INTERNATIONAL BANKING OPERATIONS
Proposed Amendments to Regulation K

To All Depository Institutions, U.S. Branches, Agencies, and
Representative Offices of Foreign Banks, and Bank Holding Companies
in the Second Federal Reserve District, and Others Concerned:

The Board of Governors of the Federal Reserve System has requested comments on a proposal to amend its Regulation K, “International Banking Operations,” in order to implement certain provisions of the Foreign Bank Supervision Enhancement Act of 1991 to permit the Board of Governors to charge foreign banks for the cost of examinations of their branches, agencies, and representative offices operating in the United States. Following is the text of the statement issued by the Board of Governors in that regard:

The Federal Reserve Board has requested public comment on a proposal to assess charges for examinations of U.S. branches, agencies and representative offices of foreign banks.

Comment should be received by April 20, 1994.

In its notice of proposed rulemaking, the Board requested comment on the methods developed for assessing the cost of examinations for foreign banks. A charge for examinations of foreign banks operating in the United States is required by provisions of the Foreign Bank Supervision Enhancement Act of 1991.

Printed below is the text of the Board’s proposal, which has been reprinted from the Federal Register of December 15. Comments thereon should be submitted by April 20, 1994, and may be sent to the Board of Governors, as specified in the notice, or, at this Bank, to Nancy Bercovici, Assistant Vice President, International Bank Examinations Function. In addition, questions concerning this matter may also be directed to Ms. Bercovici (Tel. No. 212-720-8227).

WILLIAM J. MCDONOUGH,
President.
AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is seeking public comment on a proposal to amend its regulations relating to the activities of foreign banking organizations in the United States to implement provisions of the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) requiring the Board to charge foreign banks for the cost of examinations of their branches, agencies, and representative offices in the United States (collectively, “U.S. Offices”). Under the proposal, the amount charged for examinations would be determined by multiplying examiner hours by an hourly rate. For branches and agencies, the Board proposes that the number of examiner hours would be determined by applying a formula based on the branch’s or agency’s characteristics. Comment is also sought regarding the use of actual recorded examiner hours for this purpose. For representative offices, the Board proposes that actual recorded examiner hours would be used.

DATES: Comments should be submitted on or before April 20, 1994.

ADRESSES: Comments, which should refer to Docket No. R–0820, may be mailed to the Board of Governors of the Federal Reserve System, 20th & C Street, NW., Washington, DC 20551, to the attention of Mr. William W. Wiles, Secretary. Comments addressed to the attention of Mr. Wiles may be delivered to the Board’s mail room between 8:45 a.m. and 5:15 p.m., and to the security control room outside those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in room MP–500 between 9 a.m. and 5 p.m. weekdays, except as provided in § 261.8 of the Board’s Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Michael G. Martinson, Assistant Director (202/452–3640), or Michael D. O’Connor, Supervisory Financial Analyst (202/452–3808), Division of Banking Supervision and Regulation; or Kathleen M. O’Day, Associate General Counsel (202/452–3786), Sandy Richardson, Senior Attorney (202/452–6406), or Paul Vogel, Attorney (202/452–3428), Legal Division; or Sally M. Davies, Economist (202/452–2908), Division of Research and Statistics; Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunications Device for the Deaf (TDD), contact Dorthea Thompson (202/452–3544), Board of Governors of the Federal Reserve System, 20th & C Street, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION: The FBSEA generally mandated a strengthened supervisory framework and an expanded examination program for U.S. Offices of foreign banks. Public Law 102–242, title II, subtitle A, Dec. 19, 1991, 105 Stat. 2286. The FBSEA also provides that the cost of examinations of U.S. Offices shall be assessed against and collected from the foreign bank or its parent. 12 U.S.C. 3105(c)(1)(D), 3107(c). Assessing for the cost of examinations requires consideration of various methodologies and sources of information for determining the appropriate costs of an examination, including consideration of the number and experience of the examiners involved. In this regard, in order to assure compliance with the annual examination provision of the FBSEA, the Federal Reserve was required to hire and train large numbers of new examiners during the implementation period. The Federal Reserve has now reached a point where the examination program is substantially implemented and is in a position to promulgate a methodology to assess for the cost of examinations.

The purpose of this notice of proposed rulemaking is to seek public comment regarding the methods developed by the Board for assessing the cost of examinations against foreign banks. The Board also seeks comment regarding whether implementation of the FBSEA provision requiring the assessment of examination costs against foreign banks is consistent with the policy of national treatment established...

Method of Assessment

The Board considered various methods of allocating the costs of examination to foreign banks in order to assess them for the cost of examining their U.S. Offices. The most straightforward approach would be to refer to the time spent by examiners in conducting examinations of these offices. "Examiner hours" would be used to derive the examination charge, to allocate the examiner hours to the amount of time spent on the examination. These costs include, but are not limited to, the cost of equipment, clerical support, materials, and management review of the draft examination report. The Board, therefore, proposes to use examiner hours both for purposes of deriving a per hour charge and assigning examination costs to particular banks.

