Schedule, the portion of the Schedule completed could be relied on for determining that a correspondent has sufficient risk-based capital to meet the minimum risk-based capital ratio requirement to be considered "adequately capitalized." For such institutions, it is not possible currently to calculate risk-based capital more accurately from the Call Report data. The Board anticipates, however, that by the time the benchmarks provided in § 206.4 are fully implemented, a more complete information may be available from the Call Report that will facilitate the calculation of risk-based capital for all domestic depository institutions. For a correspondent that is a foreign bank, the Board anticipates that information on capital ratios will be obtained directly from the foreign bank or from secondary sources.

Banks would be permitted to rely on capital ratios calculated from Call Report or Thrift Financial Report data or obtained directly from the correspondent or from secondary sources for the purposes of the proposed rule. A bank would be expected to use the most recently available information, which should be updated as new Call Reports or equivalent information become available publicly or from the correspondent. For domestic correspondents, updated information is available on a quarterly basis.<sup>12</sup> Where a bank cannot routinely obtain updated information on a timely basis, the bank should not rely on the information as a basis for using the higher benchmark

<sup>12</sup> Where a correspondent that is a foreign bank closes its books on a semiannual basis, information on capital ratios would not have to be obtained more frequently than semiannually.

guidelines provided for adequately capitalized correspondents or as a basis for considering a correspondent to be well capitalized.

*Section 206.7 Waiver*

The waiver provision provides the Board with the flexibility to deal with situations in which a bank cannot reasonably comply with the benchmark guidelines established in § 206.6 of the proposed rule. Use of the waiver would require the bank's primary Federal supervisor to advise the Board that the bank cannot reasonably obtain correspondent services while remaining within the benchmark guidelines. The waiver authority is intended to be used in very limited circumstances, such as where a bank's capital has been impaired to the point that the capital-based benchmark guidelines are too small to permit the institution to transact adequate business with its correspondents.

*Section 206.8 Record Retention*

A bank would be required to maintain records to demonstrate its compliance with both the prudential standards and the numerical benchmark guidelines. With respect to the general prudential standards of § 206.3, a bank should be able to demonstrate that it has instituted the appropriate policies and procedures and undertaken the necessary analysis for all of the correspondents with which it does business, and has maintained credit risk and settlement exposure within internally established limits. For the guidelines of § 206.4, a bank will need to maintain records to demonstrate that its credit exposure was ordinarily within the limits only for correspondents for which the bank's internal limits permit credit exposure in excess of the numerical benchmarks.

Issues relating to recordkeeping are discussed below in more detail as part of the Board's Initial Regulatory Flexibility Analysis.

*Section 206.9 Transition Provisions*

This section provides for a two-year transition period following the effective date of the final rule. The Board expects that the final rule will be effective on December 19, 1992. During the first year after the effective date, banks would be expected to be in compliance with the prudential standards required under § 206.3. During the second year, § 206.4 would apply, but with twice the stated numerical benchmarks. For this period, therefore, overall credit exposure to correspondents that a bank can

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demonstrate are adequately capitalized ordinarily should be limited to 100 percent of the exposed bank's total capital, and credit exposure with a term to maturity of more than 30 days should be limited to 50 percent of total capital. Credit exposure to correspondents other than those a bank can demonstrate are adequately capitalized or well capitalized should be limited to 50 percent of the exposed bank's capital. Beginning in December 1994, the final benchmark guidelines would apply.

#### Competitive Analysis

The Board's procedures for conducting a competitive impact analysis are described in policy statement titled "The Federal Reserve in the Payments System," which was revised in March 1990. 55 FR 11648, March 29, 1990. In its consideration of a proposed regulatory change that would have a substantial effect on payments-system participants, the Board assesses whether the proposed change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve Banks in providing similar services due to differing legal powers or constraints or due to a dominant market position of the Federal Reserve Banks deriving from such legal differences.

