# FEDERAL RESERVE BANK
# OF NEW YORK

[ Circular No. **10609**
January 7, 1993 ]

## New Regulation F — Limitations on Interbank Liabilities

*Effective December 19, 1992*

*To All Insured Depository Institutions, and Others
Concerned, in the Second Federal Reserve District:*

The following is quoted from a statement issued by the Board of Governors of the Federal Reserve System:

> The Federal Reserve Board has issued in final form a new Regulation F, Limitations on Interbank Liabilities. The final rule implements the interbank liability provisions under section 308 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).
>
> The final rule generally would require banks, savings associations, and branches of foreign banks with deposits insured by the Federal Deposit Insurance Corporation (FDIC) to develop and implement prudential policies and procedures to evaluate and control exposure to their correspondent banks.
>
> The rule also establishes a regulatory limit that requires that a bank ordinarily limit its overnight credit exposure to an individual correspondent that is less than "adequately capitalized" to not more than 25 percent of the exposed bank's total capital. No express regulatory limits are provided for credit exposure to correspondents that are at least "adequately capitalized," although such exposure is subject to prudential policies and procedures.
>
> The final rule provides for an extended transition for implementation of the rule. The requirements for prudential policies and procedures go into effect on June 19, 1993. The regulatory limit on credit exposure to an individual correspondent is phased in, with the limit set at 50 percent of the exposed bank's capital for a one year period beginning on June 19, 1994, and reduced to 25 percent as of June 19, 1995.

Enclosed — for all insured depository institutions and others who maintain sets of the Board's regulations — is the text of the new Regulation F, as published in the *Federal Register* of December 18, 1992. Additional, single copies may be obtained at this Bank (33 Liberty Street) from the Issues Division on the first floor, or by calling our Circulars Division (Tel. No. 212-720-5215 or 5216). Questions concerning the new regulation may be directed to our Domestic Banking Department (Tel. No. 212-720-2181).

E. GERALD CORRIGAN,
*President.*

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## REGULATION F
## LIMITATIONS ON INTERBANK LIABILITIES
Docket No. R-0769

*Effective December 19, 1992*

[Enc. Cir. No. 10609]

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**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:** Final rule.

**SUMMARY:** The Board is publishing in final a new Regulation F, Interbank Liabilities. The final rule implements section 308 of the Federal Deposit Insurance Corporation Improvement A[illegible] of 1991 (FDICIA), which requires the Board to prescribe standards to limit [illegible] risks posed by exposure of insured depository institutions to other depository institutions. The final rule applies to banks, savings associations,

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and branches of foreign banks with deposits insured by the Federal Deposit Insurance Corporation (FDIC).

The final rule generally requires insured banks, savings associations, and branches of foreign banks, referred to collectively as "banks," to develop and implement internal prudential policies and procedures to evaluate and control exposure to the depository institutions with which they do business, referred to as "correspondents."

The rule also establishes a general "limit" stated in terms of the exposed bank's capital, for overnight "credit exposure" to an individual correspondent, as defined by the rule. Under the rule, a bank ordinarily should limit its credit exposure to an individual correspondent to an amount equal to not more than 25 percent of the exposed bank's total capital, unless the bank can demonstrate that its correspondent is at least "adequately capitalized." No limit is specified by the rule for credit exposure to correspondents that are at least "adequately capitalized," but a bank is required to establish and follow its own internal policies and procedures with regard to exposure to all correspondents, regardless of capital level.

The final rule provides for a thirty-month transition period after the effective date for full implementation of the rule. Banks must have in place the internal policies and procedures required by the rule on June 19, 1993. The regulatory limit on credit exposure to correspondents that a bank cannot demonstrate are at least "adequately capitalized" will be phased in, with the limit set at 50 percent of the exposed bank's capital for a one-year period beginning on June 19, 1994, and reduced to 25 percent as of June 19, 1995.

**EFFECTIVE DATE:** December 19, 1992.

**FOR FURTHER INFORMATION CONTACT:** Oliver Ireland, Associate General Counsel (202/452–3625), Lawranne Stewart, Attorney (202/452–3513), or Manley Williams-Stander, Legal Assistant (202/452–5565), Legal Division; or Stephen Lovette, Manager (202/452–3622), or Derek L. Young, Supervisory Financial Analyst (202/452–2960), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. For the hearing impaired *only*, *Telecommunications Device* for the Deaf (TDD), Dorothea Thompson (202/452–3544), Board of Governors of the Federal Reserve System, 20th & C Streets, NW., Washington, DC 20551.

**SUPPLEMENTARY INFORMATION:** On July 20, 1992, the Board published for comment a proposed Regulation F, Interbank Liabilities, to implement section 308 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). 57 FR 31974, July 20, 1992. Section 308, which added a new section 23 to the Federal Reserve Act (FRA), 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.

## Summary of the Proposed Rule

The Board's proposed rule was designed to ensure that banks adopt prudent limits on credit and liquidity risks in dealing with other depository institutions. The proposed rule required banks to establish limits on both credit and settlement exposure to each individual correspondent. The proposed rule also established "benchmark" guidelines on the overnight credit exposure to individual correspondents that ordinarily should not be exceeded. The benchmark guidelines were stated as percentages of the exposed bank's capital. The levels of overnight credit exposure considered to be permissible under the benchmarks were 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. The benchmark guidelines under the proposed rule were 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 benchmark guidelines, which were based on a measure of credit exposure that excluded certain relatively low-risk transactions, generally permitted 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 could demonstrate is "adequately capitalized," the bank could have credit exposure under the proposed rule 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 with a term to maturity of more than thirty days. No specific benchmark guideline was provided under the proposed rule for credit exposure to a correspondent that the bank could demonstrate was "well capitalized."

## Summary of Final Rule

The final rule continues to require that a bank adopt internal policies and procedures to address exposure to correspondents, and includes a "regulatory limit" for exposure to correspondents that are less than adequately capitalized. As with the proposed rule, "correspondent" includes both domestically chartered depository institutions that are federally insured and foreign banks. The Board has made several significant modifications to the proposed rule, however, in order to improve the effectiveness of the rule and to reduce burdens identified by the comments.

### *Prudential Standards*

The final rule provides greater detail concerning the prudential standards in order to clarify the rule's requirements for internal policies and procedures to identify and control risk. Under the final rule, a bank is required to adopt internal policies and procedures to address the risk arising from exposure to a correspondent, taking into account the financial condition of the correspondent and the size, form, and maturity of the exposure. The final rule allows banks to adopt flexible policies and procedures to meet this requirement in order to permit banks to allocate resources in a manner that will result in real reductions in risk, while minimizing the burden of compliance with the rule.

The final rule requires a bank to maintain written policies and procedures to prevent excessive exposure to any individual correspondent in relation to the financial condition of the correspondent. Under the final rule, a bank's board of directors must review annually the bank's policies and procedures concerning correspondents, but need not approve individual correspondent relationships. The policies and procedures adopted by the board must provide for consideration of credit and liquidity risks, including operational risks, in establishing and maintaining relationships with correspondents. Where a bank's exposure to a correspondent is significant, considering the size and maturity of the exposure and the condition of the correspondent, the bank must periodically review the financial condition of the correspondent. The final rule does not require periodic review of the financial condition of all correspondents. For example, the final rule does not require periodic review of the financial condition of a correspondent to which the bank has only insignificant levels of exposure, such as small balances maintained for clearing purposes.

The final rule requires that a bank take into account any deterioration in

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the condition of a correspondent in evaluating the creditworthiness of the correspondent, and lists other factors that have a bearing on the financial condition of the correspondent. A bank may base its review of the financial condition of a correspondent on publicly available information, such as call reports, Thrift Financial Reports, Uniform Bank Performance Reports, or annual reports.[1] The final rule generally does not require a bank to obtain non-public information on which to base its analysis of the financial condition of a correspondent.[2]

The final rule provides that a bank may rely on another party, such as its bank holding company, a bank rating agency, or another correspondent, to provide financial analysis of a correspondent, as long as the bank has reviewed the assessment criteria used by that party. Additionally, a bank may rely on its bank holding company to select and monitor correspondents, or on a correspondent, such as a bankers' bank, to choose other correspondents with which to place the bank's federal funds, as long as the bank has reviewed and approved the selection criteria used.

The final rule requires that a bank establish internal limits on exposure only where the financial condition of the correspondent and the form or maturity of the exposure create a significant risk that payments will not be made as contemplated. Limits must be consistent with the risk undertaken, but may be flexible, based on factors such as the level of monitoring of the exposure and the condition of the correspondent. The final rule also provides that a bank need not set one overall limit on exposure to a correspondent, but may instead set separate limits for different forms of exposure, products, or maturities.

The final rule provides that, for the significant sources of exposure for which internal limits are required, the bank either should monitor its exposure or structure transactions with the correspondent in order to ensure that the exposure ordinarily remains within the internal limits established by the bank.[3] Where monitoring is used, the final rule indicates that the appropriate level of monitoring will depend on the type and volatility of the exposure, on the extent to which the exposure approaches the bank's internal limits, and on the condition of the correspondent. The final rule also indicates that *ex post* monitoring generally is sufficient.

Although the purpose of requiring monitoring or structuring of transactions to which limits apply is to ensure that exposure generally remains within established limits, the final rule recognizes that occasional excesses over limits may result from factors such as unusual market disturbances, unusual favorable market moves, or other unusual increases in activity or operational problems. The final rule requires the bank to establish appropriate procedures to address excesses over internal limits.

The final rule continues to require that a bank's internal policies and procedures address intraday exposure. As with other exposure of longer maturities, however, the final rule does not necessarily require that limits be established on intraday exposure. Such limits would be required only if the size of the intraday exposure and the condition of the correspondent indicated that there is a significant risk that payments will not be made as contemplated.

*Limit on Credit Exposure to Certain Correspondents*

The final rule provides that a bank's internal policies and procedures should limit overnight credit exposure to a correspondent to 25 percent of the exposed bank's capital, unless the bank can demonstrate that its correspondent is at least "adequately capitalized," as defined by the rule. The final rule does not specify limits for credit exposure to adequately or well-capitalized correspondents.[4]

The benchmark guideline included in the proposed rule for exposure to adequately capitalized correspondents served largely as a transition from the unrestricted exposure permitted for well-capitalized correspondents to the 25 percent benchmark for correspondents that are less than adequately capitalized. The final rule requires banks to take into account the maturity of exposure and changes in the financial condition of the correspondent in establishing internal prudential limits and monitoring, and therefore decreases the need for formal limits on credit exposure to adequately capitalized correspondents. Additionally, because existing exposure above the 25 percent limit for credit exposure to a less than adequately capitalized correspondent is not "grandfathered" under the rule if the correspondent slips below adequately capitalized, the existence of this limit will encourage banks to shorten the maturity of exposure to correspondents that are at risk of dropping below the capital levels required to be adequately capitalized.

This regulatory "limit" requires that a bank's internal policies and procedures limit "credit exposure" to a correspondent to 25 percent or less of the exposed bank's capital, unless the bank can demonstrate that the correspondent is at least "adequately capitalized," as defined in the rule. As in the proposed rule, this limit should be viewed as a maximum level for credit exposure, rather than as a safe harbor. Formal limits on credit exposure to such a correspondent would not be necessary where the banks' policies and procedures effectively limit credit exposure to an amount below the 25 percent limit, such as where only small balances are maintained with the correspondent, or where the correspondent has only been approved for a limited relationship. Although in many cases it will be necessary for a bank to establish formal internal limits to meet the regulatory limit, the provisions of § 206.3 of the final rule concerning excesses over internal limits also apply to limits established for the purpose of controlling "credit exposure" under § 206.4 of this rule.

As in the proposed rule, the "credit exposure" that is limited under the final rule is based on the assets and off-balance sheet transactions against which the bank must maintain capital under the risk-based capital guidelines, with the same exclusions of lower-risk

[1] For significant correspondent banking relationships, the Board believes that banks generally have considerable non-public information concerning their correspondents, such as information on the quality of management, general portfolio composition, and similar information. The limitation of the rule to financial analysis based on publicly available information is intended to recognize that access to non-public information is not always available, and is not intended to discourage the use of more extensive information, where available.

[2] A bank is required to obtain non-public information to evaluate a correspondent's condition only for those foreign banks for which no public financial statements are available. In these limited circumstances, the bank would need to obtain financial information directly from the correspondent.

[3] A bank could meet the requirements of the rule by monitoring actual overall exposure, or by establishing individual lines for significant sources of exposure, such as federal funds sales, and establishing procedures to ensure that exposure generally remained within the established lines. A bank could also maintain limits on exposure by establishing limits monitored by a correspondent, such as for sales of federal funds through the correspondent as agent.

[4] While the proposed rule referred to "benchmark guidelines" to reflect that the numerical limits were subject to exceptions, the successor provision in final rule refers to "limits" to reflect that this "limit" is an outside limit on the bank's own internal limits. This limit, as well as the bank's internal limits, are subject to exceptions noted in the final rule. Thus, the nature of this limit is substantially the same as the benchmark guidelines in the proposed rule.

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transactions permitted. The final rule clarifies that "credit exposure" does not include settlement exposure, transactions in which the bank acts as agent, and other forms of exposure that are not covered by the capital adequacy guidelines.

*Transition Provisions*

To mitigate the need for a bank to reduce exposure rapidly to a correspondent whose capital has slipped below the levels needed to be considered adequately capitalized, the final rule increases the transition period for application of the 25 percent limit on credit exposure to 120 days. The longer transition period will avoid undue disruptions in correspondent relationships due to temporary declines in capital ratios by allowing the correspondent an opportunity to bring its capital ratios back above the relevant levels before the end of the next quarterly report. The extended period will also provide the exposed bank more time to implement any monitoring required to demonstrate compliance with the limit on credit exposure and to adjust the maturities or level of its exposure to the correspondent.