The Board proposes to use standard examiner hours, as described below, for assessing branches and agencies for the cost of examination generally and use of actual examiner hours for assessing representative offices for such costs. The Board also seeks comment regarding the use of actual examiner hours for purposes of assessing branches and agencies for the cost of examination. Branches and Agencies

The Board seeks comment on two alternative methods of assigning costs of examination to individual branches and agencies: (1) Developing a formula based upon experience to derive the examination charge; and (2) using the actual number of hours that examiners spend in conducting examinations. Both of these approaches would relate a bank's examination charge to the amount of Federal Reserve resources expended on examination of its U.S. Offices. As discussed below, the Board recognizes that there may be advantages associated with each method. For the reasons discussed below, however, the Board proposes to use the standard examiner hours method to calculate the examination charge to be assessed against U.S. branches and agencies of foreign banks. The Board also encourages commenters to provide feedback regarding use of actual hours to calculate the examination charge. Each of these methods is described below, together with the Board's assessment of the relative merits of each.

Actual Hours

The Federal Reserve maintains records regarding the actual hours examiners spend on particular examinations. Actual hours, therefore, could be used to determine foreign banks' examination charges. The Board is concerned with the use of actual hours for this purpose, however, because there are numerous factors that can cause variability in the amount of time spent examining U.S. Offices of foreign banks, even among offices having similar profiles. Variability may result from supervisory judgments regarding matters requiring further inquiry. Decisions to make an intensive investigation of certain areas or activities, for example, will increase the number of examiner hours, even though the further inquiry may often serve to alleviate rather than to confirm supervisory concerns. Administrative decisions regarding the composition of the examination team also may affect examiner hours. For example, the number of examiner hours may increase or decrease depending upon the overall level of experience of examiners assigned to the team. Decisions to provide new examiners with on-the-job training also can increase significantly the total number of hours spent on an examination.

For these reasons, the Board is concerned that charges based on actual hours might create an atmosphere in which disagreements over the composition of examiner teams or the amount of time spent on the examination would divert attention from critical supervisory issues. Examinations conducted by the Board also do not wish to undertake the examination process by adding to pressures from the examined entities on examiners not to take the time necessary to conduct a thorough examination of a particular institution.

The Board, therefore, does not propose use of actual hours generally to calculate charges for examinations of branches and agencies. The Board, however, is interested in receiving comment on the use of actual examiner hours for this purpose, including whether actual costs per hour (based upon actual salaries, benefits and other expenses), rather than the standard rate per hour proposed below, should be used in conjunction with actual hours to derive the examination charge. In this regard, the Board is concerned that a system of cost assessment based upon actual hours and actual costs per hour may be inefficient, given the added costs that would be associated with establishing, maintaining and administering such a system. Comment is sought regarding these matters.

Standard Hours

The Board's preferred method of determining the examination charge to be assessed against a foreign bank for its U.S. branches and agencies is to develop a formula, based upon experience, that would calculate a standard number of examiner hours required to examine these offices of given profiles and with given characteristics. Use of the standard examiner hours method would offer the advantage of decreasing the variability of examination charges levied against offices with similar profiles, while increasing the predictability of examination costs for an individual office. In particular, random variations in charges that arise from differences in examiner experience or the other factors discussed above would not be reflected in the charges assessed against foreign banks for their individual branches and agencies in a given year. The Board believes that assessments based on standard hours would be less costly to administer and less likely to lead to billing disputes than would charges based on actual hours.

A number of other U.S. bank regulators use standardized assessments to charge banking institutions for examination and supervisory costs. Generally, such assessments are related to the size of the banking institution. It has been the Federal Reserve's experience, however, that the cost of examining any given institution will be influenced significantly by characteristics other than its asset size. In view of the relevant language of the FBSEA, the Board considers that, to the extent possible, such characteristics should be taken into account in determining the charges to be assessed against institutions for their examinations. The Board nevertheless would be interested in receiving comment regarding whether standardized assessments for the cost of examination based solely on asset size would be preferable to the multi-variable methodology described below.
Proposed Methodology

For the reasons discussed above, in proposed § 211.26(d), the Board proposes developing a formula to derive standard hours by using standard statistical techniques to estimate the number of hours generally required to examine branches and agencies with similar characteristics. The basic approach would be to estimate a linear regression of Federal Reserve examiner hours devoted over a past period to examining various branches and agencies on the characteristics thought likely to have affected the amount of time necessary to examine such offices. All characteristics ("variables") that are thought potentially to have a material effect on examiner hours would be considered for this purpose, including total assets, total loans, assets and loans in offshore "shell" branches, measures of off-balance sheet activities, problem loans, the composite rating of assets, internal controls and management ("AIM rating"), and the individual components of the AIM rating. These types of variables are key factors that influence the amount of time required to examine a banking entity.

The data used in the regression analysis would be collected from three sources—examination reports and two types of quarterly reports of condition, the FFIEC 002 and 002s reports. The examination reports would supply examination-specific data, such as the examination rating and its components and classified assets. The FFIEC 002 reports provide information regarding the U.S. operations of foreign banks, such as the dollar amount and composition of assets and liabilities and information on certain off-balance sheet activities. The FFIEC 002s reports contain information on the balance sheets of off-shore offices of foreign banks that are "managed or controlled" (as that phrase is defined in the instructions to the 002s report) by their U.S. Offices. Data would be collected for the year prior to the year in which the methodology, as derived under this methodology, would be applied to determine a bank’s charge. Earlier years' data, if available, may also be used in the regressions, provided that examiners’ practices have not changed significantly since that time.