The proposed rule does not limit credit exposure of a bank to Federal Reserve Banks because such exposure does not pose a risk to the bank. Similarly, the proposed rule does not impose quantitative limits on a bank's credit exposure to a "well capitalized" correspondent because this exposure generally poses little risk to the bank. However, the proposed rule imposes three substantive requirements on a bank's exposure to a well capitalized correspondent that are not imposed on a bank's exposure to a Federal Reserve Bank.

First, under § 206.3(a), a bank must have policies and procedures to limit exposure due to transactions with a well capitalized correspondent. Second, under § 206.3(b), a bank must either structure transactions with or monitor exposure to a well capitalized correspondent to ensure that exposure ordinarily remains within the internal limits established by the bank under § 206.3(a). Third, under § 206.4, a bank must be able to routinely obtain sufficient information to demonstrate that the correspondent is well capitalized.

Banks would be subject to more stringent requirements with respect to credit exposure to correspondents that are not well capitalized. In these cases,

a bank would be required to limit its credit exposure to an individual correspondent to 25 percent or 50 percent of the bank's capital, based on whether the bank can demonstrate that the correspondent is adequately capitalized. To the extent that a bank determines that the rule's requirements are burdensome and/or costly to implement, the bank may choose to be exposed, where practical, to a Federal Reserve Bank rather than to a correspondent.

Due to these requirements, which would be applicable to a bank's exposure to a correspondent, but not to exposure to a Federal Reserve Bank, the proposed rule may have a direct and material adverse effect on the ability of correspondents to compete effectively with the Federal Reserve in providing payment services, and in particular check collection services.<sup>13</sup> Small banks that collect their checks through a correspondent, rather than through a Federal Reserve Bank, often sell Fed funds to or through the correspondent and obtain other services from that correspondent. To the extent that a bank's aggregate activity with a correspondent exceeds the applicable internal limit or the appropriate benchmark guideline for the bank's credit exposure to the correspondent, the bank would be required to diversify and/or reduce its credit exposure.

Since many small banks collect their checks through one correspondent, diversifying credit exposure could entail shifting all of the bank's check collection business to another correspondent or to a Federal Reserve Bank. Alternately, a bank could reduce its credit exposure by altering its check collection and/or Fed funds relationship with its correspondent. For example, a bank could reduce or eliminate the collected balances held at the correspondent by paying for its check collection services to a greater extent with explicit fees, rather than through earnings credits on compensating balances. A bank also could sell a greater proportion of its Fed funds through the correspondent as agent, rather than directly to the correspondent as principal.

Nevertheless, to the extent that the proposed rule has a potential adverse effect on other correspondents, this adverse effect would be due to the differing legal powers of the Federal Reserve Banks, which make them

<sup>13</sup> The proposed rule may adversely affect, to a lesser extent, other service providers' ability to compete with the Federal Reserve Banks in offering other payment services, such as noncash collection and settlement services.

effectively immune to failure. Given that the potential adverse competitive effects of the proposed rule are due to legal differences between the Federal Reserve Banks and depository institutions, the Board assessed the provisions of the proposed rule and whether the proposal's objectives could be reasonably achieved with a lesser or no adverse competitive impact.

The objective of the proposed rule is to limit the risks that the failure of a correspondent would pose to exposed banks. The structure of the proposed rule minimizes any adverse competitive effects the rule may have on correspondents that provide payment services. Specifically, the proposed rule does not impose rigid limits on credit exposure, and generally permits a higher level of credit exposure to correspondents with higher capital levels. In addition, the proposed rule excludes cash items in the process of collection from the calculation of credit exposure to a correspondent. The Board believes that the objective of the proposed rule would not be met if the remaining requirements, described above, did not apply to exposures to well-capitalized correspondents. Moreover, the Board believes that no purpose would be served by imposing the proposed rule's requirements on exposures to Federal Reserve Banks, as there is, in effect, no risk that a Federal Reserve Bank would fail and cause a loss to an institution.