*Initial Implementation Period*

The proposed rule required that banks have internal policies and procedures in place by December 19, 1992, with the benchmark guidelines to be phased in over a two-year period. The final rule provides a transition period of six months before the prudential standards become effective, with the remaining limit on credit exposure phased in over a two-year period after that date. The longer initial implementation period will enable banks that have not made credit assessments of their correspondents to do so, and will provide an opportunity for banks to review and, where appropriate, improve their monitoring procedures.

Additional modifications to the proposed rule are detailed in the discussion below.

**Summary of Comments**

The Board received 321 comment letters on the proposed rule. Two hundred fourteen commenters opposed the rule. Five commenters supported the regulation's implementation of section 308. An additional seventeen commenters offered qualified support for the rule, urging the Board to modify implementation to make it less burdensome, by, for example, eliminating the guidelines based on capital. The others expressed no opinion or offered detailed comments. The comments included seventy-three "form letters," forty-one of which focused on the effect of the proposed rule on bankers' banks and sixty-one of which addressed the competition between Federal Reserve Banks and private sector correspondents. All of the form letters were from small banks.[5] The 321 commenters by category included 233 commercial banks, 41 bank holding companies, 16 bankers' banks, 13 trade associations, 5 clearinghouses, 6 savings associations, 1 Federal Home Loan Bank, and 6 others.

*General Comments*

*Cost.* One hundred fifty-one commenters expressed concern over the additional cost burden the proposed rule would impose. The Board has attempted to minimize costs to banks of implementing the final rule, but some costs are inherent in any new rule that results in changes in bank practices.

*Excessive regulation.* One hundred sixty-six commenters believed the proposed rule created excessive regulation. While the Board recognizes the regulatory burden associated with the new rule, the Board believes that the provisions of the final rule are necessary to carry out the intent of section 308.

*Federal Reserve Bank and Federal Home Loan Bank competition.* One hundred seventy-nine commenters expressed concern that the proposed rule would divert business from the private sector to the Federal Reserve Banks and Federal Home Loan Banks. Two commenters suggested that the Board reduce the competitive impact by including Federal Reserve Banks in the definition of correspondent. Another commenter suggested the Board require banks to conduct the same analysis of Federal Reserve Banks that would be required for a private correspondent. Because exposure to a Federal Reserve Bank or Federal Home Loan Bank poses minimal risk to a respondent, the Board does not believe that Federal Reserve Banks and Federal Home Loan Banks should be included in the definition of correspondent in the final rule. To treat Federal Reserve Banks and Federal Home Loan Banks as correspondents under the final rule would impose unnecessary costs and burdens on banks, with no appreciable reduction in risk.

Five commenters proposed that the Board rectify the competitive effect of the rule by changing the private-sector adjustment factor or the prices charged for check collection.[6] The Board will review the calculation of the private-sector adjustment factor to determine if modifications are appropriate.

*Disruption of the federal funds market.* Twenty-four commenters expressed concern that the proposed rule would disrupt the federal funds market by preventing banks from selling all of their federal funds to a single correspondent, and stated that the need to diversify federal funds sales among a number of purchasers could result in higher transaction costs. In addition, commenters expressed concern that the need to evaluate the financial condition of correspondents could lead banks that are members of the Federal Home Loan Banks to deposit funds in those banks rather than selling them to correspondents.

While the Board recognizes that there may be some initial restructuring of the channels for federal funds sales, the Board does not believe that the regulation will result in a material or lasting disruption of the federal funds market or to a material reduction in the availability of federal funds. The federal funds market is competitive, and the Board believes that creditworthy correspondents that are buyers of federal funds will continue to be able to fund profitable business utilizing this market. The Board also believes that modifications incorporated in the final rule, including elimination of the regulatory limit on credit exposure to adequately capitalized correspondents, will reduce the effect of the rule on the federal funds market.

*Availability of credit.* Fifty-six commenters asserted that the proposed rule would exacerbate the "credit crunch," generally either because of disruption in the federal funds markets or because of diversion of funds to Federal Reserve Banks or Federal Home Loan Banks. Twenty-two of these commenters claimed that this effect would be particularly pronounced in small communities. As discussed above, the Board believes that the modifications incorporated in the final rule have significantly reduced the

[5] For example: 30 commercial banks and bank holding companies sent identical letters which focused on competition from Federal Reserve Banks; 19 bankers' banks and their customers sent an identical resolution on the effect of the proposed rule on bankers' banks and competition from Federal Reserve Banks; 10 commercial banks, customers and shareholders of a bankers' bank, sent identical letters concerning the proposal's effect on bankers' banks; and 9 commercial banks sent substantially similar letters on bankers' banks and Reserve Bank competition.

[6] Two commenters noted that, in addition to the cost of maintaining capital, correspondents generally would have to bear the cost of disseminating call reports in order to provide their respondents with information on their capital ratios, and that Reserve Banks would not have to bear this cost.

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likelihood of any reduction in the availability of funds for lending.

*Effect on the FDIC funds.* Thirty-eight commenters, nine of whom submitted a substantially similar letter, expressed concern that the proposed rule would weaken the Federal Deposit Insurance funds. Another commenter, however, asserted that the proposed rule would actually strengthen the funds. To the degree that the proposed rule diverts deposits, generally in the form of compensating balances, from depository institutions to Federal Reserve Banks or Federal Home Loan Banks, it may reduce FDIC insurance assessments. However, the Board believes that the overall effect of the final rule will be to strengthen the funds by reducing losses.

*Repeal.* Forty-six commenters urged the repeal of the statute and one commenter asserted that similar limits at the state level have failed. The power to repeal the statute, however, rests with the Congress rather than the Board.

*Miscellaneous.* Thirteen commenters suggested that, as an alternative to regulating respondents, the federal regulators supervise the correspondent banking business by restricting which banks could engage in such business, notifying respondents that do business with unsound correspondents, setting limits on the amount of exposure a correspondent can accept, or automatically transferring balances from weak correspondents to strong ones and notifying respondents later. Seven other commenters noted that it is inefficient for a thousand banks to monitor the same correspondent, which is also being monitored by a regulator. The Board does not believe that it would be appropriate to endorse specific correspondents, as such a practice could perpetuate the "too big to fail" concept that section 308 was designed to address.

One commenter urged the Board to create a new instrument for Treasury obligations for which the Federal Reserve Banks would be the broker and administrator. The Board does not believe that the creation of such an instrument is necessary, as the government securities market is broad and deep, offering many opportunities for investment. Another commenter suggested that the Board permit banks to sell federal funds to Federal Reserve Banks. The Board does not believe that such a practice would be appropriate because it would interfere with the conduct of monetary policy.

Another commenter suggested that the Board change Regulation D and the FDIC insurance calculation to encourage fee payment. The final rule increases the incentives for respondents to compensate correspondents by fees, and the Board believes that the market will make appropriate adjustments to this change.

One commenter suggested that the Board expand legal lending limits to include off-balance sheet items. The Board does not have the authority to effect such a change, however, as these limits are administered by the Comptroller of the Currency under the National Bank Act and by state banking regulators under state law.

One commenter urged the Board to tailor the rule to the strength of the respondent on the assumption that well-capitalized respondents would be managed wisely. The final rule places greater emphasis on a bank's internal policies and procedures.

*Section-by-Section Comments*

The section and paragraph numbers in the headings refer to the numbering of the proposed rule. Where a provision has been renumbered or moved, the appropriate cite in the final rule is provided in brackets.

**Section 206.2 Definitions**

*Section 206.2(a) Bank*

The proposed rule defined "bank" as an insured depository institution as defined under section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813). Banks covered by this definition must control their exposure to correspondents under this rule. The Board received twenty-seven comments on this section.

Exclusion of Small Banks

Fourteen commenters proposed that the Board exclude small or community banks, defined by some commenters as banks with assets under $1 billion, or hold such banks to a more lenient standard, especially in their correspondents are well or adequately capitalized. Another thirteen commenters, nine of whom submitted a substantially similar letter, asserted that the current rule violated Congressional intent, as Congress did not intend to harm small banks with this regulation.

Section 308 states that the Board should address the risk posed to an insured depository institution by the failure of another depository institution. It does not restrict that mandate to risks posed to large institutions. Section 308 is designed to limit bank failures attributable to losses due to the failure of a correspondent. An exemption for small bank exposure to correspondents would be contrary to this design, as the failure of a correspondent would continue to precipitate the failure of small banks.

Coverage of Definition

One commenter urged that the Board clarify that a nonbank credit card company is excluded from the definition of "bank."
Nonbank credit card companies are not considered to be banks for the purposes of this rule. However, bank users of credit card or other payment services may, depending upon the terms of their services, incur exposure to other banks by virtue of use of such services.

The definition in the final rule has been redrafted for clarity.

*Section 206.2(b) Correspondent [Final Rule—Section 206.2(c)]*

The proposed rule defined "correspondent" as a U.S. depository institution or a foreign bank, as defined in the proposed rule, to which a bank had exposure. The Board received 134 comments on this section.

*Exclusion of Bankers' Banks*

One hundred twenty-two commenters urged exclusion of bankers' banks from the definition of correspondent. Forty-seven commenters, twenty-six of whom submitted substantially similar letters, argued that bankers' banks pose no systemic risk, either because the bankers' banks are themselves small, or because they serve only small banks. Thirteen commenters, nine of whom submitted a substantially similar letter, asserted that bankers' banks reduce systemic risk by providing alternative correspondent services. Twenty-seven commenters, eighteen of whom submitted a substantially similar letter, argued that a bankers' bank may be less risky because it is a local institution, it is chartered to serve only banks, and its board includes officers of its respondent banks, who are therefore in a position to monitor its financial condition more closely.

Forty-six commenters, twenty-nine of whom submitted a substantially similar letter, pointed out that bankers' banks rely exclusively on interbank liabilities and are thus uniquely vulnerable to the interbank liability limits. Sixty-three commenters, including twenty-eight form letters and a number of bankers' banks, argued that Congress did not intend bankers' banks to be targeted. Many of these commenters concluded that the rule should create special provisions for bankers' banks. Thirty-two commenters, nine of whom submitted a substantially similar letter, argued that Congress recognized the unique role of bankers' banks in the Depository Institutions Deregulation and Monetary Control Act of 1980. One commenter argued that it was unfair to

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subject bankers' banks to the rule when central liquidity facilities, which provide services to credit unions, are not covered. Another commenter argued that bankers' banks are not commercial banks and that the deserve the same treatment as Federal Reserve Banks. Eleven commenters argued that bankers' banks should be excluded from the scope of the rule because banks would otherwise be forced to obtain correspondent services from their competitors.

In contrast, two commenters argued that exclusion of bankers' banks would unfairly restructure the market for correspondent services, and another commenter noted that exemptions for some providers of correspondent services would erode competition.

The Board recognizes that bankers' banks are providing important services to respondents and are meeting a market need, and that Congress has given special status to bankers' banks in other statutes. Nonetheless, the Board does not believe that other legislation or the statutory language or legislative history of section 308 demonstrate a Congressional intent to exclude bankers' banks from the coverage of section 308. Nor does the Board believe the Congress intended for bankers' banks to be targeted by the rule. Accordingly, the final rule treats bankers' banks no differently than other correspondents.

The Board does not believe that bankers' banks will be unduly harmed by being treated as correspondents under the rule. Bankers' banks generally are at least adequately capitalized and there is no regulatory limit on credit exposure to an adequately capitalized correspondent under the final rule. Although respondents will need to obtain information on correspondents' capital ratios in order to demonstrate that correspondents are at least adequately capitalized, bankers' banks can reduce this burden by providing the information to their respondents directly. To the extent that bankers' banks are concerned that the burden of meeting the requirements of the rule's prudential standards will cause banks to transfer business from a bankers' bank to a Federal Reserve Bank or Federal Home Loan Bank, the Board believes that the more extensive guidance provided in the language of the final rule will reduce this effect.

The Board believes that including bankers' banks within the scope of the rule is appropriate. Bankers' banks represent a concentration of interbank risk because they rely exclusively on interbank liabilities and because their assets subject them to the same risks as other banks. Further, an exception for bankers' banks could alter the market for correspondent services, possibly increasing risk as correspondent business moves to such special purpose banks. With regard to arguments that including bankers' banks as correspondents under the rule will force banks to obtain services from their competitors, the Board notes that banks often do business with competitors.

Sixteen commenters asserted that the rule would result in a reduction in deposits at bankers' banks which, in turn, would reduce the capacity of bankers' banks to provide "overline" loan and participation arrangements and other correspondent services. The Board believes that the demand for these services will provide incentives for banks to continue to do business with bankers' banks rather than shifting to Federal Reserve Banks or Federal Home Loan Bands, which provide only limited services.

Six commenters stated that the proposed rule would preclude a bankers' bank from raising capital when it is most needed because banks could not increase exposure to the bankers' bank through stock investments. Although most bankers' banks are well or adequately capitalized, the Board recognizes that the capital of bankers' banks generally represents exposure of the owner-customers of the bankers' bank. The Board notes, however, that capital ratios may be increased by other means, such as by reducing certain assets of the bankers' bank.

## Restriction of Coverage to Large, Weak Banks

Fifty-nine commenters concerned with the regulatory burden imposed by the proposed rule urged that the rule focus exclusively on banks that might be considered "too big to fail." Thirty-five of these commenters, twenty-eight of whom submitted a substantially similar letter, suggested that the Congressional intent was to focus on the risk caused by the failure of a large depository institution, and that small banks were not to be affected by the regulation. In addition, thirty-five commenters, thirty of whom submitted a substantially similar letter, urged the Board to exempt exposure to well-capitalized correspondents from the regulation or at least to treat exposure to them no differently than exposure to a Federal Reserve Bank.

