INTRODUCTION

This section of the Manual of Examination Policies provides a broad perspective of international banking. It begins by addressing the concept of country risk, which is the primary risk associated with international banking activities. The section then discusses common international banking products and services such as foreign loans, investments, placements,[1] currency exchange, and funds management.

Within the discussion on foreign loans, significant attention is given to trade finance, which is an important, yet declining, segment of U.S. banks' international credit exposures. Due to increased globalization of international markets and competition from non-bank intermediaries, U.S. banks have become less involved in trade finance and more involved in direct loans to foreign banks, participations in syndicated credit facilities, and loans to individuals and foreign businesses.

This section also discusses the international banking operations of foreign banks in the U.S., the operational structures established by U.S. banks in order to conduct banking activities in foreign jurisdictions, and parallel-owned banking organizations (PBOs). A PBO exists where there is common control or ownership of domestic and foreign banks outside of a traditional bank holding company structure (similar to chain banks). The PBO structure results in a global financial organization that may not be subject to comprehensive, consolidated supervision standards and could present unique supervisory concerns.

Finally, this section discusses supervisory methods and examination guidance relating to the supervision of foreign banking organizations (FBOs) and provides references to applicable laws and regulations. The section concludes with a glossary of international banking terms.

Overview of International Bank Activities

While the number of U.S. banks involved in international finance is relatively small in comparison to the overall number of U.S. banks, many large institutions have notable cross-border exposure and significant international activities. Moreover, in certain markets, a considerable number of smaller banks continue to allocate significant resources to international banking.

Many international banking activities parallel those conducted in domestic banking operations. For example, in both international and domestic markets, a bank may extend credit, issue and confirm letters of credit, maintain cash and collection items, maintain correspondent bank accounts, accept and place deposits, and borrow funds. Other activities are more closely associated with international banking, such as creating acceptances and trading foreign currencies.

The most important element of international banking not found in domestic banking is country risk, which involves the political, economic, and social conditions of countries where a bank has exposure. Examiners must consider country risk when evaluating a bank's international operations.

Despite similarities between domestic and international activities, banks often conduct international operations in a separate division or department. Large banks typically operate an independent international division, which may include a network of foreign branches, subsidiaries, and affiliates. Smaller banks, or banks with limited international activity, often use a separate section that works with a network of foreign correspondent banks or representative offices. In either case, international activity is usually operated by separate management and staff using distinct accounting systems and internal controls.

Given the risks introduced by doing business in a foreign country, particularly in emerging markets, examiners must review and understand international activities when assessing a bank's overall condition. Furthermore, examiners should coordinate international reviews with Bank Secrecy Act (BSA), Anti-Money Laundering (AML), and Office of Foreign Assets Control (OFAC) reviews.

Examination Objectives

The objectives of examining international activities are largely the same as those of examining domestic activities. However, the specialized nature of international banking may require modification of some examination activities due to different accounting procedures, documentation requirements, or laws and regulations. For example, access to information at foreign branches varies according to foreign laws governing such access and the FDIC's relationships with foreign supervisors.

The examination of international activities is usually conducted concurrently with the risk management examination. The scope of the examination and staffing requirements should be established during pre-examination planning. Prior examination reports will usually indicate the existence of an international department, identify foreign branches or subsidiaries, and discuss the type and volume of international activities. Reviewing regulatory reports that the bank may be required to file, such as

[1] Interest-bearing time deposits held in foreign banks or overseas branches of U.S. banks.

Federal Financial Institutions Examination Council (FFIEC) 009 and 009a Country Exposure Reports or Treasury International Capital (TIC) Form B Reports, can also assist examiners determine a bank's level of country exposure. Other resources include recent Reports of Condition and Income (Call Reports) and Uniform Bank Performance Reports.