In sum, the Board believes that the provisions of the proposed rule are necessary to fulfill the statutory objectives even though they may adversely affect the ability of correspondents to compete with the Federal Reserve Banks in providing check collection and other payment services.

#### Initial Regulatory Flexibility Analysis

Section 603 of the Regulatory Flexibility Act (Pub. L. 96-354, 5 U.S.C. 601 *et seq.*) requires an agency publishing a proposed rule also to publish for comment an initial regulatory flexibility analysis containing: (1) A description of the reasons why the proposed rule is being considered; (2) a statement of the objectives of, and legal basis for, the proposed rule; (3) a description of the small entities to which the proposed rule would apply, and an estimate of their number, if feasible; (4) a description of projected reporting, recordkeeping, and compliance requirements of the proposed rule, including an estimate of the classes of small entities that will be subject to the requirements and the type

of professional skills required to prepare the reports or records; (5) an identification of Federal rules that may duplicate, overlap, or conflict with the proposed rule; and (6) a discussion of significant alternatives considered. Items 1, 2, and 5 are discussed in the Supplementary Information above.

As required by section 308 of FDICIA, the proposed rule would apply to all depository institutions insured by the FDIC, regardless of size. Approximately 8,500 of these depository institutions could be considered to be "small entities."<sup>14</sup>

The primary recordkeeping and compliance requirements under the proposed rule relate to (1) the establishment and monitoring of internal limits on exposure to correspondents under § 206.3, and the recordkeeping required to demonstrate compliance with this section, and (2) compliance with and recordkeeping required to demonstrate compliance with the numerical benchmarks established for credit exposure in § 206.4.

The Board anticipates that compliance with the requirements of § 206.3 for the establishment of internal limits on exposure to individual correspondents will not be excessively burdensome, as most banks already examine the creditworthiness of the correspondents with which they do business, and establish internal limits on exposure to these institutions. Smaller banks, which do business with a limited number of correspondents and which are not likely to have significant off-balance sheet exposure should bear a minimum burden in meeting the requirements.

Recordkeeping required to demonstrate compliance with the requirements of § 206.3 will include maintaining up-to-date credit files on each correspondent with the appropriate limits on exposure to the correspondent reflected in the files. A bank also will need to demonstrate that it generally has maintained its exposure to its correspondents within the internal limits established under § 206.3. For smaller banks, exposure normally will consist of deposits with or Fed funds sold to other depository institutions, and the total exposure to a correspondent should equal the total of the bank's "due from"

and "Fed funds sales" accounts for the correspondent. The recordkeeping required for larger institutions with more diverse sources of exposure will be more complex. The Board anticipates that compliance with a bank's internal limits can be demonstrated by the record systems already maintained by many banks for their own internal use. Some banks, particularly those that do not have integrated information systems, may need to develop more extensive recordkeeping systems.

More extensive recordkeeping may be required to demonstrate compliance with the benchmark guidelines for credit exposure under § 206.4. If a bank has credit exposure to an individual correspondent equal to more than 25 percent of the bank's capital, the bank will need to maintain current information to demonstrate that the correspondent to which the bank is exposed meets the criteria established for the higher numerical benchmarks. While in many cases the Board anticipates that this information will be provided to the bank by its correspondents, the bank may have to obtain this information from other sources in some instances.

For small banks, the recordkeeping required to demonstrate compliance with the guidelines established by § 206.4 generally will be the same as that described with respect to § 206.3. For larger banks, which have more diverse sources of credit exposure to other depository institutions, more comprehensive recordkeeping may be required to demonstrate compliance, particularly if the bank currently does not maintain consolidated records of outstandings under all facilities available to a correspondent. Additionally, many banks have developed sophisticated risk management systems that may measure exposure and risk differently than the proposed rule. These banks may not be able to determine their "credit exposure," as measured by the proposed rule, using their current risk management and information systems. To the extent that a bank can demonstrate the relationship between exposure measurements produced by its existing system and the measurement of credit exposure used in this rule, a bank may be able to rely on the existing systems to demonstrate compliance with § 206.4.