Although the introductory language in section 308 refers to the failure of a large depository institution, the text of the statute directs the Board to limit risks posed by exposure to "any other depository institution." Further, excluding exposure to small correspondents from the rule could cause correspondent business to shift to small correspondents, regardless of their financial condition, thereby increasing the risk that the failure of a small correspondent would cause the failure of other banks. Finally, entirely excluding exposure to well-capitalized correspondents could encourage banks to take exposure to a well-capitalized correspondent that may be excessive in relation to the overall financial condition of the correspondent. Thus, the Board believes that the definition of "correspondent" should not exclude depository institutions on the basis of size or capitalization.

## Expansion of the Definition of Correspondent

Nine commenters expressed concern about competition in the correspondent business from nonbanks and credit unions. Three of these commenters proposed that the definition of correspondent encompass all providers of correspondent services, including nonbanks. One commenter pointed out that Edge Act companies are not defined as correspondents but are included as subsidiaries.

The Board notes that the interbank liability provisions of section 308 concern exposure to depository institutions, not to financial service providers generally. The definition of "correspondent" in the proposed rule was limited to institutions that receive special treatment under the capital adequacy guidelines, which provide that claims against certain foreign banks and federally insured domestic depository institutions generally are given a 20 percent risk weight.[7] Furthermore, the Board does not believe that nonbank providers of correspondent services, including credit unions, provide a full range of correspondent services in competition with traditional correspondents or that risk to banks will increase materially through migration to providers of services that are not covered by the rule. Finally, the failure of financial institutions that are not insured by the Federal Deposit Insurance Corporation would not pose a threat to the Federal Deposit Insurance funds through invocation of "too big to fail."

## Final Rule

The definition of correspondent has been amended to exclude commonly controlled correspondents that are subject to cross-guarantees under the

[7] Claims against other types of financial institutions generally are given a 100 percent risk-weighting under the capital adequacy guidelines.

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Federal Deposit Insurance Act. The proposed rule excluded commonly controlled correspondents from the limits on credit exposure, but not from the prudential standards. In the final rule this exclusion has been extended to the prudential standards for consistency. This exclusion does not affect the applicability of other statutory provisions governing transactions with affiliated institutions, such as section 23A of the Federal Reserve Act (12 U.S.C. 371c).

*Section 206.2(c) Exposure [Final Rule—Section 206.2(d)]*

The proposed rule defined "exposure" as 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. The definition further provided that "exposure" includes the operational and liquidity risks related to the settlement of transactions and risk related to the creditworthiness of a correspondent. Both overnight and intraday exposure were covered by the definition. The proposed rule required exposure to be monitored under the prudential standards. The Board received twenty comments on this section.

Scope of the Definition

Ten commenters urged that the scope of the definition be restricted. Nine commenters suggested that the definition of exposure include only significant exposure measured by the amount at risk and the product line at issue to a particular correspondent. Four of these commenters suggested that the Board provide guidance, such as that in the payments system risk policy, as to what constitutes significant exposure. One commenter urged that the definition exclude items covered by FDIC insurance. Another commenter suggested that the purchase and sale of Treasury securities be excluded. One commenter suggested that the Board exclude settlement risk from the definition of exposure. Another commenter suggested that the settlement risk in delivery-versus-payment systems be excluded. Two commenters, clearinghouses, suggested that the settlement risk attendant to a clearing and settlement system that includes settlement finality should be excluded from the definition of exposure because it is insignificant. One commenter asked the Board to exclude collateralized interest rate swaps from the definition of exposure. Another commenter questioned whether other exposures like payroll, pending ATM, and coin and currency settlements should be included in exposure. One commenter suggested that the definition of exposure distinguish exposure due to capital market transactions from exposure due to correspondent banking activity. In addition, four commenters urged the exclusion of short-term exposure. One commenter suggested that the rule exclude all exposure with a maturity of less than 14 days, two others urged the exclusion of demand deposits, and the fourth called for the exclusion of federal funds transactions. Three commenters expressed concern that regulators would unreasonably expand the definition.

The final rule excludes certain lower-risk transactions from the definition of "credit exposure," which is the measure of exposure subject to a specific regulatory limit under the rule. The general definition of "exposure" used in the final rule, however, covers all types of transactions that create a risk of nonpayment or delayed payment. The Board believes that banks should consider all types of financial exposure in establishing prudential policies and procedures. As discussed in the summary of the final rule, however, the prudential standards in the final rule have been amended to clarify that a bank is not required to treat all types of exposure in the same manner, and that a bank's internal policies and procedures may provide for differential treatment of exposure based on the form, maturity, and size of the exposure, as well as on the condition of the correspondent.

Clarification of the Definition

Seven commenters found the definition of exposure too vague. Two commenters sought clarification of the definition of settlement risk. One commenter asked for clarification of how settlement risk relates to automated clearinghouse (ACH) transactions. One commenter urged that exposure arising out of credit card transactions should be excluded from the definition of exposure because a bank cannot control the banks to which it has this exposure. In this regard, the Board notes that exposure arising from the following transactions generally is insignificant because the exposed bank usually has prompt recourse to other parties or because the amounts involved are not significant: (1) A collecting bank's risk that a check will be returned, (2) an originating bank's risk that an ACH debit transfer will be returned or its settlement reversed, (3) a receiving bank's risk that settlement for an ACH credit transfer will be reversed, or (4) a credit card transaction. Under the final rule, a bank is not required to conduct periodic reviews of the financial condition of a correspondent where the amount of the exposure is insignificant and would not be required to limit exposure unless there is a significant risk that payment will not be made as contemplated.

Another commenter requested clarification of the terms "liquidity risk" and "operational risk" used in the definition of exposure. Liquidity risk is the risk that payment will be delayed for some period of time. For example, a bank is subject to the liquidity risk that a payment due from a failed correspondent will not be made on time; the bank's credit risk may be a lesser amount due to later distributions from the correspondent's receiver. Liquidity risk is included in the definition of exposure in the final rule. Operational risk if the risk that operational problems at a correspondent, such as computer failure, may prevent it from making payments, thereby creating liquidity risks for other banks, and is also included in the definition of exposure in the final rule.

One commenter asked if correspondent obligations that a bank holds in a fiduciary capacity are excluded. Because obligations held in a fiduciary capacity do not expose the bank itself to loss due to credit, liquidity, or operational problems, such obligations are not included in the definition of exposure.

One commenter argued that depository institution equity securities taken as collateral or in satisfaction of a debt should be excluded from the definition of "exposure" because they are not payment obligations. Such transactions are covered by the definition of "exposure," in the final rule, as they create a credit risk to the bank should the depository institution fail. The definition in the final rule has been redrafted for clarity.

*Section 206.2(d) Foreign Banks [Final Rule—Section 206.2(e)]*

The proposed rule defined a "foreign bank" as an institution that is organized under the laws of a country other than the United States, engages in the business of banking, is recognized as a bank by the bank supervisory or monetary authorities of the country of the bank's organization, receives deposits to a substantial extent in the regular course of business, and has the power to accept demand deposits. Foreign banks were included in the definition of correspondent in the proposed rule. The Board received seven comments on this section.

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Exclusion of Foreign banks

Two commenters urged that the rule exclude foreign banks because of the cost and difficulty in obtaining necessary information, such as capital information, and because the proposed rule would harm the competitiveness of U.S. banks in foreign correspondent markets. These commenters also argued that foreign banks do not pose a risk to the deposit insurance fund, or to the U.S. banking system as a whole. An additional two commenters, focusing on the lack of current risk-based capital ratio information and on the decreased risk posed by foreign banks, suggested that exposure to foreign banks be excluded from application of the benchmark guidelines and subjected only to the prudential standards. Two other commenters, however, strongly supported the coverage of foreign banks in the rule, arguing that exclusion would grant such banks a competitive advantage over domestic banks. One commenter, a clearinghouse, noted that its members were divided on this issue.

Foreign banks were included as correspondents under the proposed rule because failure to cover foreign banks could encourage a migration of correspondent and interbank business to foreign banks irrespective of their condition, thereby potentially increasing risk to insured depository institutions. Consequently, the Board does not believe that foreign banks should be excluded from coverage of the limits on credit exposure or the prudential standards. To address problems with obtaining adequate information concerning foreign banks, however, the final rule provides greater flexibility as to the timing and frequency with which a bank must obtain information on the capital levels of its foreign bank correspondents.

Clarification of the Definition

Two commenters called for recognition of the decreased risk posed by a foreign central bank or a bank guaranteed by a foreign government, and perhaps even exclusion of these institutions from coverage as "correspondents" under this rule. The definition of "foreign bank" is based on the criteria used in the risk-based capital guidelines. As those guidelines exclude the central bank of a foreign country, such institutions would be excluded for the purposes of this rule as well. The Board believes, however, that banks guaranteed by foreign central governments may pose risks and should be included as correspondents for the purposes of this rule.

The definition remains unchanged in the final rule.

*Section 206.2(e) Primary Federal Supervisor [Final Rule—Section 206.2(f)]*

No comments were received on this section, and the definition remains unchanged in the final rule.

*Section 206.2(f) Quality Asset [Final Rule—Section 206.4(f)(3)]*

The proposed rule defined a "quality asset" as an asset that is not in a nonaccrual status, on which principal or interest is not more than thirty days past due, and whose terms have not been renegotiated or compromised due to the deteriorating financial condition of the primary obligor. Furthermore, under the proposed rule an asset would 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. Under the proposed rule, a transaction for which a correspondent is only secondarily liable could be excluded from a bank's "credit exposure" to the correspondent as long as the transaction could be considered a "quality asset."

The Board received one comment, which criticized this definition as too restrictive. The commenter urged that the definition include assets on which principal or interest is not more that 90 days past due, as is the standard in SEC Guide 3 Section III C.1. This SEC standard is used for reporting and disclosure purposes and does not appear to be appropriate for the purposes of this rule. The Board believes that the proposed definition, which was derived from section 23A of the Federal Reserve Act (12 U.S.C. 371c), permits a more accurate measure of actual credit exposure. In the final rule the definition of "quality asset" has been incorporated into the section concerning "credit exposure" (§ 206.4).

*Section 206.2(g) Subsidiary [Final Rule—Section 206.4(e)]*

Under the proposed rule, the term "subsidiary" was given the same meaning as that term under section 23A of the Federal Reserve Act, and therefore included any company in which a bank owns or control 25 percent or more of any class of voting securities. This definition in the final rule has been modified and incorporated into § 206.4, and is discussed below in the description of comments on that section.

*Section 206.2(i) Total Capital [Final Rule—Section 206.2(g)]*

The proposed rule defined total capital as 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. The Board received two comments on this section.

Two commenters requested clarification that the benchmark guidelines would be based on the total capital of a foreign bank, rather than only on the capital of the branch. The limit on credit exposure of the insured branch of a foreign bank is based on the foreign bank's total capital, as defined in this section, not on the imputed capital of the branch.

The definition remains unchanged in the final rule.

*Section 206.2(j) U.S. depository Institution [Final Rule—Section 206.2(h)]*

The proposed rule defined "U.S. depository institution" as a federally insured depository institution chartered in the United States under federal or state law, and included 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 did not include an insured branch of a foreign bank. U.S. depository institutions were included in the definition of "correspondent" in the proposed rule. The Board received eight comments on this section, two of which supported the definition as written.

Scope of the Definition

Three commenters urged the inclusion of credit unions, asserting that they poses risks to the financial system through the large inter-institution liabilities of credit union corporate centrals. Credit unions do not offer a full range of correspondent services to FDIC-insured banks and are not insured by the FDIC. Therefore, the Board does not believe that exposure to credit unions poses risks to insured banks and

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to the FDIC insurance funds of the type that section 308 was designed to address.

Clarification of the Definition

Three commenters suggested that the final rule include specific language excluding Federal Home Loan Banks. The Board believes that the definition excludes Federal Home Loan Banks and that a specific exclusion for Federal Home Loan Banks is unnecessary. The definition in the final rule has been redrafted for clarity.

*Section 206.3 Prudential Standards*

*Section 206.3(a) Internal limits. [Final Rule—Section 206.3(c)]*

The proposed rule required that a bank establish and maintain policies and procedures to limit exposure to the correspondents with which it does business. The rule further required that banks 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 being on the creditworthiness of each correspondent. Finally, it required that a bank structure these limits to avoid undue concentration of settlement or credit risk with respect to any individual correspondent. Most of the comments received addressed the prudential standards, and 110 of those comments addressed § 206.3(a) on internal limits.

Appropriateness of Internal Prudential Standards

Twenty-four commenters agreed that the prudential standards reflect prudent banking and general industry practice, and twenty-eight commenters indicated that they had already established prudential standards for interbank exposure. Moreover, twenty-four commenters suggested that this provision, supplemented by examination, be the heart of the regulation. On the other hand, forty-two commenters, including five who indicated that they already conduct similar prudential analyses, disagreed with the Board's approach to the problem of interbank liabilities. These commenters argued that the examination process can adequately address the problem, both because adequate controls already exist in the safety and soundness criteria and because the examination and consultative process is superior to regulation. These commenters concluded, therefore, that the rule would impose increased costs without achieving a commensurate reduction in risk. Three of these commenters suggested that the Board conduct an empirical study of the risks associated with interbank liabilities and the cost of controlling those risks.