Examiners can usually examine international activities at a bank's main domestic office or other centralized location. Part 347 of the FDIC Rules and Regulations governs minimum recordkeeping standards at state nonmember banks that operate foreign branches or meet certain investment or control levels. These standards require banks to maintain certain information concerning offshore activities at their head office. This requirement generally enables a centralized review of asset quality, funding operations, contingent liabilities, and internal controls.

In some cases, on-site examinations of foreign branches (branches in the foreign country) may be necessary because of inadequate information at the main domestic office or the existence of unusual branch activities. Examiners should determine the availability and quality of information maintained at the main office during the pre-examination process to gain a general understanding of any unusual branch activities before considering a foreign branch examination. If the information at the centralized location appears inadequate or unusual branch activities are identified, it may be appropriate to conduct a pre-examination visitation or begin the domestic examination before commencing the foreign branch examination in order to obtain additional information.

Note: Examiners must consult with field and regional management before commencing a foreign branch examination. The consultation should include a discussion of the protocol governing notification of the foreign supervisor prior to commencement of the visitation or examination.

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COUNTRY RISK MANAGEMENT

Most facets of international banking are exposed to country risk. To address country risk, the federal regulatory agencies jointly issued a statement titled *Sound Country Risk Management Practices*, (March 2002 Statement). Examiners should assess a bank's conformance with the risk management standards detailed in the March 2002 Statement and summarize the results of their assessment in the Report of Examination (ROE) on the Analysis of the Country Exposure Management System page.

The remainder of this section describes various country risk concepts and risk management processes and describes how the federal agencies evaluate transfer risk (an aspect of country risk). The foundation for the discussion that follows is the March 2002 Statement and the Guide to the Interagency Country Exposure Review Committee (ICERC Guide). Examiners should refer to these documents for further information.

Concept of Country Risk

In addition to the risks present in their domestic operations, institutions engaged in international activities are exposed to country risk. Country risk involves the possibility that economic, social, or political conditions and events in a foreign country will adversely affect an institution's financial interests, such as defaults by obligors in a foreign country. Country risk also includes the possibility of nationalization of private assets, government repudiation of external indebtedness, exchange controls, or significant currency devaluations.

Country risk has a pervasive effect on international activities and should be explicitly considered when assessing the risk of all exposures (including off-balance sheet items) to public- and private-sector foreign-domiciled counterparties. The risk associated with even the strongest foreign counterparties will increase if, for example, political or macroeconomic conditions cause the exchange rate to depreciate and the cost of servicing external debt to rise.

The March 2002 Statement recognizes that country risk is not limited to an institution's exposure to foreign-domiciled counterparties. In some situations, the performance of domestic counterparties may also be adversely affected by conditions in foreign countries. When appropriate, examiners should consider country risk factors when assessing the creditworthiness of domestic counterparties.

Country risk is not limited solely to credit transactions. Changing policies or conditions in a foreign country may also affect matters such as investments in foreign subsidiaries, servicing agreements, or outsourcing arrangements with foreign entities, including those associated with the bank through its holding company.

Country Risk Management System

Country risk management systems should be commensurate with the type, volume, and complexity of the institution's international activities, and examiners should consider these factors when assessing country risk management systems and practices. As more fully described in the March 2002 Statement, sound country risk management systems should include:

- Effective oversight by the board of directors,
- Adequate risk management policies and procedures,
- Accurate systems for reporting country exposures,
- Effective processes for analyzing country risk,
- Forward-looking country risk rating systems,
- Country exposure limits,
- Regular monitoring of country conditions,
- Periodic stress testing of foreign exposures, and
- Adequate internal controls and audit function.

The March 2002 Statement indicates that to effectively control risk associated with international activities, institutions must have a risk management system that focuses on the concept of country risk. A program that is limited to an assessment of transfer risk, and especially one that solely relies on transfer risk designations assigned by the ICERC, ignores other important facets of country risk and would not be appropriate. Transfer risk and the ICERC program are discussed in subsequent subsections.