The Board does not anticipate that any specialized professional skills beyond those already utilized by depository institutions will be required to prepare the required recordkeeping.

Additionally, the Board anticipates that in some instances the proposed rule would require a bank to reduce its credit exposure to a correspondent below current levels, and that this reduction may result in additional costs to the bank. As discussed above in the Competitive Analysis, banks may have to diversify their exposure across a larger number of correspondents, compensate their correspondents through fees rather than compensating balances, and/or sell Fed funds through agency arrangements rather than directly to their principal correspondents. Market developments such as these may result in an overall increase in the costs of correspondent services to insured depository institutions.

The proposed rule also is expected to have an impact on certain providers of correspondent services, known as "bankers' banks," which provide services only to other depository institutions. The depository institutions to which bankers' banks provide services are often also the owners of the bankers' bank, and often use the bankers' bank for all their correspondent services, resulting in levels of exposure to the bankers' bank that may exceed the benchmarks established in the proposed rule. Although the Board believes that many bankers' banks are likely to be considered to be well capitalized, in some cases a bankers' bank may have to raise additional capital in order to meet the standard for "well capitalized" to enable the banks that own the bankers' bank to continue using the bankers' bank as their primary or sole correspondent. The Board does not anticipate that raising such capital will be prohibitively costly for most bankers' banks, as they are owned by the same institutions to which they provide services.

The Board considered several alternative structures in developing the proposed rule. For example, the Board initially considered more rigid limits on exposure. Because of the difficulty of monitoring and complying with rigid limits, however, the primary emphasis of the proposed rule focuses on prudential standards and guidelines for permissible credit exposure. The Board also considered a more liberal structure under which banks would be permitted to determine their own limits on exposure in all cases. This alternative was rejected because it would have permitted banks to expose a significant portion of their capital to an

<sup>14</sup> This figure is based on a determination made by the Small Business Administration (SBA) that financial institutions with less than \$100 million in assets are considered to be "small entities" by the SBA, 13 CFR 121.1401. This determination was made for the purpose of government contracting requirements, and no determination of size requirements for financial institutions have been made by the SBA for other purposes.

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undercapitalized correspondent and thereby to risk failure in the event of the failure of the correspondent.

**Paperwork Reduction Act Analysis**

In accordance with section 3507 of the Paperwork Reduction Act of 1980 (44 U.S.C. 35; 5 CFR 1320.13), the proposed recordkeeping requirements will be reviewed by the Board under the authority delegated to the Board by the Office of Management and Budget after consideration of the comments received during the public comment period. A detailed description of the proposed recordkeeping requirements (including the reasons for the requirements and the institutions that would be subject to them) is contained elsewhere in this notice.

**List of Subjects in 12 CFR Part 206**

Banks, banking, Interbank liability, Lending limits, Reporting and recordkeeping requirements, Savings associations.

For the reasons set forth in the preamble, and pursuant to the Board's authority under section 23 of the Federal Reserve Act, 12 U.S.C. 371b-2, the Board is proposing to add 12 CFR part 206 to read as follows:

**PART 206—LIMITATIONS ON INTERBANK LIABILITIES**

- Sec.
- 206.1 Authority, purpose, and scope.
- 206.2 Definitions.
- 206.3 Prudential standards.
- 206.4 Guidelines for credit exposure.
- 206.5 Credit exposure.
- 206.6 Capital levels of correspondents.
- 206.7 Waiver.
- 206.8 Record retention.
- 206.9 Transition provisions.

Authority: Section 308 of Pub. L. 102-242; 105 Stat. 2236 (12 U.S.C. 371b-2).

