Correspondent Concentration Risks

A financial institution's[1] relationship with a correspondent[2] may result in credit (asset) and funding (liability) concentrations. On the asset side, a credit concentration represents a significant volume of credit exposure that a financial institution has advanced or committed to a correspondent. On the liability side, a funding concentration exists when an institution depends on one or a few correspondents for a disproportionate share of its total funding.

The Agencies[3] realize some concentrations meet certain business needs or purposes, such as a concentration arising from the need to maintain large "due from" balances to facilitate account clearing activities. However, correspondent concentrations represent a lack of diversification, which adds a dimension of risk that management should consider when formulating strategic plans and internal risk limits.

The Agencies have generally considered credit exposures greater than 25 percent of total capital[4] as concentrations. While the Agencies have not established a liability concentration threshold, the Agencies have seen instances where funding exposures as low as 5 percent of an institution's total liabilities have posed an elevated liquidity risk to the recipient institution.

These levels of credit and funding exposures are not firm limits, but indicate an institution has concentration risk with a correspondent. Such relationships warrant robust risk management practices, particularly when aggregated with other similarly sized funding concentrations, in addition to meeting the minimum regulatory requirements specified in applicable regulations. Financial institutions should identify, monitor, and manage both asset and liability correspondent concentrations and implement procedures to perform appropriate due diligence on all credit exposures to and funding transactions with correspondents, as part of their overall risk management policies and procedures.

This guidance does not supplant or amend applicable regulations such as the Board's *Limitations on Interbank Liabilities* (Regulation F).[5] This guidance clarifies that financial institutions should consider taking actions beyond the minimum requirements established in Regulation F to identify, monitor, and manage correspondent concentration risks, especially when there are rapid changes in market conditions or in a correspondent's financial condition, in order to maintain risk management practices consistent with safe and sound operations.

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[1] This guidance applies to all 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.

[2] Unless the context indicates otherwise, references to "correspondent" include the correspondent's holding company, subsidiaries, and affiliates. A correspondent relationship results when a financial organization provides another financial organization a variety of deposit, lending, or other services.

[3] The Agencies consist of the Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System (Board), Office of the Comptroller of the Currency, Treasury (OCC), and Office of Thrift Supervision, Treasury (OTS) (collectively, the Agencies).

[4] For purposes of this guidance, the term "total capital" means the total risk-based capital as reported for commercial banks and thrifts in the Report of Condition and the Thrift Financial Report, respectively.

[5] 12 CFR 206. All depository institutions insured by the FDIC are subject to Regulation F.

Identifying Correspondent Concentrations

Institutions should implement procedures for identifying correspondent concentrations. For prudent risk management purposes, these procedures should encompass the totality of the institutions' aggregate credit and funding concentrations to each correspondent on a standalone basis, as well as taking into account exposures to each correspondent organization as a whole.[6] In addition, the institution should be aware of exposures of its affiliates to the correspondent and its affiliates.

Credit Concentrations

Credit concentrations can arise from a variety of assets and activities. For example, an institution could have due from bank accounts, Federal funds sold on a principal basis, and direct or indirect loans to or investments in a correspondent. In identifying credit concentrations for risk management purposes, institutions should aggregate all exposures, including, but not limited to:

- Due from bank accounts (demand deposit accounts (DDA) and certificates of deposit (CD)),
- Federal funds sold on a principal basis,
- The over-collateralized amount on repurchase agreements,
- The under-collateralized portion of reverse repurchase agreements,
- Net current credit exposure on derivatives contracts,
- Unrealized gains on unsettled securities transactions,
- Direct or indirect loans to or for the benefit of the correspondent,[7] and
- Investments, such as trust preferred securities, subordinated debt, and stock purchases, in the correspondent.

Funding Concentrations

Depending on its size and characteristics, a concentration of credit for a financial institution may be a funding exposure for the correspondent. The primary risk of a funding concentration is that an institution will have to replace those advances on short notice. This risk may be more pronounced if the funds are credit sensitive, or if the financial condition of the party advancing the funds has deteriorated.

The percentage of liabilities or other measurements that may constitute 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. For example, a concentration in overnight unsecured funding from one source might raise different concentration issues and concerns than unsecured term funding, assuming compliance with covenants and diversification with short and long-term maturities. Similarly, concerns arising from concentrations in long-term unsecured funding typically increase as these instruments near maturity.