Thirty-two commenters offered alternatives to the prudential standards. Three suggested approval of correspondent relationships by vote of the bank's board of directors. Eighteen commenters, submitting an identical letter, suggested that the prudential standards require only that a bank obtain information from its correspondents once a year to demonstrate that the correspondents meet appropriate capital standards. One commenter suggested that banks be permitted to tier their prudential standards in a similar fashion as the capital guidelines. Six commenters favored a simple statement that the risks must be addressed, while another suggested that the standard be the same due diligence standard applied to any loan. One commenter urged the Board to require specific, detailed lending policies, similar to those for highly leveraged transactions, while another commenter asserted that only on-site examinations offer a true measure of risk. One commenter suggested that the rule require an annual review of capital, management experience, and income trends.

Implementation of the Requirement

Twelve commenters expressed a desire for greater specificity regarding the preparation and review of the internal limits. Six requested specificity as to the factors that a bank should evaluate or argued that the factors be limited. One commenter sought clarification of whether internal standards could ever be breached. Four commenters indicated that respondents may lack the expertise to analyze the financial condition and risk of larger correspondent banks, particularly where the correspondent has significant off-balance sheet activities. Six commenters expressed concern about the availability of the information. One of these commenters stated that correspondents that compete on other fronts may be unwilling to divulge non-public information. One commenter asked whether banks could rely on information from correspondents. Two commenters expressed concern that call and audit reports do not address overall conditions and operations, although both are mentioned as factors in the proposed rule. Five commenters expressed concern that the proposed rule failed to encourage banks to improve continuously their risk management programs and may encourage banks to abandon a more sophisticated system for one which tracks the guidelines. One of those commenters urged that the Board adopt uniform examination guidelines that reflect to the greatest degree possible existing risk monitoring and control practices.

Final Rule

The primary focus of the final rule is on a bank's analysis of the creditworthiness of its correspondents. Many of the concerns raised by these commenters are addressed by the more extensive guidance in the final rule as to the standards that a bank's internal policies and procedures would be expected to meet. The final rule states that internal procedures should be directed at preventing excessive exposure to a correspondent in relation to the financial condition of the correspondent, and allows banks to adopt flexible policies and procedures to meet this standard. The final rule does not require the same procedures to be used for all correspondents or all types of exposure.

Under the final rule, a bank's internal policies and procedures must provide for periodic reviews of a correspondent's financial condition only where exposure to the correspondents is significant. Periodic review of the financial condition of correspondents to which the bank has only insignificant levels of exposure, such as small balances maintained for clearing purposes, would not be required under the final rule. While the bank's board of directors would be required to review the bank's policies and procedures concerning correspondents on an annual basis, the board would not be required to approve individual correspondent relationships. The final rule also does not require the bank to obtain non-public information on which to base its analysis of the financial condition of a correspondent, but permits use of publicly available information, such as call reports, Uniform Bank Performance Reports, and annual reports.[8]

Additionally, the final rule requires the establishment of internal limits only where the financial condition of the correspondent and the form or maturity of the exposure create a significant risk that payments will not be made as contemplated. The rule does not require a particular structure or method of maintaining such limits, but permits the bank flexibility to structure limits in a

[8] A bank would be required to obtain non-public financial information only in the limited circumstances where no publicly available source of information existed, such as for certain privately owned foreign banks.

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manner that will meet the needs of the bank. For example, in appropriate circumstances a bank may establish limits for longer term exposure to a correspondent, while not setting limits for overnight or intraday exposure.

Clarification of the Requirement

Eight commenters inquired whether the Board would permit a lead bank or bank holding company to conduct the prudential analysis for affiliated banks. The final rule clarifies that a bank may rely on its bank holding company, a bank rating agency, or another party to provide financial analysis of correspondents or to select correspondents, as long as the board of directors of the bank has reviewed the assessment or selection criteria used by that party.

*Section 206.3(b) Monitoring. [Final Rule—§ 206.3(c)]*

The proposed rule required that a bank 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 not exceed any applicable guidelines on credit exposure specified in § 206.4. The Board received 160 comments on this section.

One hundred fourteen commenters, thirty of whom submitted a substantially similar letter, protested the cost burden implicit in the monitoring requirements. Sixteen commenters argued that the costs of the monitoring provisions of the proposed rule outweigh the benefits. Fifty-nine commenters argued that these costs will be exacerbated if banks must spread their correspondent business among a number of banks. Two commenters complained that the cost burden would fall disproportionately. One asserted that small community banks would bear the brunt of it and another asserted it would fall inequitably on the adequately and well-capitalized banks of the Midwest. Seven commenters pointed out that even well-capitalized private correspondents and respondents will have to bear these costs.

Clarification of the Requirement

Six commenters requested clarification as to whether the requirement of the rule would be satisfied by *structuring relations* so that the limits are not exceeded, such as through agency sales policies. Five commenters urged the Board to consider permitting a lead or parent bank in a bank holding company to monitor exposure for its affiliated banks. Two commenters urged that the monitoring requirements distinguish between significant and insignificant exposure. Another urged that the final rule permit systems consistent with the institution's business, internal systems operations, and personnel. Seven commenters expressed concern that examiners might unduly restrict the regulatory flexibility that was designed to permit the use of diverse existing monitoring and risk control practices. They urged the Board to adopt uniform examination guidelines that would accommodate existing systems. Two commenters suggested as a model the guidelines for self-assessments on payment system risk.

Frequency of Monitoring

Twelve commenters argued that daily monitoring is excessive if not impossible. One commenter asserted that a banker cannot know the balance on a pass-through account. Two other commenters stated that global monitoring of outstanding exposures on a daily basis in products such as interest rate swaps, letters of credit, and other transactions would be extremely difficult, and that banks should be permitted to use their prudential limits as proxies for actual exposure where these limits are below the benchmarks. One commenter urged that the final rule match the frequency of review with the risk, while another urged the Board to permit banks to monitor exposure in arrears and take corrective action should exposure exceed prearranged levels. One commenter urged the Board to permit banks to monitor weekly or monthly averages. Two commenters expressed approval of the proposed rule's acceptance of *ex post* monitoring.

Monitoring Overnight Exposure

Fourteen commenters urged the Board to clarify the requirements for monitoring overnight interbank transactions and to consider eliminating monitoring of these transactions. Four of these commenters stated that the likelihood of a bank failing solely on the basis of its overnight exposure is very remote, and two argued that market factors weed out weak correspondent banks. Five other commenters argued that the regulatory burden on small banks in monitoring and controlling overnight interbank transactions is unreasonable and costly, and could force small banks to transfer their business to Reserve Banks. Another commenter urged the exclusion of overnight federal funds sales from the exposure that must be monitored as long as the sales were made under a preauthorized line to an approved list of correspondents, on the grounds that it may be difficult to determine other exposure to a correspondent at the time of a federal funds transaction.

Monitoring Credit Exposure

Fifteen commenters addressed the issue of monitoring credit exposure. Five of these commenters urged that the proposed rule's acceptance of occasional or inadvertent excesses be maintained and broadened sufficiently that small banks with unexpected large deposits or late incoming wire transfers be permitted to adjust their balances within a day or two. Six commenters expressed concern that the guidelines would be viewed as rigid limits. Another commenter asserted that the proposed rule's acceptance of occasional excesses would be where the trouble spots would arise. Three other commenters requested clarification as to how often and under what circumstances a bank may exceed the guidelines. One commenter suggested that the final rule grant banks time to bring combined credit exposures due to mergers or other acquisitions into compliance with the benchmark guidelines.[9]

Monitoring Intraday Exposure

Eleven commenters urged the Board to eliminate any requirement for intraday monitoring. Three of these commenters stated that most banks, and especially smaller banks, would find it difficult or impossible to monitor and manage intraday exposure. Another commenter expressed concern that banks' attempts to limit intraday exposure by delaying settlements pending receipt of offsetting funds could lead to system gridlock. Two commenters argued that intraday exposure was similar to cash items in the process of collection and should be excluded from the rule. Four additional commenters sought clarification as to whether daylight overdrafts would be violations of the rule.

The Final Rule

The final rule allows a bank to adopt monitoring policies and procedures that are appropriate for the bank's particular situation. The final rule does not require the establishment of limits or monitoring for all sources of exposure to all correspondents. The final rule provides that, for the significant sources of exposure for which internal limits are required, a bank may either monitor exposure or structure transactions to

[9] Other comments on monitoring credit exposure are addressed in the discussion of the guidelines on credit exposure.

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ensure that internal limits generally are not exceeded. A bank could accomplish this either by monitoring actual overall exposure, or by establishing individual lines for significant sources of exposure, such as federal funds sales, and establishing procedures to ensure that exposure generally remained within the established lines. A bank could also maintain limits on exposure by establishing limits with correspondents, such as for federal funds sold on an agency basis.

Under the final rule, banks are not expected to monitor exposure to correspondents on a real-time basis. Monitoring generally may be done retrospectively, and the required frequency depends on the extent to which exposure approaches the bank's internal limits, on the volatility of the exposure, and on the condition of the correspondent.

Although the purpose of requiring monitoring or structuring of transactions is to ensure that exposure generally remains within established limits, the final rule recognizes that occasional excesses may occur. The final rule provides that a bank should structure transactions or monitor exposure to a correspondent to ensure that exposure ordinarily does not exceed internal limits, except for occasional excesses resulting from factors such as unusual market disturbances, market movements favorable to the bank, operational problems, or increases in activity. Unusual late incoming wires or unusually large cash letters would be considered examples of the types of activities that could lead to excesses over internal limits that would not be considered impermissible under the final rule. The final rule requires the bank to establish appropriate procedures to address excesses over internal limits.

With respect to intraday monitoring, the Board recognizes that intraday exposure may be difficult for a bank to actively monitor and limit. Under the final rule, intraday exposure, like interday exposure, may be monitored retrospectively. Further, where the risk resulting from intraday exposure is low, taking into account the condition of the correspondent and the size of the exposure, specific limits and monitoring to those limits would not be required under the final rule.

Additionally, to ease monitoring in the case of mergers or acquisitions, the final rule excludes exposure resulting from the merger or acquisition of a bank from the calculation of "credit exposure," for the purposes of the limit on credit exposure for one year after the merger or acquisition.

Under the final rule, a bank's internal policies and procedures are required to limit credit exposure to a less than adequately capitalized correspondent to not more than 25 percent of the exposed bank's capital. Therefore, these monitoring requirements for exposure would also apply to monitoring credit exposure limits.

*Section 206.4 Guidelines for Credit Exposure*

The proposed rule provided that, in addition to the prudential limits on exposure established by a bank under § 206.3, a bank ordinarily would be expected to maintain credit exposure to an individual correspondent, as calculated under § 206.5, within certain guidelines or limits unless the exposure is to a commonly controlled insured depository institution, as provided in paragraph (b) of that section. The proposed guidelines or limits were structured as "benchmarks" that would be considered prudent outside limits on credit exposure and were not intended to endorse levels of credit exposure that otherwise would not be considered prudent based on the condition and operations of the correspondent. The Board received 112 comments addressing this section specifically.

Elimination of the Guidelines

Forty-three commenters, primarily large banks, opposed the requirement that banks adhere to these limits. Forty commenters argued that the Board should eliminate the guidelines, and three commenters urged that the guidelines be merged into the prudential standards to retain responsibility in management for the safe and sound management of exposure. One commenter proposed that where banks have appropriate internal prudential policies, they need not demonstrate that they are within the guidelines. Seven commenters argued that the proposed rule would require the creation of a comprehensive system to monitor credit exposure, as measured by the rule, simply to demonstrate that credit exposure is substantially within the guidelines. Ten other commenters argued that the benchmarks are crudely calibrated and that compliance with them would divert resources within banks away from activities designed to achieve real reductions in risks. Eight other commenters stated that the guidelines would create costly inefficiencies and reduce interbank liquidity, as banks would reduce exposure to an individual correspondent solely to avoid monitoring costs. One commenter contended that the guidelines would, in effect, penalize banks with existing internal controls. One commenter asserted that many banks lack the information technology that would permit on-line access to information on credit exposure to a specific correspondent, and that purchasing such a system would cost $1 million. Two commenters argued that it is impossible to monitor and therefor to limit global exposure daily.

The Level of the Guidelines

The board received fifty-seven comments concerning the amount of permissible exposure under the guidelines, two of which specifically endorsed the guidelines. Two commenters urged that banks in a bank holding company be permitted to aggregate their credit exposure to individual correspondents in measuring compliance with the guidelines. One commenter argued that the limits were too high and suggested that they not exceed the legal lending limits, which are themselves too high in the opinion of the commenter. The remainder of the commenters argued that the guidelines were too restrictive.

The commenters presented a number of arguments for relaxing the guidelines. Seventeen commenters noted that the benchmarks could force a bank to reduce its exposure to a well-managed, adequately capitalized correspondent while taking more exposure to other correspondents that the bank may not believe are as creditworthy. Eight commenters stated that small banks' federal funds sales can fluctuate dramatically, making continuous compliance costly and difficult. Six commenters expressed concern that cash letter fluctuations would make compliance with the guidelines difficult. Two commenters expressed concern that the guidelines would make it difficult to fund their correspondent to cover payments system transactions. One commenter argued that the guidelines would force inexperienced banks to engage in securities trading in order to avoid federal funds sales.

Sixty-two commenters emphasized the difficulty of diversifying correspondent business in order to comply with the guidelines. Fifty-nine of these commenters focused on the costs of establishing and maintaining additional correspondent relationships, and many argued that the expense of diversification exceeds the reduction in risk. Four commenters asserted that mergers and acquisitions have reduced the number of suitable correspondents. One commenter argued that larger correspondents were not interested in providing services to smaller banks.