**§ 206.1 Authority, purpose, and scope.**

(a) *Authority and purpose.* This part (Regulation F, 12 CFR Part 206) is issued by the Board of Governors of the Federal Reserve System (Board) to implement section 308 of the Federal Deposit Insurance Corporation Improvements Act of 1991 (Act), 12 U.S.C. 371b-2. The purpose of the regulation is to limit the risks that the failure of a depository institution would pose to insured depository institutions.

(b) *Scope.* This part applies to all depository institutions insured by the Federal Deposit Insurance Corporation.

**§ 206.2 Definitions.**

As used in this part, unless the context requires otherwise:

(a) *Bank* means an insured depository institution, as defined under section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

(b) *Correspondent* means a U.S. depository institution or a foreign bank, as defined in this part, to which a bank has exposure.

(c) *Exposure* means the risk that payment to complete a transaction will not be made in a timely manner, or that an obligation will not be paid in full. "Exposure" includes the operational and liquidity risks related to the settlement of transactions and risk related to the creditworthiness of a correspondent.

(d) *Foreign bank* means an institution that:

- (1) Is organized under the laws of a country other than the United States;
- (2) Engages in the business of banking;
- (3) Is recognized as a bank by the bank supervisory or monetary authorities of the country of the bank's organization;
- (4) Receives deposits to a substantial extent in the regular course of business; and
- (5) Has the power to accept demand deposits.

(e) *Primary Federal supervisor* has the same meaning as the term "appropriate Federal banking agency" in section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)).

(f) (1) *Quality asset* means an asset:  
(i) That is not in a nonaccrual status;  
(ii) On which principal or interest is not more than thirty days past due; and  
(iii) Whose terms have not been renegotiated or compromised due to the deteriorating financial condition of the primary obligor.

(2) An asset will not be considered to be a "quality asset" if any other loans to the primary obligor on the asset have been classified as "substandard," "doubtful," or "loss" or treated as "other loans specially mentioned" in the most recent report of examination or inspection of the bank or an affiliate prepared by either a Federal or a state supervisory agency.

(g) *Subsidiary* has the same meaning given that term under section 23A of the Federal Reserve Act (12 U.S.C. 371c).

(h) *Total capital* means the total of a bank's Tier 1 and Tier 2 capital under the risk-based capital guidelines provided by the bank's primary Federal supervisor. For an insured branch of a foreign bank organized under the laws of a country that subscribes to the principles of the Basle Capital Accord, "total capital" means total Tier 1 and Tier 2 capital as calculated under the standards of that country. For an

insured branch of a foreign bank organized under the laws of a country that does not subscribe to the principles of the Basle Capital Accord, "total capital" means total Tier 1 and Tier 2 capital as calculated under the provisions of the Accord.

(i) *U.S. depository institution* means a federally-insured depository institution chartered in the United States under Federal or state law, and includes an insured national bank, state bank, District bank, or savings association, as those terms are defined under section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813), but does not include an insured branch of a foreign bank.

**§ 206.3 Prudential standards.**

(a) *Internal limits.* A bank shall establish and maintain policies and procedures to limit its exposure to the correspondents with which it does business. Banks shall establish and periodically review and revise, as necessary, limits on exposure to individual correspondents based on an evaluation of the overall financial condition and other factors bearing on the creditworthiness of each correspondent. The bank shall structure these limits to avoid undue concentration of settlement or credit risk with respect to any individual correspondent.

(b) *Monitoring.* A bank shall structure transactions with a correspondent or monitor exposure to a correspondent to ensure that its exposure does not exceed its internal limits established under § 206.3(a) and that its credit exposure ordinarily does not exceed any applicable guidelines specified in § 206.4.

**§ 206.4 Guidelines for credit exposure.**

(a) In addition to the prudential limits on exposure established by a bank under § 206.3, a bank ordinarily is expected to maintain credit exposure to an individual correspondent, as calculated under § 206.5, within the guidelines in paragraphs (a) (1) through (3) of this section, except as provided in paragraph (b) of this section.