Following the specification of various regression models, the variables that produce the best fit (that is, the characteristics of the branch or agency that best explain the amount of time necessary to examine the office, which will subsequently be referred to as the "explanatory variables") will be determined. When examiner hours are regressed on these explanatory variables, coefficients will be estimated for each of these variables. Each coefficient when multiplied by its corresponding variable will produce a number of examiner hours typically attributable to that variable, which then will be totaled in order to derive the number of standard examiner hours for a particular branch or agency.

The Board proposes that the model be evaluated annually in light of the data for the previous year. In order to improve the predictive ability of the regression, additional variables may be identified and included and variables previously included may be deleted or modified. Such changes to the variables may be necessary to allow for interactions between variables or to account for possible nonlinear relationships between examiner hours and the characteristics of branches or agencies. In addition, if appropriate, lagged values of some of the variables may also be included, such as ratings from the previous examination (in addition to ratings in the current examination). In determining which variables to include in the model, three criteria will be considered: (1) How likely it seems that a variable would influence examiner hours significantly or would be indicative of unmeasured variables that significantly influence examiner hours; (2) the variable’s contribution to the predictive ability of the model; and (3) how reasonable the estimated coefficients seem when evaluated against examiner experience.

Application of Proposed Methodology

Using data that were available from the sources described above for 1993, Board staff specified a number of regression models containing all of the variables listed above.1 The variables that produced the best fit for these data were: The dollar amounts of each of total loans, loans administered by the branch or agency but booked in off-shore branches, off-balance sheet derivative activities, loans in non-accrual status, and loans past due 90 days or more; whether the composite AIM rating for the current exam was 3 or worse; whether the internal controls component ("I rating") was 3 or worse for that examination; and whether the I rating for the previous examination was 4 or worse. Each of the latter two

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1 The data used in the analysis were obtained from the five Federal Reserve Banks that conduct the vast majority of examinations of branches and agencies—Atlanta, Chicago, Dallas, New York and San Francisco. These data were then matched with data reported by the branches and agencies in the FFIEC 002 and FFIEC 002s reports.

The regression results for the model that includes these variables are discussed in further detail in a separate section below. However, statistical analysis indicates that the relationship between examiner hours and the explanatory variables is highly significant. The adjusted R-squared statistic measures the percentage of the total variation of examiner hours explained by the variables included in the regression, thereby measuring the goodness of fit of the model. A high adjusted R-squared (close to 1) indicates a good fit. If all of the explanatory variables listed above are included in the regression analysis, the adjusted R-squared is 0.85, which indicates that this method of calculating predicted examiner hours explains 85 percent of the total variation of examiner hours for examinations of branches and agencies included in the sample. An adjusted R-squared of 0.85 generally would be regarded as very good for a cross-section data, which these data are (having been drawn from actual examinations of branches and agencies during the last year). The remaining 15 percent of the variation in examiner hours that is unexplained by this model is attributable to characteristics other than the explanatory variables.

Although the total costs recovered by the Federal Reserve using standard hours should equal the total costs recovered using actual hours, for some branches and agencies there may be considerable variation between the standard hours predicted by the model and the actual hours recorded for examinations. The Board considers that a substantial portion of the unexplained variation between standard and actual hours is due to omitted supervisory and administrative factors, such as decisions to explore certain aspects of a bank’s operations in greater detail, the level of experience of various examination...
teams, and unavoidable interruptions in the examination process. In investigating differences between standard and actual hours, the Board found that use of examinations to train new examiners increased actual examiner hours significantly. The Board considers that this is a transitory development resulting from the substantial build-up of staff during the past year to meet the new FBSEA requirements and expects this factor to be much less significant in the future. Other exceptional events, such as the bombing of the World Trade Center, which houses a number of branches and agencies, also were found to disrupt or prolong the examination process.

The Board also has identified two additional bank-specific factors not taken into account in the current model that might have an effect on actual examiner hours. These factors are: (1) The presence in the branch’s or agency’s portfolio of participations in large loans that are under the Shared National Credit Program (“shared national credits”); and (2) the number of loans in a branch’s or agency’s portfolio. All shared national credits are reviewed centrally at the offices of the lead banks, which obviates the need for examiners to analyze these loans on-site. The presence of these large loans consequently reduces the number of actual examiner hours. The number of loans in a branch’s or agency’s portfolio (not just the dollar amount of loans) also may influence the actual number of hours necessary to examine that branch or agency. The greater the overall number of loans, the more examiner time that may be required.

Although it is possible that the effects of shared national credits and the number of loans are indirectly accounted for in the model because the model allows for economies of scale in examining loans, the Board considers that these factors merit further consideration with a view to possibly incorporating them as additional explanatory variables in the model if sufficient data are available. The Board would appreciate comment on whether these factors expressly should be incorporated in the model or simply taken into account indirectly through variables that allow for economies of scale.