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[6] Financial institutions should identify and monitor all direct or indirect relationships with their correspondents. Institutions should take into account exposures of their affiliates to correspondents, and how those relationships may affect the institution's exposure. While each financial institution is responsible for monitoring its own credit and funding exposures, institution holding companies, if any, should manage the organization's concentration risk on a consolidated basis.

[7] Exclude loan participations purchased without recourse from a correspondent, its holding company, or an affiliate.

Calculating Credit and Funding Concentrations

When identifying credit and funding concentrations for risk management purposes, institutions should calculate both gross and net exposures to the correspondent on a standalone basis and on a correspondent organization-wide basis as part of their prudent risk management practices. Exposures are reduced to net positions to the extent that the transactions are secured by the net realizable proceeds from readily marketable collateral or are covered by valid and enforceable netting agreements. Appendix A, *Calculating Correspondent Exposures*, contains examples, which are provided for illustrative purposes only.

Monitoring Correspondent Relationships

Prudent management of correspondent concentration risks includes establishing and maintaining written policies and procedures to prevent excessive exposure to any correspondent in relation to the correspondent's financial condition. For risk management purposes, institutions' procedures and frequency for monitoring correspondent relationships may be more or less aggressive depending on the nature, size, and risk of the exposure.

In monitoring correspondent relationships for risk-management purposes, institutions should specify internal parameters relative to what information, ratios, or trends will be reviewed for each correspondent on an ongoing basis. In addition to a correspondent's capital, level of problem loans, and earnings, institutions may want to monitor other factors, which could include, but are not limited to:

- Deteriorating trends in capital or asset quality.
- Reaching certain target ratios established by management, *e.g.*, aggregate of nonaccrual and past due loans and leases as a percentage of gross loans and leases.
- 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.
- Being placed under a public enforcement action.

For prudent risk management purposes, institutions should implement procedures that ensure ongoing, timely reviews of correspondent relationships. Institutions should use these reviews to conduct comprehensive assessments that consider their internal parameters and are commensurate with the nature, size, and risk of their exposure. Institutions should increase the frequency of their internal reviews when appropriate, as even well capitalized institutions can experience rapid deterioration in their financial condition, especially in economic downturns.

Institutions' procedures also should establish documentation requirements for the reviews conducted. In addition, the procedures should specify when relationships that meet or exceed internal criteria are to be brought to the attention of the board of directors or the appropriate management committee.

Managing Correspondent Concentrations

Institutions should establish prudent internal concentration limits, as well as ranges or tolerances for each factor being monitored for each correspondent. Institutions should develop plans for managing risk when these internal limits, ranges or tolerances are met or exceeded, either on an individual or collective basis. Contingency plans should provide a variety of actions that can be considered relative to changes in the correspondent's financial condition. However, contingency plans should not rely on temporary deposit insurance programs for mitigating concentration risk.

Prudent risk management of correspondent concentration risks should include 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. Such actions could include, but are not limited to:

- Reducing the volume of uncollateralized/uninsured funds.
- Transferring excess funds to other correspondents after conducting appropriate reviews of their financial condition.
- Requiring the correspondent to serve as agent rather than as principal for Federal funds sold.
- Establishing limits on asset and liability purchases from and investments in correspondents.
- Specifying reasonable timeframes to meet targeted reduction goals for different types of exposures.

Examiners will review correspondent relationships during examinations to ascertain whether an institution's policies and procedures appropriately identify and monitor correspondent concentrations. Examiners also will review the adequacy and reasonableness of institutions' contingency plans to manage correspondent concentrations.

Performing Appropriate Due Diligence

Financial institutions that maintain credit exposures in or provide funding to other financial institutions should have effective risk management programs for these activities. For this purpose, credit or funding exposures may include, but are not limited to, due from bank accounts, Federal funds sold as principal, direct or indirect loans (including participations and syndications), and trust preferred securities, subordinated debt, and stock purchases of the correspondent.

An institution that maintains or contemplates entering into any credit or funding transactions with another financial institution should have written investment, lending, and funding policies and procedures, including appropriate limits, that govern these activities. In addition, these procedures should ensure the institution conducts an independent analysis of credit transactions prior to committing to engage in the transactions. The terms for all such credit and funding transactions should strictly be on an arm's length basis, conform to sound investment, lending, and funding practices, and avoid potential conflicts of interest.