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Five correspondents argued that concentrating correspondent business is beneficial because a close relationship covering multiple services is important and brings such benefits as preferred customer status. One commenter argued that only by concentrating its correspondent business can a small bank engage in a broad range of transactions, such as settling trades in Treasury bills in an amount large enough to obtain the maximum yield. Six other commenters argued that concentrating correspondent business may reduce systemic risk by facilitating closer monitoring.

Eight commenters contended that reducing exposure by selling federal funds through an agent is more expensive. Four commenters asserted that reducing exposure by shifting from compensating balances to fees reduces profitability because compensating balances often provide a higher return than short-term investments. Another commenter argued that fees created a risk to the correspondent of nonpayment.

Three commenters proposed modifications to the guidelines. One urged an exemption for well-managed banks and two others suggested that the tiers be altered to permit a minimum percentage or dollar amount of acceptable exposure without regard to capitalization.

The Final Rule

The final rule places greater emphasis on analysis of the creditworthiness of correspondents and decreases the emphasis on across-the-board limits. The limit on credit exposure to adequately capitalized correspondents has been eliminated. The limit on credit exposure to correspondents that a bank cannot demonstrate are at least adequately capitalized remains, however. The Board believes that the elimination of the limit for adequately capitalized correspondents will significantly reduce the problems associated with the limits. Because fewer correspondents would be subject to the limits, monitoring to ensure compliance should be less costly. Additionally, because the remaining limit on credit exposure would be implemented as part of the bank's normal policies and procedures, the final rule permits a bank to choose to implement the limit through structuring of relationships or monitoring.

*Section 206.4(a)(1) Well-Capitalized Correspondents [Final Rule—Included With Adequately Capitalized Correspondents Under Section 206.4(a)(1)]*

The proposed rule stated that, 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 of the proposed rule. The Board received three comments on this section, two of which strongly endorsed the rule as written.

One commenter expressed concern that regulators will restrict respondent's discretion in creating exposure to well-capitalized banks and that respondents, fearing that, will themselves restrict their exposure, reducing liquidity and fragmenting correspondent relationships. The final rule continues to provide that, while prudential limits to well-capitalized correspondents may be appropriate, these limits are not bounded by an express limit in the rule.

*Section 206.4(a)(2) Adequately Capitalized Correspondents [Final Rule—Included in Section 206.4(a)(1)]*

The proposed rule provided that 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 of the proposed rule, to an amount equal to not more than 50 percent of the bank's total capital. The proposed rule also provided that, for such a correspondent, the bank ordinarily should limit its daily interday credit exposure with a remaining term to maturity of more than thirty days to an amount equal to not more than 25 percent of the bank's total capital. Twenty-three commenters specifically addressed this section.

Elimination of Limit

Eighteen commenters suggested that the final rule eliminate the distinction between adequately and well-capitalized correspondents altogether.

A number of banks argued that this provision would have an adverse effect on adequately capitalized banks or that the difference between adequately and well-capitalized banks was not meaningful. One commenter argued that the rule would interfere with an adequately capitalized bank's ability to compete in international funding markets. Three commenters pointed out that, although the difference between a well-capitalized bank and an adequately capitalized bank is insignificant at the margin, the rule imposes a significant monitoring burden on respondents dealing with an adequately capitalized correspondent. Two other commenters asserted that the burden of complying with the rule would lead respondents to cease to do business with adequately capitalized banks. Three commenters argued that it would be very difficult for banks to regain market share if they drop, even temporarily, from well to adequately capitalized. Two commenters suggested that the rule may exacerbate systemic risk by restricting credit to a bank when that bank's capital declines by an arbitrary amount.

Two commenters complained that, in effect, the rule would force banks to restrict their exposure to transactions with maturities shorter than 30 days, leading banks to concentrate bank funding in shorter maturities, rather than balancing short- and long-term exposure. These commenters also argued that the rule would force banks to buy securities, reducing liquidity and exacerbating the credit crunch. In addition, two commenters expressed concern that misunderstanding of the purpose of the capital classifications could lead to a retreat from institutions that do not pose a risk to the banking system or to their customers, but that do not meet the standards to be considered "well capitalized."

Proposed Changes

Six commenters proposed changes to the guidelines concerning adequately capitalized banks. Two commenters suggested that the 25 percent limit only apply to exposures with a maturity of over 90 days. One suggested that the only restriction on banks dealing with adequately capitalized correspondents be a limit of 50 percent of capital on exposure with maturities of 90 days or more. Two other commenters suggested that the exposure limit be increased to 100 percent of capital with a 50 percent limit for 30 day maturities. Conversely, one commenter suggested that the Board eliminate limits on credit exposure with maturities longer than 30 days, asserting that tracking exposure by maturity is expensive, especially for small banks, and that as a result banks will eliminate exposure to adequately capitalized banks.

The Final Rule

The final rule does not include a regulatory limit on credit exposure to adequately capitalized institutions. The Board believes that this change will reduce monitoring costs and avoid unwarranted reductions in the business of adequately capitalized banks due to the implementation of section 308. Elimination of this limit also reflects the difficulty in setting an appropriate

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exposure limit that reflects the actual credit and liquidity effects of a correspondent's failure in light of prompt partial payment by the FDIC.

Further, the proposed limit on credit exposure for adequately capitalized correspondents served largely as a transition from the unrestricted credit exposure permitted for well-capitalized correspondents to the 25 percent limit for less than adequately capitalized correspondents. The prudential standards of the proposed final rule have been modified to address this issue more directly by emphasizing analysis of the creditworthiness of a correspondent and requiring a bank to take into account any deterioration in the financial condition of its correspondent.

Finally, credit exposure in excess of 25 percent of the bank's total capital would not be "grandfathered" under the proposed final rule, thus encouraging a bank with significant credit exposure to a correspondent that is in danger of slipping below adequately capitalized to limit the maturity of any credit exposure in excess of the 25 percent guideline.

The final rule also reduces the need for a rapid reduction in exposure to a correspondent that has slipped below adequately capitalized by extending the transition provision to 120 days, allowing the bank more time to evaluate exposure and restructure activities.

*Section 206.4(a)(3) Other Correspondents [Final Rule—Incorporated in Section 206.4(a)(1)]*

The proposed rule provided that a bank ordinarily should limit its daily interday credit exposure to a correspondent that the bank cannot demonstrate is well or adequately capitalized to an amount equal to not more than 25 percent of the bank's total capital. The Board received nine comments on this section, one of which supported the regulation as written.

Three commenters proposed that the rule increase permissible exposure to 50 percent of capital. One of these commenters suggested that this increase be contingent upon the respondent conducting due diligence quarterly. Another commenter argued that restricting exposure to less than adequately capitalized banks would increase the likelihood of their failure. Three commenters suggested that the final rule be more stringent. Two suggested that the rule prohibit any uninsured exposure to a significantly or critically undercapitalized correspondent, and the other suggested that the rule prevent significantly undercapitalized banks from purchasing federal funds or certificates of deposit with maturities over seven days. Finally, one commenter questioned why the proposed rule did not distinguish between undercapitalized, significantly undercapitalized, and critically undercapitalized banks.

As discussed above, the limit on credit exposure to correspondents that a bank cannot demonstrate are at least adequately capitalized has been retained in the final rule. Greater credit exposure to such correspondents would generally create undue risk to banks. However, the Board does not believe that additional guidelines to address more significantly impaired correspondents are warranted. Banks' prudential policies and procedures should address exposure to particularly troubled correspondents.

*Section 206.4(b) Commonly Controlled Insured Depository Institutions [Final Rule—Section 206.2(b) and (c)]*

The proposed rule provided that, except for the general prudential standards in § 206.3, 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.

The proposed rule defined a correspondent as commonly controlled with the bank if 25 percent or more of any class of voting securities of the bank and the correspondent were owned, directly or indirectly, by the same depository institution or company; or, either the bank or the correspondent owns 25 percent or more of any class of voting securities of the other. Exposure to a commonly controlled depository institution was excluded from the limits on credit exposure because there is no effective way for an insured bank to limit its credit exposure to an FDIC-insured depository institution that is commonly controlled with the bank. The cross-guarantee provisions of the Federal Deposit Insurance Act make an insured depository institution potentially liable to the FDIC for losses resulting from the failure of a commonly controlled insured depository institution. The Board received fourteen comments on this section, three of which supported the section as written.

Substantive Comments

Eleven commenters criticized the exemption for commonly controlled institutions. Eight of them, submitting a substantially similar letter, argued that this provision would permit big banks to evade the purpose of the statute by shifting funds among commonly controlled institutions. Another commenter argued that depositor risk is measured by institutions and that risk to the deposit insurance system is not reduced because of bank consolidation. The commenter questioned whether the rule reflects a regulatory bias towards consolidation. In contrast, two other commenters argued that the Board should exclude inter-affiliate transactions from the rule entirely.

The provisions of the proposed rule reflected the authority of the FDIC to invoke cross-guarantees and thereby override any efforts of a bank to limit exposure to a commonly controlled correspondent, as well as current inter-affiliate funding arrangements within bank holding companies. Because of the cross-guarantees, disruption of these arrangements would not yield a commensurate reduction in risk to the FDIC insurance funds or to the banking system. The Board believes that exposure to commonly controlled correspondents should not be covered by either the limits on credit exposure or the prudential standards provisions of the final rule, as a bank cannot effectively limit its exposure to such correspondents under either provision. However, the Board notes that section 23A(a)(4) of the Federal Reserve Act would continue to apply to transactions with affiliates, including commonly controlled insured depository institutions.

One commenter suggested that the exclusion apply to banks that own shares in bankers' banks. The Board does not believe that it is appropriate to apply the exclusion to owners of a bankers' bank because the failure of the bankers' bank would not subject the owners to the cross-guarantee provisions of section 5(e) of the Federal Deposit Insurance Act.

Drafting

Two commenters suggested that the exception include banks subject to the provisions of section 23A of the Holding Company Act. This portion of the rule reflects those banks subject to the cross-guarantee provisions, which will cover virtually all those covered by section 23A.

This provision has been retained in the final rule but has been moved to the definitions section with conforming drafting changes.

*Section 206.4(c) Exposure of Subsidiaries [Final Rule—Section 206.4(e)]*

The proposed rule provided that, in calculating credit exposure to a correspondent under this part, a bank must include the credit exposure of the bank's subsidiaries to the

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correspondent. If the bank did not own 100 percent of the shares of the subsidiary, the proposed rule required the bank's credit exposure to include a *pro rata* portion of the subsidiary's exposure, based on the percentage ownership of the bank in the subsidiary. The purpose of this section was to capture the full exposure of a bank to a correspondent. The Board received five comments on this section.

Four commenters argued for restricting the scope of the regulation to subsidiaries of which the bank owns a majority of the voting stock. Two commenters argued that where a bank owns only a minority position, it may be unable to obtain daily exposure figures. Three commenters stated that the parent bank is unlikely to have consolidated systems for calculating exposure for minority-owned subsidiaries, and one noted that the percentage ownership may not justify the expense to the subsidiary of establishing an information reporting system for the shareholder bank. One of the commenters argued a bank cannot cause a subsidiary that the bank does not control to reduce its exposure, and the bank therefore could ensure compliance with the limits only by selling its interest in the subsidiary or by reducing its own exposure to the counterparty. Finally, three commenters argued that where the subsidiary is not included in the bank's consolidated financial statements, but is only reported as an investment, the parent's exposure is not the subsidiary's exposure but is limited to the bank's investment.

One commenter queried how the *pro rata* portion should be determined if a bank holds different classes of stock in the subsidiary. This commenter suggested that the provision only apply to banks holding common stock because the same credit exposure does not exist if the bank holds preferred stock, and proposed that where a bank holds a different class of stock, it should be permitted to use any reasonable method to calculate exposure.

In formulating the proposed rule, the Board noted that banks may assume obligations to support a subsidiary beyond their actual investment. However, the Board has modified the final rule to require a bank to include with the bank's own credit exposure 100 percent of the credit exposure of any subsidiary that the bank is required to consolidate on its Report of Condition and Income or Thrift Financial Report. This provision generally captures the credit exposure of any majority-owned subsidiary of the bank. Under the final rule, therefore, none of a minority-owned subsidiary's exposure and all of a majority-owned subsidiary's exposure would be included in the parent bank's exposure calculation.

*Section 206.4(d) Transition Provisions [Final Rule—Section 206.4(a)(2)]*

The proposed rule required that, 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 § 206.4(a) within 30 days after the date when current call report or other relevant financial data normally would be available. The Board received forty-seven comments on this section.

Extension of the Transition Period

Forty-five commenters expressed concern about the increase in monitoring requirements when a correspondent drops from well to adequately capitalized, the competitive impact on the correspondent, and compliance burdens. These commenters urged the Board to avoid overreaction to temporary dips in capital and to extend the transition period. Thirty of these commenters, submitting a substantially similar letter, proposed that banks be given one year to resume well-capitalized status. Eight commenters recommended transition periods ranging from 90 to 120 days. Four commenters noted that a variety of factors, such as regulatory changes, increases in reserves, asset revaluation, or acquisitions, could cause a bank's capitalization ratio to change abruptly without necessarily signifying significantly increased risk. Another commenter argued that the proposed rule, as written, would require a swift, abrupt adjustment to temporary swings in capital, resulting in a market bias for banks with capital less subject to fluctuations. Five commenters argued that where the credit exposure consists of off-balance sheet items or instruments with maturities of longer than 30 days, judicious reductions in credit exposure may not be possible within the rule's time frame. Three others stated that delays in financial reporting, especially where the respondent relies on a reporting service, may make compliance with the transition provisions extremely difficult.

One commenter inquired whether a respondent must adjust its exposure if the correspondent provides assurances that it will reacquire its former status within the next reporting period.