Finally, as noted above, the standard hours methodology assigns similar hours to institutions with similar measured characteristics. However, as also discussed above, actual hours can vary substantially across institutions with similar profiles. Thus, the difference between actual and standard hours also may be due to differences in actual examiner hours for institutions with similar profiles. When these differences in actual hours are substantial, one would expect that the variation between actual and standard hours also would be substantial. Some of these differences in actual hours likely result from the administrative and supervisory factors discussed above and are smoothed out by the standard hours methodology based upon any differences resulting from unmeasured bank characteristics. Any such differences would be examined to determine possible reasons and adjustments to the model would be as appropriate.

The Board specifically seeks comment from foreign banks that would be subject to these examination charges regarding whether they consider the standard hours approach preferable to establishing the charge based upon the actual number of hours taken to complete the examination. The Board recognizes that the standard hours methodology is based upon complex statistical analysis, but considers that, once the methodology is implemented, it may be more straightforward to apply, more cost-effective in nature because new record-keeping systems would not be required by the Reserve Banks, and more predictable in its end result.

In establishing a system for recovery of examination costs, the Board is particularly mindful of the additional costs potentially associated with the implementation, maintenance and administration of such a cost-assessment system; in the Board’s view, such costs should be kept to a minimum and certainly in proportion to the amounts eligible for recovery. Comments on these matters are requested.

Specialized Examinations

The Board is mindful that the standard hours methodology described above may prove to be less appropriate for certain types of examinations conducted by the Federal Reserve, either because the examinations are of a specialized nature or because they may be conducted less than annually. Among these types of specialized examinations are electronic data processing (EDP) examinations, consumer compliance examinations, and trust examinations. The Board seeks comment on whether, if feasible, the costs associated with specialized examinations should be included in the total cost of examination and recovered on the basis of the standard hours methodology described above or some variation thereof, or whether these costs should be recovered on the basis of actual examiner hours.

Representative Offices

While the Board generally favors the standard hours method described above, the model discussed above is based upon data relating to the examinations of branches and agencies and would not be appropriate for calculating charges for examinations of representative offices. Examinations of representative offices by the Federal Reserve commenced in late 1992. These initial examinations by Federal Reserve examiners have been, in large part, exploratory, and further experience with examinations of these offices is necessary before examination procedures for these offices can be standardized. In these circumstances, the Board considers that development of a model for representative offices similar to that described above is not feasible at this time. The Board proposes that, until further experience with examinations of these offices is gained, actual examiner hours will be used to assess representative offices for examination costs.

Identifying the Costs To Be Recovered

Another question considered by the Board in developing this proposal is which costs constitute the cost of examinations, given that such costs are the costs to be recovered by the Federal Reserve pursuant to the FBSEA. The Board considers that only those costs reasonably related to the conduct of examinations should be considered to be the cost of examinations and assessed against foreign banks.

The official cost accounting system of the Federal Reserve System is known as the Planning and Control System (PACS). PACS is used for purposes of developing budgets for Reserve Banks, accounting for Federal Reserve System expenses, and determining the cost of its various output services, including prices for check collection, Fedwire, and automated clearinghouse services. PACS data, which are available to the public, constitute the sole source of information on examination costs other than examiners’ salaries, benefits, and travel expenses. Such costs include, e.g., costs related to materials and supplies, computer equipment and software, data processing, and printing and duplication.

The Board considers that the fundamental role of PACS in accounting for Federal Reserve System expenses and its use in setting the prices of the Federal Reserve’s services sold in the market argue for its use as the basis for determining the appropriate amounts to assess foreign banks for examinations of their U.S. Offices. As currently
structured, however, PACS does not provide information sufficient to segregate the costs incurred in conducting examinations of U.S. Offices of foreign banks from other examination and supervisory costs.

Instead, these costs presently are aggregated in PACS with the cost of examining the U.S. subsidiaries of foreign banks (e.g., commercial banks, bank holding companies and their nonbank subsidiaries, and Edge Act corporations) and with other examination and supervisory costs. It is necessary, therefore, to revise PACS in order to provide information sufficient to segregate the costs of examining U.S. Offices from other examination and supervisory costs.

For this reason, the Board has provisionally created for 1993 subcategories referred to as “sub-activities” in order to isolate examination costs pertaining to U.S. Offices from these other costs. For example, the Reserve Bank has reviewed the information reported in PACS for the first quarter of 1993 and has provided provisional data for the new sub-activities for that quarter, as well as cost estimates for these sub-activities for the entire year. The Reserve Bank has also reported total examiner hours spent thus far in 1993 in the examination of U.S. Offices and estimated total examiner hours in this sub-activity for the year as a whole. Commencing with the first quarter of 1994, the Board proposes to revise the relevant PACS activities in order to provide information sufficient to isolate the costs of examination of U.S. Offices of foreign banks from other examination and supervisory costs.

The Board believes that the information provided in the revised PACS activity will constitute a reliable and appropriate measure of the cost of examination to be recovered by the Board pursuant to the cost-assessment provision of the FBSEA. These activities will include both direct and support costs as these components are defined in PACS.