Policies and Procedures

Management is responsible for developing and implementing sound, well-defined policies and procedures for managing country risk. Management should also ensure that country risk management policies and practices are clearly communicated to applicable offices and staff. At a minimum, policies and procedures should:

- Articulate a strategy for conducting international activities;
- Specify appropriate products, services, and affiliates (e.g., banks, branches, affiliates, joint ventures, etc.);
- Identify allowed and disallowed activities;
- Describe major risks in applicable countries or regions;
- Establish risk tolerance limits;
- Develop standards and criteria for analyzing and rating country risk;
- Delineate clear lines of responsibility and accountability for country risk management decisions;
- Require periodic reporting of country risk exposures and policy exceptions to senior management and the board; and
- Ensure compliance with regulatory guidance and reporting requirements.

Rating Country Risk

Countries often experience political and economic shocks, and institutions with international activities must appropriately manage country risk. Critical risk mitigation components include effective country risk monitoring, accurate risk ratings, and timely implementation of exit strategies.

When collecting data to examine country risk, useful sources of qualitative information may include market data from the bank's internal country studies or representative office; officer visits to the home country, central bank, or correspondent bank; and external credit-rating-agency information. For instance, foreign/local currency ceiling ratings for the sovereign country, foreign/local currency deposit ratings for banks, and bank financial-strength ratings can be effectively employed as part of a country risk management program. Management should have a clear understanding of the assumptions and analysis that rating agencies use to develop external ratings if they consider the information when assigning internal ratings.

The causes of sovereign defaults can be broadly grouped into the following categories:

- Banking crises,
- Chronic economic stagnation,
- High debt burden, and
- Institutional or political factors.

In general, country risk ratings should encompass qualitative and quantitative analysis and reflect an estimate of the likelihood of adverse events. Qualitative analysis does not require sophisticated modeling and may simply involve a careful, general analysis of key indicators. When quantitative models are used, management should apply sound modeling practices typically employed elsewhere (e.g., credit and interest rate risk modeling).

Quantitative factors to consider include gross domestic product (GDP) growth, GDP per capita, inflation and unemployment rates, bond yields, government and private sector debt levels, current account deficits, short- and long-term external debt, credit default swap prices, and foreign exchange/international reserves. Statistics regarding these items are often available through multilateral agencies or official national sources. While the availability of data has substantially improved, examiners should be aware that in certain less-developed countries, data may be unavailable, infrequently reported, or unreliable, and qualitative in-country analysis may be significantly more reliable.

Although a country risk rating should be assigned to all foreign countries, it may be helpful to vary rating methodologies between emerging and non-emerging market countries (or other similar delineations). Also, in certain high-export countries, such as countries heavily dependent on oil exports, it may be useful to monitor specific market factors to more effectively evaluate risks.

Additionally, depending on the size and complexity of certain exposures, it may be appropriate for management to consider institution-specific factors when assigning internal ratings. For example, management should consider the legal and governance framework of the institution's activities in the foreign country, the type and mix of exposures, reliance on in- or out-of-country funding sources, and the economic outlook for specific industries. Additionally, management should consider potential risk mitigants, including the ability to effectively manage foreign exposures through in-country personnel.

It is common for banks to adjust or qualify country risk ratings based on the level and type of exposure of the counterparty. For example, trade-related and banking-sector exposures may receive better risk ratings than other categories of exposure. The importance of trade and banking transactions to a country's economy often results in preferential treatment by foreign governments for repayment. However, management should closely monitor signals from foreign governments when conditions deteriorate to ensure expectations of support are still warranted.

Finally, while country risk rating and monitoring systems can affect general and specific risk management decisions, the information provided should be an integral part of the strategic decision making process as it relates to foreign operations. Ultimately, the information provided should stimulate discussion, assessment, and potential action at the senior management and board levels.

Country Exposure Concentrations

The federal banking agencies recognize that concentration limits and diversification are useful ways to moderate country risk. Diversification is especially relevant to international lending because the assessment of country risk can involve major uncertainties. Diversification provides some protection against a dramatic change in the economic or political environments of a particular country or region.