The Board believes that a longer transition period of at least a calendar quarter will avoid undue disruptions in correspondent relationship for temporary declines in capital ratios by allowing the correspondent an opportunity to bring its capital ratios back the relevant levels before the next quarterly report. The extended period will also provide the exposed bank more time to implement any monitoring required to demonstrate compliance with the regulatory limit and to adjust the maturities or level of exposure to the correspondent. Accordingly, the final rule would permit a bank 120 days to reduce its credit exposure to a correspondent.

If a bank has been relying on information from call reports or from a bank rating service for a correspondent's capital ratios, the 120-day period would run from the date when the call report or bank rating reflecting the correspondent's reduced capital ratios was received, or from the date that the information normally would be received. If a bank has been relying on information received from the correspondent to demonstrate that the correspondent is at least adequately capitalized, and the correspondent is no longer providing such information, the 120-day period would run from the date when the bank ordinarily would have received the information from the correspondent.

*Section 206.5 Credit Exposure [Final Rule Consolidated in Section 206.4]*

*Section 206.5(a) Scope of Credit Exposure [Final Rule—Section 206.4(b)]*

The proposed rule defined the credit exposure of a bank to a correspondent as 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. The proposed rule excluded certain relatively lower-risk items. In addition, for the purposes of this section, the rule provided that off-balance sheet items were to be valued on the basis of current exposure. Under the proposed rule, "credit exposure" was subject to the numerical benchmark guidelines or limits. In addition to the comments concerning the definition of exposure, addressed in § 206.2(c) above, the Board received ten comments on the definition of credit exposure.

One commenter noted that credit exposure is difficult to measure and criticized the proposed rule's emphasis on it. The proposed final rule deemphasizes credit exposure by

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eliminating the regulatory limit on credit exposure to adequately capitalized correspondents. While most of the commenters addressed the specific exclusions from the calculation of credit exposure, one commenter expressed concern about the inclusion of derivative instruments, such as swaps, in the calculation of interbank exposures, especially in light of the fact that non-bank correspondents or parties to derivative instruments are excluded. This commenter argued that the rule would drive the derivative business to non-bank counter-parties, weakening the safety protocols introduced into the swaps and other derivative markets as a result of bank participation in the markets. The Board believes that banks should have similar controls on credit exposure to nonbanks as on credit exposure to banks. However, exposure to nonbanks was not addressed by the statute. Further, the Board believes that it is not appropriate to exclude credit exposure from derivative instruments from the rule, as it represents a significant source of interbank exposure in many cases.

One commenter argued that depository institution equity securities taken as collateral or in satisfaction of a debt should be excluded from the definition of "credit exposure" because these instruments are not payment obligations. Such transactions give rise to a risk of loss if the correspondent fails, and therefore are covered by the definition of "credit exposure." In some circumstances, however, obligations collateralized by bank stock may qualify for exclusion under 206.4(d)(3) of the final rule. The definition in the final rule has been redrafted to clarify that capital instruments issued by the correspondent are included in the definition of "credit exposure."

Another commenter asked if the calculation of "current replacement value" for interest rate and foreign exchange contracts means that banks must make daily mark-to-market calculations on a counterparty by counterparty basis. The rule provides that monitoring must be on a mark-to-market basis. However, the marking need only be done at the appropriate monitoring intervals, which depend on the factors listed in the revised monitoring provision discussed above, not daily. One commenter stated that it has a sophisticated system which measures fractional rather than mark-to-market exposure, and inquired whether it may use its own system rather than the proposed rules. As noted above in the discussion of monitoring, alternative systems may be used where they will effectively maintain exposure within the prescribed limits.

Six commenters urged that settlement exposure be specifically excluded for the sake of clarity. Two commenters urged that intraday exposure be specifically excluded. One commenter suggested that intraday exposure be defined as exposure of less than 24 hours.

The proposed final rule has been redrafted for greater clarity, specifying that intraday or settlement exposure and agented funds are not included in "credit exposure."

*Section 206.5(b) Netting [Final Rule—Section 206.4(c)]*

The proposed rule provided that transactions covered by netting agreements that are valid and enforceable under all applicable laws may be netted in calculating exposure. The Board received two comments on this section.

One commenter urged the Board to permit mutual correspondents to deduct the reciprocal "due from" balances from exposure limits because they reduce exposure risk. Another commenter requested that the Board clarify the requirements that a bank "must have reasoned legal opinions" that netting contracts are valid and enforceable.

Under the final rule, the netting provision remains unchanged. Reciprocal "due from" balances that do not result in legally binding netting do not reduce credit risk to the same extent as legally binding netting. Reasoned legal opinions that netting contracts are valid would include opinions of counsel describing the legal reasoning that led to the conclusions expressed in the opinions.

*Section 206.5(c) Exclusions [Final Rule—Section 206.4(d)]*

The proposed rule established four exclusions to the scope of credit exposure.

*Section 206.5(c)(1) Secured Transactions [Final Rule—Section 206.4(d)(1)]*

The first exclusion involved transations, 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" were defined as 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. Both of these definitions were taken from the Office of the Comptroller of the Currency's lending limits on national banks. The Board received six comments on this section.

Two commenters suggested that this exception cover transactions to the extent that they are secured. The final rule has been redrafted to exclude transactions to the extent that they are secured.

Two other commenters suggested that the definition of government securities include those backed by the full faith and credit of a state government as well. The definition of government securities has not been changed, but the Board believes that most state securities would be covered by the definition of "readily marketable collateral." Transactions secured by these securities, therefore, would be excluded from credit exposure.

One commenter asked if letters of credit guaranteed by the Export-Import Bank of the United States would be considered government securities. The Board notes that, regardless of whether guaranteed letters of credit would be considered to be government securities, such transactions generally would qualify for exclusion from the calculation of credit exposure provided under § 206.4(d)(3) of the final rule (see discussion under "Quality assets").

Another commenter expressed concern that the exclusion for transactions secured by government-backed securities would lead to increased investment in government securities and decreased loans. The Board recognizes that the rule could encourage investment in government securities, but investment in government securities reflects lower credit risk than many other transactions and is consistent with the capital guidelines.

*Section 206.5(c)(2) Cash Items in the Process of Collection (CIPC) [Final Rule—Section 206.4(d)(2)]*

The second exclusion from the calculation of credit exposure covered the proceeds of checks and other cash items deposited in an account at a correspondent that are not yet available for withdrawal. The Board received nine

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comments on this section, three of which supported the section as written.

Three commenters expressed concern about the rule's treatment of when a cash item becomes exposure. One asked if "due from" balances should be measured by the actual available balance as reported by the bank on its internal ledger balance. The final rule requires that such balances be measured by the actual available balance. Two trade associations commenting on the rule stated that current correspondent practice is to make funds available as early in the day as possible, causing respondents under the proposed rule to incur a measurable exposure for a longer period of time and perhaps before collection of the underlying item has actually taken place. The Board notes that the valuation of cash items in the process of collection that would not be considered to be deposits by the FDIC, acting as receiver of a failed bank, can only be made after the fact. The Board believes, however, that the proposed standard best approximates this value and has retained it in the final rule.

Clarification

Six commenters asked what comparable items are included in "checks and other cash items." One commenter specifically suggested that credit card and debit card transaction be covered by the exclusion. Two commenters urged that it exclude all cash items, since the associated risk tends to be relatively short in duration. While cash items that are not treated as "agency" transactions by the FDIC clearly result in credit risk and should be included in credit exposure, the Board believes that it is appropriate to exclude from credit exposure any item that the FDIC treats as being collected in an agency capacity rather than as a deposit or claim. The Board does not believe, however, that the FDIC has addressed whether the credit and debit card transactions are collected in an agency capacity.

Miscellaneous

One commenter asked if the Board would provide systems support in accounting for settlement exposure and cash items in the process of collection. The Board believes that this support is better provided by the market, and that correspondents may provide such support.

This exclusion remains unchanged in the final rule.

*Section 206.5(c)(3) Quality Assets [Final Rule—Section 206.4(d)(3)]*

The third exclusion covered "quality assets" on which the correspondent is secondarily liable or that result in secondary exposure to the correspondent, including loans to third parties secured by stock or debt obligations of the correspondent, loans to third parties purchased from the correspondent with recourse, and loans or obligations of third parties backed by stand-by letters of credit issued by the correspondent. The Board received three comments on this section.

One commenter expressed concern that the definition of "quality asset" raises the possibility that a loan secured by the stock of a correspondent may lose its status and be counted as exposure, discouraging such loans. Another commenter suggested that the rule give an exposed bank at least 30 days to adjust to a decline in the quality of a quality asset. The third commenter argued that credit exposure backed by a quality asset, such as a letter of credit, should be excluded from the definition of credit exposure.

In the final rule the exclusion for quality assets has been broadened to include direct exposure to a correspondent that is backed by a creditworthy obligor as well as a correspondent's secondary exposure on a quality asset. Additionally, under the final rule, the potential for excesses in exposure is recognized and a bank is required to have appropriate procedures to deal with such excesses.

*Section 206.5(c)(4) FDIC-Insured Amounts [Final Rule—Section 206.4(d)(5)]*

No comments were received on this section and it remains unchanged in the final rule.

*Mergers and Acquisitions [Final Rule—Section 206.4(d)(4)]*

As noted above, one commenter suggested that banks be given time after a merger to bring exposure within the guidelines for credit exposure. The final rule excludes exposure that results from a merger or acquisition of a bank from the definition of "credit exposure" for one year after the merger or acquisition. This exclusion gives banks one year to merge their systems for monitoring credit exposure.

*Section 206.6 Capital Levels of Correspondents [Final Rule—Section 206.5]*

The proposed rule provided that, for the purpose of compliance with the credit exposure guidelines, a correspondent would be considered "well capitalized" if the correspondent has a total risk-based capital ratio of 10.0 percent or greater, a Tier 1 risk-based capital ratio of 6.0 percent or greater, and a leverage ratio of 5.0 percent or greater. A correspondent would be considered "adequately capitalized" if the correspondent has a total risk-based capital ratio of 8.0 percent or greater, a Tier 1 risk-based capital ratio of 4.0 percent or greater, and a leverage ratio of 4.0 percent or greater. As used in the proposed rule, the terms "well capitalized" and "adequately capitalized" were similar but not identical to the definition of those terms as used for the purposes of the prompt corrective action standards under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o) ("prompt corrective action standards"). The proposed rule further provided that 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 subparagraphs (a)(1)(iii) and (a)(2)(iii) of this section of the proposed rule. The Board received 137 comments on this section.

Criticism of the Emphasis on Capital

Sixteen commenters disagreed with the Board's approach to structuring the limits on credit exposure. Ten commenters argued that the proposed rule overemphasized capital relative to other creditworthiness indicators such as liquidity, asset quality, earnings strength, regional and product line portfolio diversity, and operating environment. These commenters expressed concern that the proposed rule could encourage banks to focus on capitalization rather than on their own, broader based, prudential systems for analyzing correspondent credit or on the efficiency or competitiveness of the correspondent's payments and processing systems. In addition, seven commenters questioned the value of capital as an indicator of strength. One commenter pointed out that risk-based capital provides a numerical assessment of subjective risks. Another commenter asserted that capital levels measured on a daily or quarterly basis are notoriously inaccurate. A third commenter argued that the limits on credit exposure should be based on the book value rather than on the market value of a correspondent's assets. A bank holding company argued that inadequate loan loss provisions can lead to a misrepresentation of a bank's actual strength. Two commenters suggested that if the proposed rule is seeking an objective measure it should select one which is easy to measure and not subject to frequent fluctuations. One commenter suggested that, as an alternative, the guidelines be based on

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the financial markets. In contrast, two commenters pointed out that the advantage of using capital is that it will encourage large banks that are not well capitalized to strengthen their capital position in order to maintain their interbank business. The final rule has been amended to de-emphasize the capital of correspondents by removing the limit on credit exposure to adequately capitalized correspondents.

Monitoring Capital of Domestic Banks

Sixteen commenters argued that gathering and analyzing data to the extent required by the rule is extremely difficult and unfairly burdensome, and that small banks lack the technical capacity and resources to conduct this analysis. Eight commenters objected to the cost of monitoring capital. Another commenter claimed that large banks may resist giving capitalization information to smaller banks seeking to initiate a correspondent relationship. Moreover, this commenter pointed out that prompt corrective action rules forbid advertizing capital levels. One commenter argued that without access to its correspondent's examination report, it would be unable to determine if the correspondent was adequately capitalized. Four commenters noted that CAMEL ratings are confidential.

Nineteen commenters suggested that regulatory agencies publish capitalization ratings, lists of well and adequately capitalized correspondents, or exposure limits for particular correspondents, domestic and foreign. These commenters justified the request by arguing that regulatory agencies have access to the information and have the capacity to make a more complete evaluation of safety and soundness. One commenter urged that the regulatory authorities release the data they have available. Five others urged that call reports or financial reports be altered to require banks to disclose capital adequacy.

Four commenters expressed concern that small banks will be unable to analyze capitalization information from a call report due to the length and complexity of the document. Four commenters urged that where federal funds are sold on an agency basis, the respondent should be able to rely on the capitalization information supplied by the agent. One commenter expressed concern that although the regulation only required a ratio analysis, respondents will ask for quarterly call reports. Moreover, seven commenters complained of the cost of disseminating this information. One of these commenters, for example, noted that it has 110 respondents to distribute the report to. Two other commenters expressed concern that the compliance burden would increase the advantage enjoyed by other financial service providers. One commenter proposed that the Board draft a model form with only the essential information necessary to comply with the rule.

