May 5, 2010

Interagency Guidance on Correspondent Concentration Risks

OVERVIEW

On April 30, 2010, the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency (the "OCC"), and the Office of Thrift Supervision (the "OTS") (the "Agencies") issued guidance on *Correspondent Concentration Risks* ("Guidance") in order to promote prudent risk management practices among financial institutions. The Guidance outlines the Agencies' expectations for (i) identifying, (ii) monitoring, and (iii) managing correspondent risks between financial institutions and (iv) performing appropriate due diligence on all credit exposures to and funding transactions with other financial institutions.[1]

The Agencies agree that some concentrations meet certain business needs or purposes. However, as stated in the Guidance, correspondent concentrations represent a lack of diversification, which adds a level of risk that should be considered by management when it formulates and implements strategic plans and internal risk limits. The Agencies emphasize that the Guidance is not intended to replace or amend Regulation F (12 C.F.R. Part 206), in which the Board addresses limitations on interbank liabilities. Rather, the Guidance clarifies that financial institutions should consider taking actions beyond the minimum requirements of Regulation F, maintain sound and effective risk management policies and procedures, and address credit exposures accordingly.

IDENTIFYING CORRESPONDENT CONCENTRATIONS

Financial institutions should implement procedures that will enable them to identify correspondent credit (asset) and funding (liability) concentrations. With respect to *assets*, a credit concentration results when a financial institution has advanced or committed a significant volume of credit exposure to a correspondent. With respect to *liabilities*, a funding concentration occurs when a financial institution depends on at least one correspondent for a disproportionate share of its total funding.

While the Agencies have generally considered credit exposures of greater than 25% of total capital as concentrations, they have not established a liability threshold. However, the Guidance states that the Agencies have seen in the past instances where funding exposures as low as 5% of an institution's total liabilities have posed an elevated liquidity risk to the recipient institutions. Please note that the Guidance emphasizes that these levels of credit and funding exposure are not firm limits but rather indicate that an institution has concentration risk with a correspondent.

The Agencies advise financial institutions to aggregate their credit exposures as part of their identification procedure since credit concentrations can result from a variety of assets and activities. Among the types of assets and activities that can create credit concentrations are (i) due from bank accounts, (ii) Federal funds sold on a principal basis, (iii) the over-

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[1] For purposes of the Guidance, the term "financial institutions" includes "banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, and savings and loan holding companies and their subsidiaries," while "correspondent" includes "the correspondent's holding company, subsidiaries and affiliates."

collateralized amount on repurchase agreements or the under-collateralized portion of reverse repurchase agreements, and (iv) net current credit exposure on derivative contracts. The Guidance further states that a concentration of credit for a financial institution can result in funding exposure for the correspondent, depending on the size and characteristics of that concentration of credit and that the threshold of what constitutes a concentration of funding is likely to vary depending on the type and maturity of the funding, and the structure of the recipient's sources of funds.

Procedures that identify correspondent concentrations should account for the credit and funding concentrations of each individual correspondent on a stand-alone basis as well as on a correspondent organization-wide basis, and financial institutions should calculate both gross and net exposures. The Guidance includes an appendix that provides sample calculations of credit and funding exposures on an organization-wide basis.

MONITORING CORRESPONDENT RELATIONSHIPS

The Agencies expect financial institutions to establish and maintain written policies and procedures that would limit excessive exposure to any correspondent in relation to the correspondent's financial conditions. Factors to consider in determining how frequently a given financial institution should monitor correspondent relationships include the nature, size and risk of exposure. Financial institutions should also determine what information, ratios, or trends will be reviewed for each correspondent on an ongoing basis. The Guidance lists a non-exhaustive number of additional factors that can be reviewed as part of an ongoing and timely monitoring process, such as:

- Deteriorating trends in capital or asset quality;
- Reaching certain target ratios established by management;
- Increasing level of other real estate owned;
- Attaining internally specified levels of volatile funding sources such as large CDs or brokered deposits;
- Experiencing a downgrade in its credit rating (if publicly traded); or
- Being placed under a public enforcement action.

Financial institutions should ensure that there is written evidence of each review that is conducted.

MANAGING CORRESPONDENT CONCENTRATIONS

According to the Guidance, a financial institution that participates in correspondent relationships should (i) establish internal concentration limits in addition to ranges or tolerances for each factor being monitored for each correspondent and (ii) create a contingency plan that would become effective if the internal limits or ranges are met or exceeded. In order to comply with prudent risk management of correspondent concentration risks, the Guidance suggests the implementation of procedures that "provide for orderly reductions of correspondent concentrations that exceed internal parameters over a reasonable timeframe that is commensurate with the size, type, and volatility of the risk in the exposure." These procedures can include, among others, (i) reducing the volume of uncollateralized/uninsured funds, (ii) transferring excess funds to other correspondents after conducting appropriate reviews of their financial condition, (iii) establishing limits on asset and liability purchases from and investments in correspondents, and (iv) specifying reasonable timeframes to meet targeted reduction goals for different types of exposures.

Examiners will review correspondent relationships in order to determine whether a given financial institution's policies and procedures effectively identify and monitor correspondent concentration and will review the adequacy and reasonableness of a financial institution's contingency plan.

PERFORMING APPROPRIATE DUE DILIGENCE

Any financial institution that either maintains credit exposures in another financial institution or provides funding to another financial institution should ensure that it has implemented a risk management program that appropriately accounts for these credit and funding arrangements. The financial institution should also institute written policies and procedures regarding investment, lending and funding as well as the appropriate limits to engaging in these practices. The Guidance further advises financial institutions to conduct independent analyses of credit transactions before committing to engage in such transactions. Additionally, the terms of any credit and funding transactions should strictly be at arm's length, conform to sound investment, lending and funding practices, and avoid potential conflicts of interests.

The following are the links to the FDIC's Financial Institution Letter, containing a summary of the Guidance, and the Interagency Guidance on Correspondent Concentration Risks:

Financial Institution Letter FIL-18-2010, April 30, 2010

Interagency Guidance on Correspondent Concentration Risks, April 30, 2010

The Appendix A, *Calculating Correspondent Exposures*, can be approached through the following FDIC website (see "Attachments: Illustrations – Excel"):

Link to Appendix A, Calculating Correspondent Exposures

Link to Regulation F – *Limitations on Interbank Liabilities* (12 C.F.R. Part 206):

Regulation F (12 C.F.R. Part 206)

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