As part of their country risk management process, internationally active institutions should adopt a system of country exposure limits. Because the limit setting process often involves divergent interests within the institution (such as senior management, country managers, and the country risk committee), country risk limits will usually require the balancing of several considerations, including:

- The overall strategy guiding the institution's international activities,
- The country's risk rating,
- The institution's risk appetite,
- The perceived business opportunities in the country, and
- The desire to support the international business needs of domestic customers.

The March 2002 Statement notes that concentrations of exposures to individual countries that exceed 25 percent of Tier 1 Capital plus the ALLL are considered significant. In the case of troubled countries, lower exposure levels may be considered significant and should be carefully monitored. Refer to the ROE Instructions for preparing ROE commentary and the concentrations schedule.

Sovereign crises are often not limited to just one country. Surrounding regions and industries are typically affected as well, and the March 2002 Statement advises banks to consider limiting exposures on a broader (e.g., regional) basis. Examiners should identify exposures to broader country groupings in the ROE when bank or market analyses identify links or risks between countries where the bank is exposed (e.g., Central America or the Caribbean).

Risk Mitigation - Exit Strategies

Effective risk mitigation requires the development of board-approved policies regarding exit strategies (a.k.a., action plans). Action plans should define trigger points that indicate portfolio exposure in a given country may have escalated beyond an acceptable threshold and should be reduced or eliminated. The substance of an exit strategy should be commensurate with an institution's level of exposure. Items for consideration include how a bank will reduce risk to:

- Aggregate country exposures;
- Asset classes (e.g., loans, Eurobonds, medium-term notes, commercial paper, etc.);
- Issuers (sovereign, financial, private sectors, etc.);
- Product types and concentrations (trade transactions, pre-export finance, foreign-deposit concentrations, derivatives, off-balance sheet items, etc.); and
- Tenor (generally, tenor should be reduced when country risk is increasing).

Management should use quantitative and qualitative data to define, substantiate, and initiate action plans. Related policies should include procedures for estimating risk levels and reporting material exposures. The policies should also incorporate risk-reduction strategies stemming from contagion risk (the likelihood that economic problems in one country, region, or market will affect another).

Some institutions have increased the use of credit derivatives to reduce country risk. When complex financial products are used, management should consider all relevant issues, such as counterparty, credit, and correlation risks.

Transfer Risk

Transfer risk is an important part of country risk. Transfer risk reflects the possibility that an asset cannot be serviced in the currency of payment because the obligor's country lacks the necessary foreign exchange or has put restraints on its availability.

In general, transfer risk is relevant whenever a bank extends credit across international borders and the extension of credit is denominated in a currency other than the obligor's country of residence. In these situations, an obligor must, in the absence of an ability to obtain and retain foreign currency outside the country of residence, obtain the foreign currency from domestic sources. When a country is beset by economic, political, or social turmoil leading to a domestic shortage of foreign currencies, the obligor could default on its external obligations because it is unable to obtain foreign currency at a reasonable price.

Although a country risk management program must be based on the broadly defined concept of country risk, the federal banking agencies consider transfer risk when assigning classifications, designating cross-border exposures, and determining minimum transfer risk reserve requirements on cross-border exposures.

Interagency Country Exposure Review Committee (ICERC)

The ICERC consists of representatives from all federal banking agencies that are jointly responsible for providing uniform transfer risk designations. Transfer risk designations serve as a starting point for adverse classifications of all cross-border exposures. Aided by tools such as balance-of-payment statistics and internal studies of country conditions, the ICERC makes decisions on the extent of transfer risk in countries where U.S. bank exposure meets the committee's review criteria.

When a country is experiencing political, social, or economic conditions leading towards an interruption in debt servicing by obligors within the country, or when an interruption in payments appears imminent, credits within the country are adversely classified using the designations of *Substandard*, *Value Impaired*, or *Loss*. When an adverse classification is assigned, the committee prepares a standard narrative on the country to be used in the ROE. The criteria for reporting transfer risk classifications and designations established during an examination are discussed in the ROE instructions.