The Board considers that certain of the Federal Reserve System’s expenses that under PACS presently are categorized as overhead also should be recovered as additional direct examination costs. Specialist staff, such as lawyers, accountants or systems experts, that are assigned to examinations because of a need for their particular expertise would charge their time directly to the examination activity. The Board also considered whether certain other of the Reserve Banks’ general overhead expenses should be recovered from foreign banks.

The Board concluded that such costs are too remotely related to the conduct of examinations to include such costs in examination charges assessed against foreign banks.

Table 1 summarizes the direct and support costs of examination for the Federal Reserve System as a whole for 1993, which have been estimated based upon PACS data. Table 1 also includes an estimate of the additional specialist costs associated with examination, which under PACS presently are included in overhead. This estimate was derived by taking the total PACS cost allocated to such staff and multiplying it by .0743, which is the approximate proportion of examination costs for U.S. Offices of foreign banks to the total costs for the PACS category or “service” to which examination costs presently are attributed. Commencing with the first quarter of 1994, PACS will be revised such that specialist staff used during the course of an examination will charge their time directly to the examination function rather than generally to overhead.

### TABLE 1.—PROJECTED SYSTEM COSTS OF EXAMINATION OF U.S. OFFICES OF FOREIGN BANKS FOR 1993 [In dollars]

<table>
<thead>
<tr>
<th>Cost Category</th>
<th>Per Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total PACS Direct Costs</td>
<td>$11,023,302</td>
</tr>
<tr>
<td>Personnel</td>
<td>$10,128,406</td>
</tr>
<tr>
<td>Travel</td>
<td>$554,621</td>
</tr>
<tr>
<td>Other Direct</td>
<td>$340,275</td>
</tr>
<tr>
<td>Total PACS Support Costs</td>
<td>$493,806</td>
</tr>
<tr>
<td>Allocated Specialist Costs</td>
<td>$11,517,108</td>
</tr>
<tr>
<td>(derived from PACS overhead</td>
<td>$202,369</td>
</tr>
<tr>
<td>data)</td>
<td></td>
</tr>
<tr>
<td>Total Costs</td>
<td>$11,719,477</td>
</tr>
</tbody>
</table>

### Calculating the Examination Charge

The Board proposes that a particular bank’s examination charge would be calculated as the product of examiner hours (either actual or standard) times a rate per hour. An hourly rate would be derived by dividing the projected total examination costs for a given period, e.g., a year, by the projected total hours spent by examiners in conducting such examinations during that period.

Hourly rates based upon projected 1993 total costs and examiner hours are set out in Table 2.

### TABLE 2.—PROJECTED SYSTEM COSTS OF EXAMINATION OF U.S. OFFICES PER EXAMINER HOUR—ESTIMATED 1993 ANNUAL DOLLARS

<table>
<thead>
<tr>
<th>Cost Category</th>
<th>Hourly Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Direct Costs</td>
<td>$45.12</td>
</tr>
<tr>
<td>Personnel</td>
<td>$40.53</td>
</tr>
<tr>
<td>Travel</td>
<td>$22.33</td>
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<tr>
<td>Other Direct</td>
<td>$1.37</td>
</tr>
<tr>
<td>Total Support Costs</td>
<td>$1.98</td>
</tr>
<tr>
<td>Total Direct and Support Costs</td>
<td>$47.10</td>
</tr>
<tr>
<td>Total Examiner Hours</td>
<td>$248.77</td>
</tr>
</tbody>
</table>

1 For purposes of this Table, the specialist costs separately listed in Table 1 have been included as additional direct personnel costs, which will be the approach taken by PACS commencing first quarter 1994 as noted above.

Federal Reserve examination costs vary by Federal Reserve District. The Board considers, however, that a single national hourly rate, representing average Federal Reserve System costs, is appropriate for determining banks’ assessments. This is the approach taken by the OCC, the other Federal banking regulator that assesses banks for its supervisory costs including the cost of examination. A single national rate would be much simpler and less costly to administer than would a system of local rates. It also would be consistent generally with the Board’s policy of assuring uniformity of examination standards and procedures throughout the Federal Reserve System.

### Regression Results

The standard hours methodology described above has been applied to data for 143 full-scope U.S. Office examinations that were completed in 1993. Table 3 sets out the definitions of the variables used in the regression. All variables specified in terms of a dollar amount are expressed in millions of dollars.

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4 Direct costs are those expenses charged directly to a PACS activity based on actual resource usage. Examples of direct costs include salaries and benefits, equipment, supplies, and software, shipping and communications. Support costs are charged to a PACS activity based on that activity’s usage of the support function. Examples of support costs include data processing, office space, housekeeping and printing and duplication.