Eight commenters urged the Board to shift the burden from respondents to correspondents. Two commenters proposed that the rule require correspondents to prepare uniform disclosure reports and to disclose promptly any deterioration in capitalization. Two other commenters urged that the rule permit respondents to base their credit assessment on a correspondent's self-assessment of its capital adequacy classification together with any supporting information it may provide. Twenty commenters, nineteen of whom submitted a substantially similar letter, urged the Board to permit respondents to rely on a correspondent's annual documentation of its capital levels. Thirty-four commenters suggested that quarterly submissions satisfy the requirement. One commenter urged the Board to inform correspondents that the financial information provided to other banks is subject to review by examiners and should be consistent with the information provided to regulators.

The Board recognizes that it is currently difficult to obtain information on the risk-based capital levels of a correspondent. Under the final rule, this task is somewhat simplified, as a bank will be required to demonstrate only that its correspondent's capital ratios qualify it as at least adequately capitalized. While the call report for correspondents that are not required to file a complete Schedule RC–R currently does not provide sufficient information to calculate a correspondent's precise capital ratios, it can be relied on to demonstrate that a correspondent is at least adequately capitalized.[10] Further, the Board anticipates that most banks will receive information on their correspondent's capital ratios either directly from the correspondents or from a bank rating agency. Finally, the Board notes that the standard used in the rule is based solely on capital ratios and does not require disclosure of CAMEL ratings.

Five commenters asked for clarification of permissible sources for capitalization information. One claimed that the most accurate information is informal information and sought acknowledgement of the validity of it as a source. Another suggested that the rule explicitly permit banks to rely on call reports in determining capitalization. Two commenters requested that banks be permitted to rely on call reports alone. Three commenters asked the Board to describe a publicly available information base. The final rule does not limit a bank to a single source of information for capital ratios, but indicates that a bank may rely on capital information obtained from a correspondent, bank rating agency, or other reliable source of information. The bank may also rely on information contained in the call report for this purpose. While the Board recognizes that informal information may be useful in evaluating the overall condition of a correspondent, such information is not sufficient to justify the higher levels of credit exposure permitted to adequately or well-capitalized correspondents under the rule. As stated in the summary of the final rule, the rule does not limit a bank to the use of publicly available information, but merely provides that a bank generally is not required to obtain non-public information.

Application of the Provision to Foreign Banks

Thirteen commenters expressed concern about the difficulty and cost of monitoring capital levels of foreign banks. One commenter noted that disclosure of capital information varies widely among foreign banks and another noted that information is difficult to obtain from the institution or from secondary sources. One requested that G–10 banks be required to provide uniform information. Two other commenters suggested that additional flexibility be granted to U.S. banks which deal with non-Basle banks because of the added difficulty in obtaining capital information. Two commenters requested that the Board develop a method to determine the capital levels of foreign correspondents.

One commenter proposed that the rule permit respondents to rely on annual data if that is the best available. Another commenter argued that it is inequitable to require quarterly analysis of the capital of U.S. banks while permitting banks to analyze the

[10] Banks with assets of $1 billion or less generally are required to complete only Part I of the Schedule, which provides a rough estimate of risk-based capital. A bank may assume that its correspondent is at least adequately capitalized if the correspondent has completed only Part I of Schedule RC–R. For correspondents that file a complete Schedule RC–R, the call report does include sufficient information to calculate a correspondent's risk-based capital. The Board expects that further information to facilitate this calculation will be made available prior to the implementation of the regulatory limit on credit exposure to less than adequately capitalized correspondents.

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capitalization of foreign banks semi-annually because information on foreign banks is unavailable on a more frequent basis. A third commenter proposed that if information is not available at least semi-annually, exposure to foreign banks should be restricted to 25 percent.

As in the proposed rule, the final rule permits a foreign correspondent to be considered "adequately capitalized" without regard to the level of the foreign bank's leverage ratio. As indicated in the supplementary information to the proposed rule, the Board believes that this treatment of foreign banks is consistent with the findings of the Capital Equivalency Report submitted by the Board and the Department of Treasury to Congress earlier this year.

The Board recognizes that public sources of information on risk-based capital ratios may not be available for many foreign bank correspondents. As with domestic correspondents, however, the Board anticipates that in most instances the correspondent will provide the information to the banks with which it does business. As foreign banks do not necessarily prepare financial statements on a quarterly basis, as domestic banks do, the final rule would permit a bank to rely on the foreign bank correspondent's most recent financial statements.

Clarification of the Provision

Eight commenters quoted the supplementary information to the proposed rule, which stated that banks should not rely on capitalization alone and that weakness in a correspondent's management, operations, or loan portfolio might lead a bank to restrict its exposure below the permissible limits on credit exposure. These commenters pointed out that these terms are subjective and that their interpretation by the various federal bank regulators may lead to substantial and unevenly enforced compliance burdens. Two of these commenters added that it may be prohibitively expensive to judge any potential "weakness" in a correspondent and, as a result, respondents may shift their correspondent activities to the public sector. One commenter suggested that to facilitate compliance, the final rule eliminate references which cut back on what is permissible under the guidelines and leave other considerations for the prudential analysis section.

The Board continues to believe that the remaining limit on credit exposure should be viewed as a maximum level for credit exposure rather than a safe harbor. To the extent that a bank's prudential policies and procedures suggest a lower level of credit exposure to a correspondent, the bank should adhere to the lower level.

Frequency of Monitoring

Twenty-six commenters sought clarification of the frequency with which capital must be monitored and the way it must be measured. Two commenters suggested that quarterly monitoring is too frequent and another proposed that capital be monitored annually. Twenty-three commenters, nineteen of whom submitted a substantially similar letter, urged that capital be measured over a period of time, rather than at a point in time. Three commenters urged that the capitalization of a correspondent in a multibank holding company be based on the capital of the bank holding company.

Under the final rule for domestic correspondents, capital should be monitored quarterly to pick up information based on the correspondent's most recent call report, financial statement, or bank rating report. For foreign bank correspondents, monitoring frequency should be related to the frequency with which financial statements or other regular reports are available. Although such information is available quarterly for some foreign banks, for many foreign banks financial statements generally will be available only on a semi-annual basis. Further, quarterly monitoring of capital is only required for correspondents to which a bank's potential credit exposure is more than 25 percent of its own capital. If the internal systems of a bank ordinarily limit credit exposure to a correspondent to less than 25 percent of the exposed bank's capital, no monitoring of the correspondent's capital would be necessary, although periodic reviews of the correspondent's financial condition may be required under § 206.3(a)(2) if exposure to the correspondent is significant.

Six commenters expressed concerns about the timeliness of the required information. Three noted substantial delays before generally published reports become available and another noted that this information is more expensive if it is obtained before it is commercially available. Two commenters requested guidelines on the requisite freshness of this data. Because information in risk-based capital ratios is generally based on the call report, a bank would be justified in relying on the most recently available reports based on call report data. While there may be a significant lag in such data, the Board believes that where the information in such reports is followed by the bank on a continuing basis, the reports remain a useful monitor of trends in the conditions of the correspondent.

Definition of "Adequately Capitalized"

Several commenters criticized the definition of "adequately capitalized." One suggested that the definition include all banks with a leverage ratio of 4 percent or greater and a total risk based capital ratio in excess of 8 percent. One suggested it include all banks with a tier 1 ratio of at least 5 percent. Another argued that the definition of adequately capitalized is unjustifiably more restrictive than the definition in the prompt corrective action standards and suggested that the definition include correspondents with a capital ratio of 3 percent and a 1 CAMEL rating. While acknowledging that a bank cannot disclose its CAMEL rating, the commenter suggested that it could disclose if it is adequately capitalized under this standard. Another bank suggested that the leverage ratio be excluded because it is not applied to foreign banks. Commenters also addressed the definition of "well capitalized," which has been deleted. One commenter suggested that the rule be written to state clearly the capital requirements imposed upon correspondents. Another commenter supported the capital definitions.

The definition of adequately capitalized in the proposed rule was based on, but not identical to, the definition used for prompt corrective action. The difference between the definitions is to enable banks to determine, from publicly available information, a correspondent's capital for the purpose of this rule. The Board believes that it would be confusing to make further changes in this rule's definition of "adequately capitalized" and the definition in the final rule remains unchanged.

*Section 206.7 Waiver [Final Rule—Section 206.6]*

The proposed rule provided that 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. The Board received three comments on this section.

Two commenters suggested that if the guidelines are not relaxed, small rural banks with seasonal cash flows should receive waivers. As noted above, the

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proposed final rule would eliminate the regulatory limit on credit exposure for adequately capitalized banks, substantially easing this constraint. To the extent that seasonal cash flows require rural banks to sell federal funds or engage in other transactions in excess of 25 percent of their capital, the Board believes that they should deal with banks that are adequately capitalized or better or diversify their credit exposure.

Another commenter suggested that the Board use its waiver authority liberally when the exposure is of a length or a type that extrication within 30 days is quite difficult. The Board does not believe that this use of the waiver authority is appropriate. The waiver is designed for low capital banks that need payment services and would not be able to obtain them otherwise. Rather than liberalize the waiver provisions, the Board has extended to 120 days the transition period for compliance with the limit on credit exposure to a correspondent that is less than adequately capitalized. This extension should permit banks to reduce exposure judiciously to a bank whose capital has been reduced. Under the final rule, the waiver provision remains unchanged.

*Section 206.8 Record Retention [Deleted in Final Rule]*

The proposed rule required that banks establish recordkeeping reasonably designed to demonstrate compliance with the provisions of §§ 206.3 and 206.4. The Board received forty-seven letters that commented on this section specifically and one hundred eight letters that complained of excessive paperwork generally.

Concerns With Cost Burdens

All of the forty-seven comments on this section complained of the cost and burden of these requirements. A trade association pointed out that banks already confront substantial compliance and recordkeeping requirements and that the requirements in the proposed rule may exceed banks' compliance capacity and ability. Two commenters asserted that requiring documentation of every closed transaction would substantially increase compliance costs. These commenters stated that records of closed transactions generally are not retained. Rather, limits are set for specific products and maturities, and internal limits are monitored to ensure they are not exceeded without specific credit approval. The commenters proposed that rather than requiring that records of closed transactions be available for review, the final rule should focus on the adequacy of a bank's establishment and monitoring of limits, including any reported overages.

Clarification of the Requirement

Three commenters requested that the final rule articulate what documentation must be maintained on file, in what format, and for how long, both to assist banks in maintaining reasonable records and to provide examiners with guidelines to effect uniform enforcement.

Proposals of Modification

Thirty-eight commenters offered specific suggestions for reducing the burden. Two commenters suggested that the requirements should not apply to exposure covered by FDIC insurance and that the requirements should be reduced for smaller amounts of exposure regardless of the correspondent's capitalization. Another commenter suggested an exception when exposure is less than 25% of capital.

Thirty-two commenters urged a reduction in recordkeeping requirements for respondents dealing with well-capitalized banks. Thirty of them sent an identical letter urging that the recordkeeping requirement be the same for a well-capitalized bank as it is for a Federal Reserve Bank. One commenter suggested that if a respondent selects a well-capitalized correspondent the recordkeeping burden should be restricted to maintaining on file the correspondent's quarterly disclosure and certification of its capitalization.

Other commenters urged a generalized reduction in the burden. One commenter suggested that the prudential standards requirement be limited to documenting an annual review. Two commenters suggested that the capital monitoring requirement be satisfied by documentation of an annual review of capital.

One commenter urged that the requirement be eliminated altogether, proposing that examiners rely on the adequacy of the prudential policies and that the burden be on the examiners to prove a violation of the regulation rather then on banks to prove compliance.

Final Rule

The specific record retention requirement has been deleted from the final rule. Examiners will use examiner guidance to determine compliance with the rule.

*Section 206.9 Transition Provisions [Final Rule—Section 206.7]*

The proposed rule provided that for a period of one year beginning on December 19, 1992, a bank would be required to comply with the prudential standards required under § 206.3(a), and under § 206.3(b) would be required to structure transactions with a correspondent or monitor exposure to a correspondent to ensure that its exposure did not exceed its internal limits established under § 206.3(a). During this period, the proposed rule did not require the bank to meet the guidelines for credit exposure established under § 206.4 or monitor credit exposure under § 206.3(b).

The proposed rule further provided that 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(b)(ii) would be 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 at 50 percent of the bank's capital. The proposed rule set the interim guideline on credit exposure to an individual correspondent contained in § 206.4(a)(iii) at 50 percent of the exposed institution's total capital. This section was designed to allow banks adequate time to rearrange their correspondent banking relationship to meet the new requirements. The Board received twelve comments on this section, one of which supported the provision as written and another of which supported the idea of a transition period.

Proposed Extension of the Transition Period.

Nine commenters urged the Board to extent the initial transition period, i.e. the period before the prudential guidelines become effective, to permit banks to prepare new policies or review and revise existing policies, to establish procedures to monitor and control interbank exposures, and to restructure correspondent relationships. Two commenters suggested that the proposed implementation date would not allow bank regulatory agencies sufficient time to train examiners.

The Board believes that a longer initial transition period will enable banks that have not made credit assessments of their correspondents to do so and for banks to review and, where appropriate, improve their monitoring procedures. An extended initial transition period also will enable the Board to develop examination guidelines related to the rule. Therefore, the final rule provides for a six-month transition period before the prudential standards become effective, with the regulatory limit on credit exposure

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phased in over a two year period after that date.