For sovereign exposures, ICERC's designation is the only applicable rating. However, if they are carried on the institution's books as an investment, securities issued by a sovereign entity are also subject to the interagency Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts. If a rating is different under the two systems, the examiner should assign the more severe of the two ratings. For private sector exposures, the applicable rating is the more severe of either the ICERC-assigned transfer risk rating for the country or the examiner-assigned credit risk rating (including ratings assigned as a result of the Shared National Credit Program). Further discussion of the application of transfer risk ratings can be found in the ICERC Guide.

Contingent liabilities subject to transfer risk (including commercial and standby letters of credit as well as unfunded loan commitments) that will result in a concomitant increase in bank assets if the contingencies convert into an actual liability (Category I contingent liabilities) should also be considered for special comment or classification, as applicable. Contingent liabilities extended for classification should be classified according to the type and tenor of the bank asset that would result from conversion of the contingency into an actual liability. For example, commercial import/export letters of credit would be accorded the same classification as trade transactions, while commitments to fund long-term project loans would be accorded the same classification as long-term loans. In cases where type or tenor is not easily discernible and the exposure is accorded a split classification, the more severe classification should prevail.

Transfer Risk Reserve Requirements

The International Lending Supervision Act of 1983 (ILSA) directs federal banking agencies to require banks to establish and maintain a special reserve when the value of international loans has been impaired. The ILSA requires that the special reserves be established through a charge against current income and segregated from both the ALLL and capital. A bank must establish a special reserve when an appropriate federal banking agency determines that a bank's assets have been impaired by a protracted inability of borrowers in a foreign country to make payments on their external indebtedness. Factors indicating such impairment include:

- A failure by such public or private borrowers to make full interest payments on external indebtedness,

- A failure to comply with the terms of any restructured indebtedness,
- A failure by the foreign country to comply with any International Monetary Fund (IMF) or other suitable adjustment program, or
- No definite prospects exist for the orderly restoration of debt service.

The federal banking agencies refer to this special reserve as the Allocated Transfer Risk Reserve (ATRR). The ATRR requirements are established on an interagency basis through the ICERC program. When applicable, ICERC assigns ATRR requirements to country exposures classified as Value Impaired. Banks also have the option of taking a charge-off in lieu of establishing an ATRR. The ATRR is a contra-asset to the international asset and is not included as part of the ALLL nor is it included in regulatory capital. For further details on the ATRR, refer to Part 347, Subpart C, of the FDIC Rules and Regulations.

Country Risk Exposure Report

One of the tools examiners may use to monitor a bank's country risk exposure is the FFIEC's Country Risk Exposure Report (Form 009), which details material international exposure and must be filed quarterly by certain financial institutions. This report provides information regarding the amount, type, and location of foreign assets. The examination process should include assurances that management adheres to the reporting requirements and that such reports are accurate. Differences between a bank's method of calculating country exposure and the methods required by the Form 009 are generally acceptable; however, management should be able to reconcile any differences between the two reports, as well as explain the logic behind their internal method.

Form 009 requires reporters to disclose foreign claims (assets excluding premises, ORE, and intangibles) based on the residency of the counterparty, as well as residence of the ultimate obligor (which may be different). A central concept of Form 009 is the difference between *immediate-counterparty* and *ultimate-risk* exposure. Even though a loan may be extended to a counterparty in one country, a common feature of international lending is that the presence of credible guarantees or financial collateral shifts the ultimate repayment source (and thus the source of country risk) to a different country.

For example, if a bank lends to a Brazilian subsidiary of a German parent company, the bank must report the loan as a foreign claim to Brazil on an immediate-counterparty basis. If the German parent guarantees the loan, the bank must report a *risk-transfer*, which is an outward risk-transfer (decrease) from Brazil and a commensurate inward risk-transfer (increase) to Germany. The loan is then reported as a German claim on an ultimate-risk basis. In addition to parent-subsidiary guarantees, cash and securities collateral, insurance, and credit derivatives can all be used to risk-transfer.