5 PACS overhead expenses consist largely of administrative, bank services, accounting and legal costs.

6 The total of all charges for the examination of branches, agencies, and representative offices collected during a given period should be roughly equivalent to the Board’s aggregate examination costs relating to those offices for the same period.
The regression results reported in Table 4 can be used to devise a schedule of standard examiner days based on the characteristics of U.S. branches and agencies. This schedule can be represented by a formula, which is derived by multiplying each variable by its corresponding coefficient:

Standards days = \( \frac{27.3 + 0.0315 \times \text{TOT LE1B} + 0.0118 \times \text{TOT GT1B} + 0.0098 \times \text{IPOOR} \times \text{TOT LE1B} + 0.025x \text{IPOOR} \times \text{TOT GT1B} + 0.039x \text{OFF LE1B} + 0.0167x \text{OBS LE1B} + 0.0004x \text{OBS GT1B} + 0.0981 \times \text{NONACCR} + 0.228 \times \text{PASTDUE}}{1} \)

The next two coefficients, on \( \text{IPOOR} \times \text{TOT LE1B} \) and \( \text{IPOOR} \times \text{TOT GT1B} \), measure the increment to standard days attributable to total loans by an additional 0.0098 days per million dollars of loans (the coefficient on \( \text{IPOOR} \times \text{TOT GT1B} \)), for a total of 0.0413 days per million dollars of loans. For branches or agencies with total loans above $1 billion and an I rating no better than 3, the increment to standard days attributable to total loans increases by an additional 0.0098 days per million dollars of loans (the coefficient on \( \text{IPOOR} \times \text{TOT GT1B} \)), for a total of 0.0413 days per million dollars of loans. For branches or agencies with total loans above $1 billion and an I rating no better than 3, 0.120 days per million dollars of loans in excess of $1 billion (the coefficient on \( \text{IPOOR} \times \text{TOT LE1B} \)), for a 0.1318.

For ease of interpretation, the regression results are presented in terms of days, as opposed to examiner hours. To convert standard examiner days to examiner hours, simply multiply standard days by eight.

### Table 4—Regression Results: Examiner-Days Regressed on Branch and Agency Characteristics—Continued

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient estimate (t-statistics are listed in parentheses)</th>
<th>Coefficient estimate (t-statistics are listed in parentheses)</th>
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</thead>
<tbody>
<tr>
<td>INTERCEPT</td>
<td>27.3** (6.6)</td>
<td>15.3** (2.5)</td>
</tr>
<tr>
<td>TOT LE1B</td>
<td>0.0315** (2.9)</td>
<td>0.0390** (2.9)</td>
</tr>
<tr>
<td>TOT GT1B</td>
<td>0.0118** (2.9)</td>
<td>0.0167** (3.5)</td>
</tr>
<tr>
<td>IPOOR×TOT LE1B</td>
<td>0.0098 (3.5)</td>
<td>0.0377** (3.6)</td>
</tr>
<tr>
<td>IPOOR×TOT GT1B</td>
<td>0.120** (6.9)</td>
<td>0.0004* (6.9)</td>
</tr>
<tr>
<td>PIBAD×TOTLOANS</td>
<td>0.250** (7.4)</td>
<td>0.0981 (7.4)</td>
</tr>
<tr>
<td>AIMPOOR</td>
<td>0.0981 (2.5)</td>
<td>0.0981 (2.5)</td>
</tr>
<tr>
<td>OFF LE1B</td>
<td>0.0377** (3.6)</td>
<td>0.0228 (1.1)</td>
</tr>
<tr>
<td>OFF GT1B</td>
<td>0.0004* (6.9)</td>
<td>0.0228 (1.1)</td>
</tr>
<tr>
<td>OBS LE1B</td>
<td>0.0981 (2.5)</td>
<td>0.228 (1.1)</td>
</tr>
<tr>
<td>OBS GT1B</td>
<td>0.0981 (2.5)</td>
<td>0.228 (1.1)</td>
</tr>
<tr>
<td>NONACCR</td>
<td>0.0004* (6.9)</td>
<td>0.228 (1.1)</td>
</tr>
<tr>
<td>PASTDUE</td>
<td>0.0981 (2.5)</td>
<td>0.228 (1.1)</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.85</td>
<td>0.85</td>
</tr>
</tbody>
</table>

*Significant at the 5 percent confidence level.
**Significant at the 1 percent confidence level.

The coefficient on the INTERCEPT indicates that the minimum standard days for an examination is 27.3 days. The next two coefficients, on \( \text{IPOOR} \times \text{TOT LE1B} \) and \( \text{IPOOR} \times \text{TOT GT1B} \), measure the number of additional examiner days typically needed to examine a given amount of total loans. If the branch or agency has less than $1 billion in total loans, then the increment to standard days attributable to total loans is 31.5 days ($1,000 million times 0.0315) plus 0.0118 days for each million dollars of loans in excess of $1 billion. The next two coefficients, on \( \text{IPOOR} \times \text{TOT LE1B} \) and \( \text{IPOOR} \times \text{TOT GT1B} \), required to examine loans if the branch's or agency's I rating is 3 or worse. For branches or agencies with total loans less than $1 billion and an I rating no better than 3, the increment to standard days attributable to total loans increases by an additional 0.0098 days per million dollars of loans (the coefficient on \( \text{IPOOR} \times \text{TOT GT1B} \)), for a total of 0.0413 days per million dollars of loans. For branches or agencies with total loans above $1 billion and an I rating no better than 3, standard days increases by an additional 0.120 days per million dollars of loans in excess of $1 billion (the coefficient on \( \text{IPOOR} \times \text{TOT LE1B} \)), for a 0.1318.