**Competitive Analysis**

The proposed rule included a competitive impact analysis discussing the effects of the proposed rule on the ability of private sector correspondent banks to compete effectively with the Federal Reserve Banks in providing similar services. The proposed rule did not limit credit exposure of a bank to Federal Reserve Banks or to "well capitalized" correspondents because such exposure would not pose a risk to the bank. However, the proposed rule did impose 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, requiring a bank to have internal policies and procedures to limit exposure to a well capitalized correspondent, to structure transactions or monitor exposure to ensure that exposure ordinarily remains within the internal limits established, and to obtain sufficient information to demonstrate that the correspondent is well capitalized. Additionally, for adequately-capitalized correspondents, the proposed rule required a bank to limit overall credit exposure to an amount equal to not more than 50 percent of the exposed bank's capital, and to limit credit exposure with a term to maturity of greater than thirty days to an amount equal to not more than 25 percent of the exposed bank's capital.

The analysis included with the proposed rule indicated that the rule could have a direct and material adverse effect on the ability of correspondents to compete effectively with the Federal Reserve Banks in providing payment services, particularly in the area of check collection. The analysis concluded that this adverse effect was due to the differing legal powers of the Federal Reserve Banks. In assessing whether the objective of the proposed rule, to limit the risks that the failure of a correspondent would pose to exposed banks, could be reasonably achieved with a lesser or no adverse competitive impact, the Board concluded that the structure of the proposed rule minimized any adverse competitive effects on correspondents by not imposing rigid limits on credit exposure, by permitting higher levels of credit exposure to correspondents with higher capital levels, and by excluding cash items in the process of collection from the calculation of credit exposure to a correspondent.

In light of comments received on the proposed rule, however, the Board has made a number of modifications to the final rule to reduce further any adverse competitive effect on private sector correspondents. These modifications, described in detail above, include removing the limit on credit exposure to adequately capitalized correspondents, requiring internal limits on exposure to a correspondent only where there is a significant risk that payments will not be made as contemplated, and requiring monitoring or structuring of transactions to remain within limits only where limits are required by the final rule. Additionally, the final rule affords a longer initial implementation period in order to provide banks adequate time to review existing internal policies and procedures. The Board believes that the extended implementation period, along with the other modifications to the final rule, will reduce the likelihood that a bank will conclude that it must transfer activities to a Federal Reserve Bank.

While the Board recognizes that the modifications to the final rule do not completely remove the adverse competitive effects of the rule, the Board believes that the provisions of the final rule are necessary to fulfill the statutory objectives. Additionally, the Board will consider whether modifications should be made to the private-sector adjustment factor (PSAF) used to calculate the prices of Reserve Bank services to address disparities in capital ratios between the Reserve Banks and private correspondents resulting from the rule.

**Regulatory Flexibility Analysis**

Pursuant to section 603 of the Regulatory Flexibility Act (Pub. L. 96–354, U.S.C. 601 *et seq.*), the Board published for comment an initial regulatory flexibility analysis analyzing the provisions of its proposed Regulation F. Section 604 of the Regulatory Flexibility Act requires the Board to publish a final regulatory flexibility analysis with the final rule containing: (1) A statement of the need for, and objectives of, the rule; (2) a summary of the issues raised by the public comment in response to the initial regulatory flexibility statement, a summary of the assessment of such comments, and a statement of changes made in the proposed rule in response to comments; (3) a description of each of the significant alternatives to the rule consistent with the stated objectives of applicable statutes and designed to minimize any significant economic impact of the rule on small entities, and a statement of why these alternatives were rejected.

Each of these items are discussed in detail in the Supplementary Information above. The Board believes that the modifications included in the final rule significantly reduce the recordkeeping and regulatory burden imposed by the rule. The final rule places greater emphasis on the general internal policies and procedures of the bank, and does not require internal limits for all exposure to correspondents. The proposed rule also had been clarified to reduce the burden of monitoring such exposure. Additionally, the limit on credit exposure to adequately capitalized correspondents has been removed, significantly reducing the regulatory burden on banks in complying with the rule. This change lessens the probability that a bank will be required to diversify its exposure to a correspondent as a result of the rule, and eliminates the need for banks to monitor credit exposure to an adequately capitalized correspondent. Although a bank will continue to be required to monitor the capital levels of correspondents to which it has significant exposure, the final rule clarifies that a bank may rely on information obtained from its bank holding company, correspondent, or other party, significantly reducing the burden of obtaining the information.

**Notice of Final Rule**

A final rule is generally required to be published at least thirty days prior to its effective date. 5 U.S.C. 553(d). An exception is provided, however, where the agency has found good cause and provided the basis for the finding in the publication of the rule. 5 U.S.C. 553(d)(3). The final rule has been made effective as of December 19, 1992, in order to comply with the requirements of section 308 of FDICIA, which becomes effective on December 19, 1992. Further, although less than thirty days' notice has been provided before the effective date of the final rule, the rule contains transition provisions for actual compliance with the provisions of the regulation. Depository institutions covered by the rule will have six months after the effective date before actual compliance with any of the provisions of the rule is required. The Board therefore finds that there is good cause for the final rule to be made effective with less than a thirty-day notice period.

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

Banks, Banking, Interbank liability, Lending limits, 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 adding 12 CFR Part 206 to read as follows:

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## PART 206—LIMITATIONS ON INTERBANK LIABILITIES

Sec.
206.1 Authority, purpose, and scope.
206.2 Definitions.
206.3 Prudential standards.
206.4 Credit exposure.
206.5 Capital levels of correspondents.
206.6 Waiver.
206.7 Transition provisions.

**Authority:** Section 308 of Public Law 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 this part 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 in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813), and includes an insured national bank, state bank, District bank, or savings association, and an insured branch of a foreign bank.

(b) *Commonly-controlled correspondent* means 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 is 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) *Correspondent* means a U.S. depository institution or a foreign bank, as defined in this part, to which a bank has exposure, but does not include a commonly controlled correspondent.

(d) *Exposure* means the potential that an obligation will not be paid in a timely manner or in full. "Exposure" includes credit and liquidity risks, including operational risks, related to intraday and interday transactions.

(e) *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.

(f) *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)).

(g) *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.

(h) *U.S. depository institution* means a bank, as defined in § 206.2(a) of this part, other than an insured branch of a foreign bank.

### § 206.3 Prudential standards.

(a) *General.* A bank shall establish and maintain written policies and procedures to prevent excessive exposure to any individual correspondent in relation to the condition of the correspondent.

(b) *Standards for selecting correspondents.* (1) A bank shall establish policies and procedures that take into account credit and liquidity risks, including operational risks, in selecting correspondents and terminating those relationships.

(2) Where exposure to a correspondent is significant, the policies and procedures shall require periodic reviews of the financial condition of the correspondent and shall take into account any deterioration in the correspondent's financial condition. Factors bearing on the financial condition of the correspondent include the capital level of the correspondent, level of nonaccrual and past due loans and leases, level of earnings, and other factors affecting the financial condition of the correspondent. Where public information on the financial condition of the correspondent is available, a bank may base its review of the financial condition of a correspondent on such information, and is not required to obtain non-public information for its review. However, for those foreign banks for which there is no public source of financial information, a bank will be required to obtain information for its review.

(3) A bank may rely on another party, such as a bank rating agency or the bank's holding company, to assess the financial condition of or select a correspondent, provided that the bank's board of directors has reviewed and approved the general assessment or selection criteria used by that party.

(c) *Internal limits on exposure.* (1) Where the financial condition of the correspondent and the form of maturity of the exposure create a significant risk that payments will not be made in full or in a timely manner, a bank's policies and procedures shall limit the bank's exposure to the correspondent, either by the establishment of internal limits or by other means. Limits shall be consistent with the risk undertaken, considering the financial condition and the form and maturity of exposure to the correspondent. Limits may be fixed as to amount of flexible, based on such factors as the monitoring of exposure and the financial condition of the correspondent. Different limits may be set for different forms of exposure, different products, and different maturities.

(2) A bank shall structure transactions with a correspondent or monitor exposure to a correspondent, directly or through another party, to ensure that its exposure ordinarily does not exceed the bank's internal limits, including limits established for credit exposure, except for occasional excesses resulting from unusual market disturbances, market movements favorable to the bank, increases in activity, operational problems, or other unusual circumstances. Generally, monitoring may be done on a retrospective basis. The level of monitoring required depends on:

(i) The extent to which exposure approaches the bank's internal limits;

(ii) The volatility of the exposure; and

(iii) The financial condition of the correspondent.

(3) A bank shall establish appropriate procedures to address excesses over its internal limits.

(d) *Review by board of directors.* The policies and procedures established under this section shall be reviewed and approved by the bank's board of directors at least annually.

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**§ 206.4 Credit exposure.**

(a) *Limits on credit exposure.* (1) The policies and procedures on exposure established by a bank under § 206.3(c) of this part shall limit a bank's interday credit exposure to an individual correspondent to not more than 25 percent of the bank's total capital, unless the bank can demonstrate that its correspondent is at least adequately capitalized, as defined in § 206.5(a) of this part.

(2) Where a bank is no longer able to demonstrate that a correspondent is at least adequately capitalized for the purposes of § 206.4(a) of this part, including where the bank cannot obtain adequate information concerning the capital ratios of the correspondent, the bank shall reduce its credit exposure to comply with the requirements of § 206.4(a)(1) of this part within 120 days after the date when the current Report of Condition and Income or other relevant report normally would be available.

(b) *Calculation of credit exposure.* Except as provided in §§ 206.4 (c) and (d) of this part, 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 or capital instruments issued by the correspondent. For this purpose, off-balance sheet items shall be valued on the basis of current exposure. The term "credit exposure" does not include exposure related to the settlement of transactions, intraday exposure, transactions in an agency or similar capacity where losses will be passed back to the principal of other party, or other sources of exposure that are not covered by the capital adequacy guidelines.

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

(d) *Exclusions.* A bank may exclude the following from the calculation of credit exposure to a correspondent:

(1) Transactions, including reverse repurchase agreements, to the extent that the transactions are secured by government securities or readily marketable collateral, as defined in paragraph (f) of this section, based on the current market value of the collateral;

(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, as defined in paragraph (f) of this section, on which the correspondent is secondarily liable, or obligations of the correspondent on which a creditworthy obligor in addition to the correspondent is available, including but not limited to:

(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; or

(iv) Obligations of the correspondent backed by stand-by letters of credit issued by a creditworthy third party;

(4) exposure that results from the merger with or acquisition of another bank for one year after that merger or acquisition is consummated; and

(5) The portion of the bank's exposure to the correspondent that is covered by federal deposit insurance.

(e) *Credit exposure of subsidiaries.* In calculating credit exposure to a correspondent under this part, a bank shall include credit exposure to the correspondent of any entity that the bank is required to consolidate on its Report of Condition and Income or Thrift Financial Report.

(f) *Definitions.* As used in this section:

(1) *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.

(2) *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- ask-price market.

(3)(i) *Quality asset* means an asset:

(A) That is not in a nonaccrual status;

(B) On which principal or interest is not more than thirty days past due; and

(C) Whose terms have not been renegotiated or compromised due to the deteriorating financial conditions of the additional obligor.

(ii) An asset is not considered 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.

**§ 206.5 Capital levels of correspondents.**

(a) *Adequately capitalized correspondents.*[1] For the purpose of this part, a correspondent is considered adequately capitalized if the correspondent has:

(1) A total risk-based capital ratio, as defined in paragraph (e)(1) of this section, of 8.0 percent or greater;

(2) A Tier 1 risk-based capital ratio, as defined in paragraph (e)(2) of this section, of 4.0 percent or greater; and

(3) A leverage ratio, as defined in paragraph (e)(3) of this section, of 4.0 percent or greater.

(b) *Frequency of monitoring capital levels.* A bank shall obtain information to demonstrate that a correspondent is at least adequately capitalized on a quarterly basis, either from the most recently available Report of Condition and Income, Thrift Financial Report, financial statement, or bank rating report for the correspondent. For a foreign bank correspondent for which quarterly financial statements or reports are not available, a bank shall obtain such information on as frequent a basis as such information is available. Information obtained directly from a correspondent for the purpose of this section should be based on the most recently available Report of Condition and Income, Thrift Financial Report, or financial statement of the correspondent.

(c) *Foreign banks.* A correspondent that is a foreign bank may be considered adequately capitalized under this section without regard to the minimum leverage ratio required under paragraph (a)(3) of this section.

(d) *Reliance on information.* A bank may rely on information as to the capital levels of a correspondent obtained from the correspondent, a bank rating agency, or other party that it reasonably believes to be accurate.

(e) *Definitions.* For the purposes of this section:

(1) *Total risk-based capital ratio* means the ratio of qualifying total capital to weighted risk assets.

(2) *Tier 1 risk-based capital ratio* means the ratio of Tier 1 capital to weighted risk assets.

(3) *Leverage ratio* means the ratio of Tier 1 capital to average total consolidated assets, as calculated in accordance with the capital adequacy

[1] 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. See, *e.g.* 12 CFR part 208, subpart B.



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guidelines of the correspondent's primary federal supervisor.

(f) *Calculation of capital ratios.* (i) 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.

(ii) 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 ratios shall be calculated in accordance with the capital adequacy guidelines of the appropriate supervisory authority of the country in which the correspondent is chartered.

(iii) 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.

**§ 206.6 Waiver.**

The Board may waive the application of § 206.4(a) of this part 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 the otherwise applicable limit.

**§ 206.7 Transition provisions.**

(a) Beginning on June 19, 1993, a bank shall comply with the prudential standards prescribed under § 206.3 of this part.

(b) Beginning on June 19, 1994, a bank shall comply with the limit on credit exposure to an individual correspondent required under § 206.4(a) of this part, but for a period of one year after this date the limit shall be 50 percent of the bank's total capital.

By order of the Board of Governors of the Federal Reserve System, December 11, 1992.

**William W. Wiles,**

*Secretary of the Board.*

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