Form 009 is required for every U.S.-chartered insured commercial bank or savings association that has, on a fully consolidated bank basis, total outstanding claims on residents of foreign countries exceeding $30 million in the aggregate, and has at least one of the following:

- A branch in a foreign country,
- A consolidated subsidiary in a foreign country,
- An Edge or Agreement subsidiary,
- A branch in Puerto Rico or in any U.S. territory or possession (except that a bank or savings association with its head office in Puerto Rico or any U.S. territory or possession need not report if it meets only this criterion), or
- An International Banking Facility (IBF).

Additionally, institutions that report total gross notional values of derivative contracts exceeding $10 billion on Schedule RC-L of the FFIEC 031 Call Report or FR Y-9C are also required to submit Form 009, regardless of the preceding criteria. In addition, bank regulatory authorities may specifically require a report (or any specific schedule therein) to be filed by other banking organizations that are deemed to have significant country exposures. Detailed instructions for compiling the report can be found on the FFIEC.gov website under Reports/Reporting Forms.

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INTERNATIONAL ACTIVITIES

International banking embraces a wide spectrum of financial services and products. This sub-section describes products and services that an examiner is likely to encounter in a bank that has international activities.

International Lending

Entities that borrow funds from banks include importers, exporters, multinational corporations, foreign businesses, governments, consumers, foreign banks, and overseas branches of U.S. banks. International lending is concentrated at the largest global institutions and a number of smaller institutions in select markets, such as New York City, Miami, and San Francisco.

Interest earned from lending to foreign borrowers, both internationally and domestically, remains a major source of profit for banks that conduct international activities.

Other international activities, such as fund transfers, are necessary components of international banking and enhance a bank's ability to service correspondent relationships, but do not necessarily produce significant, if any, income after expenses.

The tendency for international loans to be larger than domestic loans promotes economies of scale by allowing banks to originate, monitor, and collect the loans more efficiently than smaller loans. However, larger credits often attract strong price competition from other global lenders, which may result in lower net interest margins.

International Lending Risks

All loans involve some degree of default risk, and credit officers must effectively assess the degree of risk in each credit extension. However, while foreign loans share many of the same risks of domestic credits, several other risks are unique to international lending.

As discussed earlier, all international activities are exposed to country risk. International lending is especially exposed, as problems that may arise in a particular country can lead to default, payment moratoriums, or forced modifications.

Additionally, the amount and mix of international credits can affect liquidity, capital, and sensitivity to market risk requirements and risk management practices. Credit and currency risks are also key risks associated with international lending.

Credit Risk refers to the potential inability of a borrower to comply with contractual credit terms. Evaluation of foreign credit risk is similar to domestic credit analysis and requires the review of appropriate information, including the amount of credit requested, loan purpose, collateral, anticipated terms, and repayment source. In addition, reviews should assess standard credit file information such as financial statements covering several years and the borrower's performance history on previous loans.

A key problem with assessing international credits is that applicable information is often less readily available and less detailed than in domestic credit files. Foreign loans are often extended in foreign currencies, and financial statements are often in a foreign language and formats that vary from country to country. Moreover, there are often barriers to acquiring such information from foreign sources. Therefore, when evaluating international loans, credit decisions are frequently based on information inferior to that available in domestic credit files.

