# INTERBANK LIABILITY

## Introduction

The sources of bank exposure to its correspondents tend to arise when banks: (1) obtain from their correspondents such services as check collection and other trade- or payment-related correspondent activities; and, (2) engage in transactions with correspondents in the financial markets. Each type of exposure presents its own risks and characteristics.

Correspondent banking services are the primary source of interbank exposure for most banks, particularly small- and medium-sized ones. Banks often maintain balances with their correspondents to settle transactions and compensate them for the services provided. These balances may result in exposure risks. Although correspondent services sometimes are provided on a fee basis, many correspondents may prefer compensating balance arrangements.

Exposure to a correspondent may be significant, particularly when a bank uses one for several services. The bank may use the correspondent for check collections and other payment services, to sell "fed funds" to the correspondent, and to engage in other banking transactions. This exposure may increase when interest rates fall, as higher levels of compensating balances are necessary to provide adequate compensation to the correspondent.

Although a bank's correspondent often will buy fed funds as principal directly from the bank, it may act as agent to place them with another institution. In such agency arrangements, a bank may provide its correspondent with an approved list of institutions with which it may place the funds. When a correspondent acts as the bank's agent in placing fed funds, its exposure is to the funds ultimate purchaser. Fed funds sales generally are unsecured.

Other transactions may be secured. A bank may provide funds to a correspondent through "reverse repurchase agreements." In these transactions the bank provides funds to the correspondent by buying an asset, generally a government security. The correspondent agrees that it will repurchase the asset from the bank at the expiration of a set period, generally overnight. The asset's repurchase price compensates the bank for the use of its funds. These transactions are generally secured.

Money center and large regional banks may have significant exposure to correspondents[1] through their activities in interbank markets. Interbank transactions such as swaps, foreign exchange contracts, and over-the-counter options, that call for future performance, create exposure to banks that act as counterparties in such transactions. In addition to credit risk, this exposure may include settlement risk that a counterparty will fail to complete a payment or delivery as expected. Settlement risk may arise from transactions in the government securities, foreign exchange, or other markets, and may result from liquidity, credit, or operational problems.

## Regulation F

Regulation F, Interbank Liabilities, implements section 308 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). It requires the Board of Governors of the Federal Reserve (Board) to prescribe standards to limit the risks posed by exposure of insured depository institutions to other depository institutions. Regulation F limits the risks that the

[1] Although the depository institutions (banks) that are parties to the interbank transactions generally are referred to as "counterparties," the term "correspondent" denotes any depository institution (bank) to which an insured depository institution is exposed. Commonly controlled correspondents are exempted by the regulation.

failure of a depository institution would pose to insured depository institutions. All banks insured by the FDIC are subject to the Federal Reserve Board's Regulation F, Interbank Liabilities.

Regulation F, Interbank Liabilities, consists of:

- **Prudential Standards** (Section 206.3), effective June 19, 1993; and,
- **Credit Exposure** (Section 206.4), which will be phased in beginning June 19, 1994.

The "Prudential Standards" section requires banks to develop and adopt internal policies and procedures to evaluate and control exposure to the banks (correspondents) with which they do business.

The "Credit Exposure" section requires a bank to enact internal policies and procedures that limits correspondent's "credit exposure." This exposure is limited to 25 percent or less of the exposed bank's capital, unless it can show that the correspondent is at least "adequately capitalized," as defined in the rule.[2] "Credit exposure" to a correspondent that is at least "adequately capitalized" is not limited, but prudential standards are required for all correspondents. Under this rule, "correspondent" includes both domestically chartered banks that are FDIC insured and foreign banks.

*Prudential Standards (Section 206.3)*

Regulation F requires insured banks to adopt internal policies and procedures that address the risk arising from exposure to a correspondent. They will consider the financial condition of the correspondent and the size, form, and maturity of the exposure. Banks may adopt flexible policies and procedures to permit resource allocation that will result in real reductions in risk and minimize the burden of compliance.

The bank's board of directors must review the policies and procedures annually, but do not need to approve individual correspondent relationships. Examiners will determine that the guidelines adopted by the board provide for consideration of liquidity and credit risks, including operational risks. Such considerations are required to establish and maintain relationships with correspondents. Liquidity risk is the risk of payment being delayed for some period of time. For example, a bank is subject to the liquidity risk that a payment due from a failed correspondent may be delayed. The bank's credit risk may be a lesser amount because of later distributions from the correspondent's receiver. Operational risk is the risk that work flow problems may create liquidity risks. For example, if a correspondent provides extensive data processing support, computer failure may prevent it from making payments. The bank may address this exposure in its operational procedures.

A bank's policies and procedures should provide for periodic review of the financial condition of all correspondents to which it has significant exposure. Significant exposure is an individual bank assessment that relates the exposure's size and maturity to the condition of the correspondent. The frequency of these reviews will also depend upon the size and maturity of the exposure and the condition of the correspondent. For example, the policies of many banks provide for an extensive annual review of a correspondent's financial condition. They require more extensive interim reviews when exposure to a correspondent is high or it has experienced financial difficulty.

