REGULATION H

Proposed Amendments Regarding Standby Letters of Credit and Ineligible Acceptances by State Member Banks

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

The following statement was issued January 17 by the Board of Governors of the Federal Reserve System:

The Board of Governors of the Federal Reserve System today proposed limitations on the issuance of so-called standby letters of credit and ineligible acceptances by State banks that are members of the Federal Reserve. Comment on the proposal should be received by the Board by March 15, 1974.

The Board's proposal would require State member banks to treat standby letters of credit and ineligible acceptances in the same manner that they treat ordinary loans. This means that the instruments would be subject to State restrictions on the amount of credit provided to any one borrower and to Federal requirements on loans to affiliates.

As part of a coordinated approach to the matter, similar proposals are also being issued for banks under their supervision by the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

A standby letter of credit does not normally involve an immediate outlay of funds by a bank. Such a letter, however, creates an obligation of the bank that involves a credit risk and could result in an outflow of funds at a later date.

Banks sometimes issue standby letters of credit to businesses that use them to support their own notes that are sold in the money markets to raise funds either for long-term investment or for general short-term working capital. So used, these letters of credit function virtually as a guaranty by a bank of the businessmen's note. These instruments are sometimes called documented discount notes.

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

The Board proposal would treat the issuance of both instruments as an unsafe or unsound banking practice in any case where the issuing bank does not subject the instruments to credit practices and requirements similar to those that are applied to ordinary loans. The proposal would not affect "traditional" letters of credit used to finance the shipment of goods.

Printed on the reverse side is the text of the Board of Governors' proposal. Comments thereon should be submitted by March 15 and may be sent to our Regulations and Bank Analysis Department.

ALFRED HAYES,
President.
MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM

Standby Letters of Credit and Ineligible Acceptances

The Board has under current consideration regulatory action with respect to certain practices which have developed in the issuance of some standby letters of credit and ineligible acceptances by State member banks.

For the purposes of this proposal, standby letters of credit include every letter of credit (or similar arrangement, however named or described), other than a letter of credit issued to facilitate the sale of goods and under which sight drafts or bankers' acceptances of the kind eligible, or which would become eligible, for discount by a Federal Reserve Bank under Regulation A, could be drawn. Standby letters of credit would include, but not be limited to, letters of credit attached to promissory notes (so-called documented discount notes). An ineligible acceptance is a time draft, accepted by a bank, which does not meet the requirements for rediscount with a Federal Reserve Bank.

A standby letter of credit, unlike an ordinary loan, does not usually involve an immediate outlay of funds by the issuing bank. The standby letter of credit creates an obligation of the bank that may mature into a current liability, however, and, in this regard, the standby letter of credit and the loan involve a similar degree of credit risk. The risk exposure of an issuing bank under a letter of credit obligation is demonstrated by the following examples:

If a standby letter of credit is issued with a provision that the beneficiary of the letter may collect from the bank upon default of the account party under a construction contract, and if for any reason at any time performance of the contract is not accepted, the bank could be required to pay.

In the case of the issuance of a documented discount note, the duty of the issuing bank is to pay the beneficiary in the event the account party does not pay. While the bank might have legal recourse to the account party for payment of the obligation, often such party may be found insolvent.

In both of the above examples, the issuing bank may be called upon at any time to disburse funds and, should the account party become insolvent, the issuing bank is situated as if a borrower under an ordinary loan agreement had become insolvent. In view of the foregoing, safe and sound banking practices would require that the credit of the account party under a standby letter of credit be examined with the same care as the credit of a potential borrower in an ordinary loan situation.

With respect to credit risk, the timing, amount, and degree of exposure to risk, standby letters of credit and ineligible acceptances are virtually identical.

In view of these and other considerations that are involved in the issue of standby letters of credit and ineligible acceptances, the Board proposes to amend Federal Reserve Regulation H (12 CFR 208), Membership of State Banking Institutions in the Federal Reserve System.