Currency Risk reflects the possibility that variations in value of a currency will adversely affect the value of investments denominated in a foreign currency. Currency conversion exposure exists in every international credit extension, and currency risk can affect financial transactions in several ways. For borrowers, rapid depreciation in the home currency relative to the borrowing currency can significantly increase debt service requirements. For lenders, rapid appreciation or depreciation in currencies can substantially affect profit or loss depending on how the institution finances the assets. If a U.S. bank lends in a foreign currency, it must acquire that currency by either borrowing or exchanging dollars for the new currency. In the latter situation, a bank might find itself effectively financing its cross-border lending with domestic liabilities, exposing itself to currency risk. If the foreign currency assets depreciate, a bank might suffer economic or accounting losses even without a default because the foreign currency assets must be translated back into dollars for financial statement purposes. In this capacity, currency risk is a sub-set of market risk, and institutions should apply appropriate techniques to monitor and manage this risk.

U.S. banks can attempt to reduce the market risk aspect of currency risk by lending and requiring repayment in U.S. dollars, but the effectiveness of this technique is limited and may simply substitute currency risk for transfer risk (the risk that occurs when a borrower incurs a liability in a currency different from the currency in which revenues are generated).

For example, a foreign borrower might borrow dollars to use the proceeds in a foreign country because of the relative ease of obtaining loans denominated in dollars from a global institution. In this situation, the borrower may convert some or all of the proceeds into the foreign currency. Subsequently, when payments become due, the borrower will need to exchange some foreign currency for dollars. If the local currency depreciated against the dollar, the borrower may find itself unable to meet its debt service requirements.

Another situation that could arise in smaller markets is the inability to obtain sufficient currency at official exchange rates. This could occur because the exchange rate does not reflect competitive market dynamics, or because the loan being repaid is too large for the private-sector foreign exchange market of that country. Consequently, the borrower may be unduly controlled by its central bank or feel compelled to obtain currency from illicit market sources.

Forms of International Lending

Trade Finance

The most common function of international banking is the financing of trade. Generally, several types of trade credit facilities are used by banks, with the most common types being letters of credit and bankers acceptance financing. Exporters may be willing to ship goods on open account (self-financed) to credit-worthy customers in developed countries, but are often unwilling to accept the risk of shipping goods without established bank financing when dealing with an importer in a high-risk, or developing country. Other types of trade finance instruments and methods, such as discounting of trade acceptances and direct trade advances, are also covered in this section.

Letters of Credit

Letters of credit are issued in many forms depending on the type and circumstances of the underlying transaction. Historically, the use of letters of credit involved many documents and was labor intensive. However, automation has made it easier to create letters of credit, verify documents evidencing shipped goods, and collect payments. In some cases, the process has been streamlined into simple tracking of a bar code, similar to techniques employed at retail stores or shipping companies. Despite technological advances, the careful review of documents is paramount in order to protect the bank from liabilities and financial loss.

Commercial documentary letters of credit are instruments in which a bank (issuing bank) agrees to pay money on behalf of the customer (account party/buyer/ importer) to the party (beneficiary/seller/exporter) named in the instrument. The beneficiary is paid when specific documents are submitted to the issuing bank, as required by the terms of the letter of credit. Therefore, through a letter of credit, the bank substitutes its creditworthiness for that of the account party.

Issuance and negotiation by banks of documentary letters of credit are governed by the *Uniform Customs and Practice for Documentary Credits* of the International Chamber of Commerce. All letters of credit must:

- Be issued in favor of a definite beneficiary,
- Be for a fixed or determinate amount,
- Be in a form clearly stating how to make payments and under what conditions, and
- Include a definite expiration date.

The usual routing of a documentary letter of credit is from the issuing bank, through its correspondent bank in the country of the exporter, to the exporter. Basic letters that correspondent banks receive include *revocable* and *irrevocable* letters of credit.

The revocable form is generally of little use to the exporter. As the term indicates, the importer's bank can revoke its credit if requested to do so by its principals (the buyers) or a bank can amend credit terms without the specific agreement of the beneficiary. Ordinarily an exporter would request an irrevocable letter of credit. In this case, the buyer could not instruct their bank to rescind or change the letter of credit without first securing the consent of the exporter. When the exporter presents their documents exactly as described in the letter of credit to the correspondent bank, the latter will be able to secure payment from the importer's bank.