(1) *Well-capitalized correspondents.* Except as otherwise provided in § 206.3, a bank need not limit its credit exposure to a correspondent that the bank can demonstrate is well capitalized, as defined in § 206.6.

(2) *Adequately-capitalized correspondents.* A bank ordinarily should limit its daily interday credit exposure to a correspondent that the bank can demonstrate is adequately capitalized, as defined in § 206.6, to an amount equal to not more than 50

percent of the bank's total capital. For such a correspondent, the bank also ordinarily should limit its daily interday credit exposure with a remaining term to maturity of more than 30 days to an amount equal to not more than 25 percent of the bank's total capital.

(3) *Other correspondents.* A bank should ordinarily limit its daily interday credit exposure to any other correspondent to an amount equal to not more than 25 percent of the bank's total capital.

(b) *Commonly controlled insured depository institutions.* A bank need not limit its credit exposure to a correspondent that is commonly controlled with the bank and for which the bank is subject to liability under section 5(e) of the Federal Deposit Insurance Act. A correspondent shall be considered to be commonly controlled with the bank if:

(1) 25 percent or more of any class of voting securities of the bank and the correspondent are owned, directly or indirectly, by the same depository institution or company; or

(2) Either the bank or the correspondent owns 25 percent or more of any class of voting securities of the other.

(c) *Exposure of subsidiaries.* In calculating credit exposure to a correspondent under this part, a bank shall include the credit exposure of the bank's subsidiaries to the correspondent. If the bank does not own 100 percent of the shares of the subsidiary, the bank's credit exposure shall include a *pro rata* portion of the subsidiary's exposure. The *pro rata* portion shall be based on the percentage ownership of the bank in the subsidiary.

(d) *Transition provisions.* Where a bank is no longer able to demonstrate that a correspondent is adequately capitalized or well capitalized for the purposes of § 206.4(a) (1) or (2), including where the bank cannot obtain adequate information concerning the capital ratios of the correspondent, the bank should reduce its credit exposure to the appropriate level under § 26.4(a) within 30 days after the date when current Call Report or other relevant financial data normally would be available.

**§ 206.5 Credit exposure.**

(a) *Scope of credit exposure.* Except as provided in § 206.5 (b) and (c), the credit exposure of a bank to a correspondent shall consist of the bank's assets and off-balance sheet items that are subject to capital requirements under the capital adequacy guidelines of the bank's

primary Federal supervisor, and that involve claims on the correspondent. For this purpose, off-balance sheet items shall be valued on the basis of current exposure.

(b) *Netting.* Transactions covered by netting agreements that are valid and enforceable under all applicable laws may be netted in calculating exposure.

(c) *Exclusions.* Credit exposure to a correspondent does not include:

(1) Transactions, including reverse repurchase agreements, that are fully secured by government securities or readily marketable collateral having a current market value equal to 100 percent of the credit exposure under the transaction. For the purpose of this exclusion, "government securities" means obligations of, or obligations fully guaranteed as to principal and interest by, the United States government or any department, agency, bureau, board, commission, or establishment of the United States, or any corporation wholly owned directly or indirectly by the United States. "Readily marketable collateral" means financial instruments or bullion that may be sold in ordinary circumstances with reasonable promptness at a fair market value determined by quotations based on actual transactions on an auction or a similarly available daily bid- and ask-price market;

(2) The proceeds of checks and other cash items deposited in an account at a correspondent that are not yet available for withdrawal;

(3) Quality assets on which the correspondent is secondarily liable or that result in secondary exposure to the correspondent, including:

(i) Loans to third parties secured by stock or debt obligations of the correspondent;

(ii) Loans to third parties purchased from the correspondent with recourse;

(iii) Loans or obligations of third parties backed by stand-by letters of credit issued by the correspondent; and

(4) The portion of the bank's credit exposure to the correspondent that is covered by Federal deposit insurance.

