The Federal Home Loan Bank of Cincinnati
Fifth District Serving Kentucky, Ohio and Tennessee

NewsLine

NL-93-16 April 30, 1993

TO ALL MEMBERS:

Federal Home Loan Bank Exempt From Regulation F

The Bank has received inquiries from stockholders regarding Federal Reserve Board Regulation F. This regulation implements Section 308 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) which requires the Federal Reserve to prescribe standards to limit an institution's exposure to overnight credit risk with an individual correspondent bank.

In accordance with the various provisions contained in this regulation, an institution must establish internal procedures and policies and monitor credit exposure limits with each of its correspondent banks. The level of permissible credit exposure with any one correspondent bank is based on the capital of the correspondent. The various exposure limits relative to the correspondent's capital level and the phase-in periods for this regulation can be found in Federal Register notice - Regulation F (Docket No. 0769).

There are two exceptions to the definition of correspondent banks in Regulation F - Federal Reserve Banks and Federal Home Loan Banks. The regulation states:

> "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 Reserves 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."

Therefore, our customers are neither required to limit their correspondent relationship with us, nor are they required to apply internal controls and procedures regarding credit exposure at the Bank.

If you have any question regarding Regulation F and its ramifications on your correspondent relationship at the FHLB, please contact your marketing representative or Thomas F. Schlager, Vice President (513-852-7613) at the FHLB.

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President

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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 these 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.[4]

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

[4] 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.