The proposed amendment would aggregate in each bank the amounts of standby letters of credit and ineligible acceptances with other loans in determining whether each bank would exceed Federal and State loan limitations. Moreover, a bank would be required to subject the account party to credit analysis equivalent to that applicable to a potential borrower in an ordinary situation. The proposed amendment also requires that the total amount of standby letters of credit and ineligible acceptances be adequately disclosed on published financial statements. If the proposed amendments are adopted, the Board will use its cease and desist powers (12 U.S.C. 1818(b)) with respect to any violation of the regulation.

The Board will not regard the issuance of standby letters of credit and ineligible acceptances within the proposed guidelines as an unsound practice. The Board believes these instruments, if issued prudently, can provide flexibility in financial transactions and be used in current commercial practices.

This notice is published for comment pursuant to Section 553(b) of Title 5, United States Code and Section 262.2(a) of the Rules of Procedure of the Board of Governors, and pursuant to the Board's supervisory authority over State member banks contained in Section 9 (12 U.S.C. 321) and Section 11 (12 U.S.C. 248(a) and (o)) of the Federal Reserve Act, and the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818(b)), and related provisions of the law.

Any comments should be submitted in writing to the Secretary, Board of Governors of the Federal Reserve System, Washington, D. C. 20551, to be received not later than March 15, 1974. Such material will be made available for inspection and copying on request, except as provided in section 261.6(a) of the Board's Rules Regarding Availability of Information.

To implement its proposal, the Board is considering amending Regulation H (12 CFR 208) by adding a new section 208.8, “Banking practices,” and renumbering the succeeding sections as set forth below.

1. The table of contents of Part 208 would be changed to read as follows:

SEC.
208.1 Definitions
208.2 Eligibility requirements
208.3 Insurance of deposits
208.4 Application for membership
208.5 Approval of application
208.6 Privileges and requirements of membership
208.7 Conditions of membership
208.8 Banking practices
208.9 Establishment or maintenance of branches
208.10 Publication of reports of member banks and their affiliates
208.11 Voluntary withdrawal from Federal Reserve System
208.12 Board forms
2. As an incident to these amendments, sections 208.8, 208.9, 208.10, and 208.11 would be redesignated 208.9, 208.10, 208.11, and 208.12, respectively.

A new section 208.8 would be added, as follows:

SECTION 208.8—BANKING PRACTICES

(a) Scope. No State member bank shall engage in practices which are unsafe or unsound or which result in a violation of law, rule, or regulation, or which violate any condition imposed by or agreements entered into with the Board. This section outlines certain of the practices in which State member banks should not engage.

(b) Waiver. A State member bank has the right to petition the Board to waive the conditions of section 208.8. A waiver may be granted upon a showing of good cause. The Board in its discretion may choose to limit, among other items, the scope, duration, and timing of the waiver.

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

(d) Letters of credit and ineligible acceptances.

(1) Restriction. A State member bank shall aggregate the amounts of any and all outstanding standby letters of credit (or other similar arrangements, however named or described), ineligible acceptances, and loans in determining whether the bank would be in excess of State legal limitations on loans of the bank (including limitations on loans to any one borrower or on aggregate loans) or on legal limits pertaining to loans to affiliates under Federal law (12 U.S.C. 371c). In addition, the credit standing of the account party under any letter of credit and/or the credit standing of the customer under the ineligible acceptance must be the subject of credit analysis equivalent to that applicable to a potential borrower in an ordinary loan situation.

(2) Definitions. For the purposes of this paragraph, standby letters of credit include every letter of credit (or similar arrangement, however named or described), other than a letter of credit issued to facilitate the sale of goods and under which sight drafts or bankers' acceptances of the kind eligible or which would become eligible for discount by a Federal Reserve Bank under Regulation A, could be drawn. Standby letters of credit would include, but not be limited to, letters of credit attached to promissory notes (so-called documented discount notes). An ineligible acceptance is a time draft, accepted by a bank, which does not meet the requirements for rediscount with a Federal Reserve Bank.

(3) Disclosure. The amount and general term of outstanding standby letters of credit and ineligible acceptances shall be adequately disclosed in the bank's published financial statements.