**§ 206.6 Capital levels of correspondents.**

(a) For the purpose of this part, a correspondent will be considered:

(1) "Well capitalized" <sup>1</sup> if the correspondent has:

(i) A total risk-based capital ratio of 10.0 percent or greater;

<sup>1</sup> As used in this part, the term "well capitalized" is similar but not identical to the definition of that term as used for the purposes of the prompt corrective action standards, as proposed at 57 FR 29226, July 1, 1992, under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1891) (prompt corrective action standards).

(ii) A Tier 1 risk-based capital ratio of 6.0 percent or greater; and

(iii) A leverage ratio of 5.0 percent or greater.

(2) "Adequately capitalized" <sup>2</sup> if the correspondent has:

(i) A total risk-based capital ratio of 8.0 percent or greater;

(ii) A Tier 1 risk-based capital ratio of 4.0 percent or greater; and

(iii) A leverage ratio of 4.0 percent or greater.

(b) A correspondent that is a foreign bank may be considered "well capitalized" or "adequately capitalized" under this section without regard to the minimum leverage ratios required under paragraphs (a)(1)(iii) and (a)(2)(iii) of this section.

(c) *Definitions.* For the purpose of this section:

(1) *Leverage ratio* means the ratio of Tier 1 capital to average total consolidated assets, as calculated in accordance with the capital adequacy guidelines of the correspondent's primary Federal supervisor.

(2) *Total risk-based capital ratio* means the ratio of qualifying total capital to weighted risk assets. "Tier 1 risk-based capital ratio" means the ratio of Tier 1 capital to weighted risk assets. For a correspondent that is a U.S. depository institution, the ratios shall be calculated in accordance with the capital adequacy guidelines of the correspondent's primary Federal supervisor. For a correspondent that is a foreign bank organized in a country that has adopted the risk-based framework of the Basle Capital Accord, the ratio shall be calculated in accordance with the capital adequacy guidelines of supervisory authority of the country in which the correspondent is chartered. For a correspondent that is a foreign bank organized in a country that has not adopted the risk-based framework of the Basle Capital Accord, the ratios shall be calculated in accordance with the provisions of the Basle Capital Accord.

**§ 206.7 Waiver.**

The Board may waive the application of § 206.4(a) to a bank if the primary Federal supervisor of the bank advises the Board that the bank is not reasonably able to obtain necessary services, including payment-related services and placement of funds, without incurring exposure to a correspondent in excess of otherwise applicable limits.

<sup>2</sup> As used in this part, the term "adequately capitalized" is similar but not identical to the definition of that term as used for the purposes of the prompt corrective action standards.

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**§ 206.8 Record retention.**

Banks shall establish recordkeeping reasonably designed to demonstrate compliance with the provisions of §§ 206.3 and 206.4.

**§ 206.9 Transition provisions.**

(a) For a period of one year beginning on December 19, 1992, a bank shall comply with the prudential standards required under § 206.3(a), and under § 206.3(b) shall structure transactions with a correspondent or monitor exposure to a correspondent to ensure

that its exposure does not exceed its internal limits established under § 206.3(a). During this period, a bank need not meet the guidelines for credit exposure established under § 206.4 or monitor credit exposure under § 206.3(b).

(b) For a period of one year beginning on December 19, 1993, the overall guideline for credit exposure to an adequately capitalized correspondent contained in § 206.4(a)(2) is changed to 100 percent of the bank's total capital, with the guideline for credit exposure

having a remaining term to maturity of more than 30 days changed to 50 percent of the bank's capital. The guideline on credit exposure to an individual correspondent contained in § 206.4(a)(3) is changed to 50 percent of the exposed institution's total capital.

By order of the Board of Governors of the Federal Reserve System, July 13, 1992.

**William W. Wiles,**

*Secretary of the Board.*

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