[2] June 19, 1994 is the date that banks should begin to limit credit exposure to correspondents that are not at least "adequately capitalized." Initially, the limit will be set at 50 percent of the exposed bank's capital for a one-year period. On June 19, 1995, it will decline to 25 percent.

A bank need not require periodic review of the financial condition of all correspondents. Those reviews would not be necessary for a correspondent with only insignificant levels of exposure, such as small balances maintained for clearing purposes. Other insignificant forms of exposure include: (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. In those transactions, amounts generally are small and the exposed bank usually has prompt recourse to other parties. Federal Reserve Bank or Federal Home Loan Bank exposures pose small risk and are not included in the definition of a correspondent.

Examiners must verify that a bank has reviewed periodically the financial condition of any correspondent to which it has significant exposure. Significant levels of exposure should reflect those amounts that a prudent bank believes to deserve analysis for risk of loss.

A bank may base its review of the financial condition of a correspondent on such publicly available information as call reports, Thrift Financial Reports, Uniform Bank Performance Reports, annual reports, or rating service information. A bank generally is not required to obtain nonpublic information for its analysis of a correspondent's financial condition. Banks must obtain nonpublic information to evaluate a correspondent's condition only on those foreign banks for which no public financial statements are available. Then the bank must obtain financial information directly from the correspondent. For correspondents with which a bank has significant relationships, the bank may have considerable nonpublic information on such areas as the quality of management and general portfolio composition. Such complete information is not always available, nor is it routinely required.

Financial analysis of a correspondent may also be provided by another party, such as its holding company, a bank rating agency, or another correspondent. Examiners will verify that the bank has reviewed the assessment criteria used by the source of the financial analysis. Additionally, when a bank relies on its bank holding company to select and monitor correspondents, examiners will verify that it has approved the selection criteria. Approval of selection criteria is also expected when a correspondent, such as a banker's bank, chooses other correspondents with which to place it's federal funds or other deposits.

Examiners should verify that a bank whose correspondent has experienced a deterioration in its financial condition has taken that deterioration into account. Their evaluation of the creditworthiness of the correspondent and the appropriate level of exposure should be documented. Factors identifying deterioration include the capital level of the correspondent, the level of nonaccrual and past due loans and leases, and the level of earnings.

When an exposure creates a significant risk that payments will not be received as contemplated, examiners must verify that the bank has established appropriate limits on the exposure. They will verify that the limits are consistent with the risk undertaken given the maturity of the exposure and the condition of the correspondent. The regulation does not require a particular structure or method of maintaining internal limits. Limits can be flexible and are based on factors such as the monitoring level of the exposure and the condition of the correspondent. For example, a bank may choose not to establish a specific limit on exposure when it is able to track account balances daily. Such balances are subject to quick reduction if necessary. In appropriate circumstances a bank may establish limits for longer term exposure to a correspondent and not set them for interday (overnight) or intraday (within the day) exposure. Generally, banks do not need to set one total limit on exposure to a correspondent. Many banks prefer to set separate limits for different forms of exposure, products, or maturities. Although the total of all facilities may be high relative to a bank's capital, evaluation of such facilities will consider general utilization levels. Additionally, evaluation will consider procedures for further limiting or monitoring total exposure.

The bank's establishment of internal limits will require specific review by the examiners. Examiners will verify that a bank either: (1) has monitoring procedures for remaining within established limits; or (2) structures transactions to ensure that the exposure ordinarily remains within the internal limits. Some banks may monitor actual total exposure, others may establish individual lines, such as for federal funds sales. For such banks, examiners should ascertain that they have established procedures to ensure that exposure generally remained within established individual lines. A bank may also establish limits for a correspondent to monitor, such as when the correspondent is acting as an agent in selling federal funds.

Regulation F suggests that the appropriate level of monitoring depends on: the type and volatility of the exposure; the extent to which it approaches the bank's internal limits; and the condition of the correspondent. Generally monitoring may be done retrospectively. Monitoring includes checking close-of-business balances for the prior day or obtaining daily balance records at the end of each month. Monitoring exposure to correspondents on a real-time basis is not required.

The regulation recognizes that occasional excesses over limits may result from such unusual factors as market disturbances, favorable market moves, other increases in activity, or operational problems. Unusually late incoming wires or large cash letters could also lead to excesses not considered impermissible. Examiners should verify that the bank has established appropriate procedures to address those excesses.

A bank's internal policies and procedures must address intraday exposure. However, the regulation does not require limits unless needed. Examiners should expect to see such limits or frequent monitoring of balances only if the size of the intraday exposure and the condition of the correspondent suggest a significant risk. Examiners should keep in mind that intraday exposure may be difficult for a bank to actively monitor and limit. Consequently, like interday exposure, intraday exposure may be monitored retrospectively. In addition, smaller banks may merely monitor the range of peak intraday exposure to particular banks and its effect. For example, a bank may receive monthly reports on intraday balances of a correspondent. If concerned, it would need to limit or more actively monitor such exposure. Concern about the size of the intraday exposure is relative to the condition of the correspondent.