This result suggests that there may be economies of scale in examining total loans. As discussed above, examiner hours likely increase with the number of loans, but decrease with the number of loans that are shared national credits. At larger values of total loans, the number of loans likely increases at a slower rate because both loan size and the number of shared national credits likely increase. This would create the observed relationship between total loans and examiner hours—examiner hours increase as total loans increase, but they increase more slowly at higher values of total loans.

Poor internal controls in a banking office generally lengthen the amount of time it takes to examine an office of any particular size. Regression results indicate that scaling this variable against total loans provides a reasonable basis for assessing a charge taking into account this variable.
plus an additional 9.8 days for the first $1 billion, for a total of 41.3 days for the first billion. The coefficient on PIBADxTQT LOANS, 0.25, is the increment to standard days per million dollars of loans for branches or agencies that have an I rating of 4 or worse in the previous exam. The coefficient on AIMPOOR indicates that the increase in the minimum standard days for a branch or an agency with a current AIM rating of 3 or worse is 15.3 days.

The marginal cost in examiner days of examining off-shore loans and off-balance-sheet derivatives also declines as total off-shore loans and the notional value of derivatives, respectively, exceed $1 billion. The coefficient on OFFLE1B indicates that up to the first billion dollars of off-shore loans, standards days increase by 0.039 per million. Above the first billion dollars of off-shore loans, standards days increase by 0.0167 days per million of these loans (the coefficient on OFFGT1B). The coefficient on OBSLE1B suggests that up to the first billion dollars of off-balance-sheet derivatives, standards days increase by 0.0377 per million. Above the first billion dollars of off-balance-sheet derivatives, standards days increase by 0.0004 days per million of the notional value of these instruments (the coefficient on OBSGT1B).

The coefficients on NONACCR and PASTDUE indicate that standard days increased 0.292 and 0.251, respectively, per million dollars of loans in non-accrual status and past-due loans. Note that the coefficients on NONACCR and PASTDUE are not statistically significantly different from zero. However, one would expect that these variables should have an influence on the amount of time required to perform an examination. Since it may be the case that these variables are insignificant because of the small sample size, these variables are included for consideration. If the coefficients remain insignificant when estimated using a larger sample, they may be removed from the model.

Paperwork Reduction Act

No collections of information pursuant to section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3501 et seq.) is contained in the proposed rule.

Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601–612) does not apply to a rule of particular applicability relating to rates, wages, corporate or financial structures or reorganizations thereof. Id. at 601(5). Accordingly, the Act’s requirements regarding an initial and final regulatory flexibility analysis (id. at 603 and 604) are not applicable here. In any event, two of the requirements of an initial regulatory flexibility analysis—a description of the reasons why the action of the agency is being considered and a statement of the objectives of, and the legal basis for, the proposed rule—are contained in the supplementary information above. The Board’s proposed rule would require no additional reporting or recordkeeping requirements by the public; nor are there any relevant Federal rules that duplicate, overlap, or conflict with the proposed rule, other than as required by law.

Another requirement of the initial regulatory flexibility analysis is a description of and, where feasible, an estimate of the number of small entities to which the rule shall apply. The Board’s proposed rule would apply to all U.S. Offices of foreign banks, and would charge each foreign bank for the costs of examination attributable to that bank’s U.S. Offices, as required by Congress. Thus, the proposed rule fulfills the primary purpose of the Regulatory Flexibility Act, which is to make sure that agencies’ rules do not impose disproportionate burdens on small businesses.

Accordingly, the Board hereby certifies that the proposed rule, if adopted in final form, will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act.

For the reasons set out in the preamble, 12 CFR part 211 is proposed to be amended as follows:

PART 211—INTERNATIONAL BANKING OPERATIONS
(REGULATION K)

1. The authority citation for part 211 is revised to read as follows:


2. Section 211.26 is amended by adding paragraphs (d) through (g) to read as follows:

§ 211.26 Examination of offices and affiliates of foreign banks.

* * * * *

(d) Cost of examinations of branches and agencies—

(1) Assessment and payment of costs. The Board shall assess against the foreign bank or its parent the cost of any examination of its U.S. branches or agencies conducted by the Federal Reserve pursuant to paragraphs (a)(1) or (c) of this section. The foreign bank or its parent shall pay to the appropriate Reserve Bank or, if so directed, to the Board the amount assessed for the cost of such examination.

(2) Determination of cost. The cost assessed by the Board, pursuant to paragraph (d)(1)(i) of this section, shall be determined by multiplying the standard hours, determined pursuant to paragraph (d)(3) of this section, by the hourly rate, determined pursuant to paragraph (f) of this section.

(3) Linear Regression: standard hours formula. (i) The standard hours for a foreign bank shall be calculated by using a formula derived from a linear regression that relates examiner hours to characteristics of U.S. branches or agencies of foreign banks.

(ii) The linear regression shall be used to estimate coefficients for each characteristic included in the regression.

(iii) The formula shall be used to calculate standard hours for each branch or agency of a foreign bank examined by the Federal Reserve by multiplying each regression coefficient by the value of the corresponding characteristic of the branch or agency and adding the products to the intercept, which is the minimum number of standard hours for an examination.

(iv) The value of each of the characteristics used in the calculation described in paragraph (d)(3)(iii) of this section shall come from one or more of the following sources: examination reports and Federal Financial Institutions Examination Council Forms 002 and 002s.

(4) Regression data. (i) The data used in the examination shall be collected from one or more of the following sources: examination reports and Federal Financial Institutions Examination Council Forms 002 and 002s.

(ii) The data used in the regression shall include data for examinations in which the “Notice of Standard Hours Formula and Hourly Rate for Examinations of U.S. Offices of Foreign Banks” (hereafter referred to as “Notice”), provided for in paragraph (g) of this section, is published in the Federal Register.

(iii) The data used in the regression may, in the discretion of the Board, also include data relating to previous years, if including such data improves the predictive ability of the regression and examiners’ practices have not changed significantly since that time.

(5) Regression variables.

Characteristics that, in the discretion of the Board, may be specified as variables in the regression include:

...
(i) The dollar amounts of each of total assets, total loans, loans administered by a U.S. branch or agency but booked in off-shore branches, off-balance sheet, derivatives and credit activities, loans in non-accrual status, loans past due 90 days or more, and classified assets; and
(ii) The composite AIM rating and the individual components of the AIM rating (asset quality, internal controls, and management).

(6) Other considerations regarding variables. In order to improve the predictive ability of the regression, in the light of developments regarding characteristics of branches or agencies of foreign banks or the Federal Reserve's examination practices, the Board may:
(i) Include additional variables other than those specified in paragraph (d)(5) of this section;
(ii) Drop variables or amend their specification, if appropriate, to allow for possible interactions between variables or non-linear relationships; or
(iii) Include lagged values of some variables.

(7) Factors considered in determining regression variables. In determining which variables to include in the regression, the Board shall consider:
(i) The likelihood that a variable would influence examiner hours significantly or would serve as a proxy for unmeasured variables that would influence examiner hours significantly; and
(ii) The variable's contribution to the predictive ability of the regression; and
(iii) The reasonableness of the signs and magnitudes of the estimated coefficients.

(8) Publication of standard hours formula and hourly rate. The formula for calculating standard hours pursuant to paragraph (d)(3) of this section shall be published in the Notice provided for in paragraph (g) of this section.

(e) Cost of examination of representative offices—
(1) Assessment and payment of costs. The Board shall assess to the foreign bank the cost of any examination of its representative offices conducted by the Federal Reserve, pursuant to paragraph (a)(2) of this section. The foreign bank shall pay to the appropriate Reserve Bank or, if so directed, to the Board the cost of such examination.

(2) Determination of cost. The cost assessed by the Board, pursuant to paragraph (e)(1) of this section, shall be determined by multiplying the actual number of hours taken to examine the representative office by Federal Reserve examiners by the hourly rate, determined pursuant to paragraph (f) of this section.

(f) Calculation of hourly rate—
(1) Formula. The hourly rate charged by the Board, pursuant to paragraphs (d)(2) and (e)(2) of this section, shall be calculated as follows:

\[
\frac{DC + SC}{EH} = HR
\]

where:

- DC: Direct costs
- SC: Support costs
- EH: Examiner hours
- HR: Hourly rate

(2) Components of formula. The component parts of the hourly rate formula set out in paragraph (f)(1) of this section are defined as follows:

(i) Direct costs: Those expenses budgeted for the coming year to be charged directly to the Federal Reserve's Planning and Control System (PACS) for the examination of U.S. branches, agencies and representative offices of foreign banks, including, but not limited to, expenses relating to salary and benefits, travel, materials and supplies, equipment, software, shipping, and communications.

(ii) Support costs: Those expenses budgeted for the coming year to be charged directly to PACS for the usage of support functions during the course of examinations of U.S. branches, agencies and representative offices of foreign banks, including, but not limited to, expenses relating to data processing, office space, housekeeping, and printing and duplication.

(iii) Examiner hours: The number of hours budgeted for on-site examinations of U.S. branches, agencies, and representative offices of foreign banks by examiners for the coming year.

(3) Publication of hourly rate. The hourly rate determined pursuant to paragraph (f) of this section shall be published in the Notice provided for in paragraph (g) of this section.

(g) Notice of standard hours formula and hourly rate for examinations of U.S. offices of foreign banks—
(1) December Notice. A Notice shall be published in the Federal Register by the Board no later than the first business day in December of each year. The Notice shall specify the standard hours formula and the hourly rate to be used by the Federal Reserve to charge for the examination of U.S. branches, agencies, and representative offices of foreign banks and shall be effective on January 1 of the calendar year following publication.

(2) Interim or amended notice. The Board may publish in the Federal Register an interim or amended Notice from time to time throughout the year. Unless otherwise specified, an interim or amended Notice will be effective 30 days after the date of publication in the Federal Register.