*Credit Exposure (Section 206.4)* Phase-in beginning June 19, 1994.

A bank's internal policies and procedures limit overnight "credit exposure" to a correspondent to 25 percent (50 percent in the first year) of the exposed bank's capital, unless it can show that the correspondent is at least "adequately capitalized."[3] The regulation does not specify limits for "credit exposure" to adequately or well-capitalized correspondents.

Examiners, however, should not necessarily expect those banks to have formal internal limits on "credit exposure", when their policies and procedures effectively limit it to an amount below 25 percent. This occurs when only small balances are maintained with the correspondent or when it has been approved only for a limited relationship. Often a bank will establish formal internal limits to meet the regulatory limit. The provisions of section 206.3 (Prudential Standards)

[3] For Regulation F, an "adequately capitalized" correspondent is defined as one with 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.

concerning excesses over internal limits also apply to section 206.4 regulatory limits (Credit Exposure).

The "credit exposure" limit is based on the bank's assets and off-balance sheet items exposed at the correspondent. Those accounts are ones in which the bank must maintain capital under the risk-based capital guidelines. The regulation identifies lower-risk transactions that are excluded. A bank must include all of the credit exposure of any subsidiary consolidated on its Report of Condition and Income or Thrift Financial Report. This provision generally captures the credit exposure of any majority-owned bank subsidiary. Therefore, in the parent bank's exposure calculation, include none of a minority-owned subsidiary's exposure and all of a majority-owned subsidiary's exposure. "Credit exposure" includes items, such as deposit balances with a correspondent and federal funds sales. It also includes credit equivalent amounts of interest rate and foreign exchange rate contracts and other off-balance sheet transactions. "Credit exposure" does not include settlement exposure, transactions in which the bank acts as agent, and other forms of exposure not covered by the capital adequacy guidelines. For example, there is no exposure to the correspondent for safekeeping bank assets, such as securities.

Existing exposure above the 25 percent limit to a correspondent originally rated higher, but now less than adequately capitalized, is not "grandfathered." This will encourage banks to shorten the maturity of exposure to correspondents at risk of dropping below the adequately capitalized level. It also emphasizes the importance of banks having adequate procedures to analyze the creditworthiness of correspondents.

This limit on "credit exposure" should be incorporated in the bank's policies and procedures required under the "Prudential Standards" section. Correspondents to which a bank's potential "credit exposure" is more than 25 percent of its own capital require quarterly capital monitoring. Because information on risk-based capital ratios is generally based on the call report, a bank may rely on the most recently available analysis using call report data. Although a significant lag may occur in such data, the analysis remains a useful monitor of trends in the condition of the correspondent. If the internal systems ordinarily limit "credit exposure" to less than 25 percent of the exposed bank's capital, no monitoring of the correspondent's capital would be necessary. However, the Prudential Standards section may require periodic reviews if exposure to the correspondent is significant. Banks may use existing risk monitoring and control systems and practices if they effectively maintain "credit exposure" within the prescribed limits. For smaller institutions, it is fairly easy to decide how their measure of exposure compares to the definition of "credit exposure." The regulation intends to emphasize appropriate levels of exposure based on analysis of the creditworthiness of correspondents and not merely to concentrate on staying within regulatory limits. Accordingly, for those correspondents not at least "adequately capitalized," this limit is a maximum, not a safe harbor, level of "credit exposure."

Examiners will verify that the capital of domestic correspondents is monitored quarterly based on their most recent call report, financial statement, or bank rating service. Currently, information on the risk-based capital levels of a correspondent is difficult to obtain. Under Section 206.4, a bank must prove only that its correspondent's capital ratios qualify it as at least adequately capitalized. Call reports for correspondents that do not file a complete Schedule RC-R can still be used to show that they are at least adequately capitalized. Banks with assets of $1 billion or less generally complete only Part I of Schedule RC-R which provides a rough estimate of risk-based capital. A bank may assume its correspondent is at least adequately capitalized, if it qualified by using only Part I of Schedule RC-R. For correspondents that file a complete Schedule RC-R, the call report includes sufficient information for calculating their risk-based capital.

A bank is not limited to a single source of information for capital ratios. It may rely on capital information obtained from a correspondent, bank rating agency, or other acceptable source.

Further, examiners should anticipate that most banks will receive information on their correspondents' capital ratios either directly from the correspondents or from a bank rating agency. The standard used in the rule is based solely on capital ratios. The OCC does not allow disclosure of CAMEL ratings.

The frequency of monitoring foreign bank correspondents depends on the availability of financial statements or other regular reports.[4] Although such information is available quarterly for some foreign banks, for many, it can be obtained only semiannually.

Public sources of information on risk-based capital ratios may not be available for many foreign bank correspondents. However, examiners should anticipate that the correspondent will provide the information to the banks with which it does business.

[4] Regulation F permits a foreign correspondent to be considered "adequately capitalized" without regard to the level of the foreign bank's leverage ratio. This treatment of foreign banks is consistent with the findings of the *Capital Equivalency Report* submitted by the Federal Reserve Board and by the Department of Treasury to Congress in 1992.