An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay upon presentation of the documents. The letter of credit may be sent directly to the exporter by the issuing bank or through a local correspondent bank of the issuer. In the latter case, the correspondent may merely *advise* the letter of credit. This means that it is acting as an agent of the importer's bank without any commitment on its part. This is evidenced by a printed clause appearing in the credits such as, "This advice is not an engagement on our part, but is simply for your guidance in preparing and presenting drafts and documents."

Some exporters, especially when they are not familiar with the issuing bank, require an agreement from bankers in their own country. For this purpose, the exporter will ask its local (correspondent) bank to *confirm* the irrevocable letter of credit, which requires the correspondent to obtain authorization and compensation from the issuing bank. Once confirmed, the exporter has a definite agreement from a bank in their country that it will make payment upon presentation of documents in accordance with the terms of the letter of credit, regardless of payments by the issuing bank or customer. This is evidenced by a printed clause in the agreement from the confirming bank such as, "We undertake that all drafts drawn and presented as specified above will be honored by us." The result of this transaction is that an exporter no longer has credit risk/cross-border risk from the original customer.

Payment terms of a letter of credit usually vary from when presented (sight letter of credit) to 180 days, although special forms of letters of credit allow for other terms. Usually the letter of credit will call for drafts to be drawn on the advising (and confirming) bank. If drawn at sight, the bank will effect payment immediately, provided the terms of the credit have been met. If drawn on a time basis, the bank will accept the draft, which thereafter can be held by the exporter, or by the bank on the exporter's behalf, until maturity. Alternatively, accepted drafts can usually be discounted or sold at going market rates. (Refer to the section on Bankers Acceptances.)

The ultimate repayment of letters of credit generally depend upon the eventual sale of the goods involved, and subsequent negotiations regarding letters of credit rarely occur unless caused by document discrepancies. If discrepancies occur, banks often charge a fee to resolve identified issues. The proper handling and accuracy of the documents used to process letters of credit is of primary concern, and management should maintain appropriate internal controls to ensure transactions are accurately and timely processed.

All commercial documentary letters of credit are contingent liabilities and should be included as such in the Call Report. If the payment of a letter of credit is refinanced, or the draft is discounted, it should be included as an asset in the loan schedules of the Call Report. Management should regularly monitor the volume of letters of credit outstanding through a general ledger memorandum account or contra accounts.

Standby letters of credit are another type of instrument used to facilitate international transactions. This instrument guarantees payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the bank's customer). A standby letter of credit is payable against an official statement of default or nonperformance (whereas a commercial documentary letter of credit is normally payable against the presentation of documents conveying or securing title to goods, such as a bill of lading). Some of the most common purposes for standby letters of credit include:

- Standby credit for the account party's performance under a contract award. In this case, the beneficiary presents the issuing bank a draft accompanied by a statement to the effect that the contract bidder (account party) did not perform under an awarded contract. The issuing bank is obligated to pay the beneficiary and seek reimbursement from the account party (customer).
- Standby credit for the account party's borrowing or advances from another bank. This arrangement requires the issuing bank to reimburse the lending bank if the account party (customer) does not repay their loan.
- Standby credit to back commercial paper or other obligations of the bank's customers.

A standby letter of credit transaction usually involves more risk for the issuing bank than a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of this instrument generally retains nothing of value to protect it against loss, unlike a commercial documentary letter of credit that provides the bank with title to the goods being shipped. Therefore, to reduce the credit risk of standby letters of credit, the issuing bank's credit analysis should be strong and at least equivalent to that applicable to ordinary, unsecured loans.

Back-to-back letters of credit are another type of trade finance transaction that examiners may encounter in international banks. Though the term *back-to-back* does not appear on the letter of credit, this situation is similar to a confirmed letter of credit, except that two separate letters of credit are issued.

These transactions occur when a seller receives a letter of credit covering goods that must first be obtained from a third party, which in turn requires a letter of credit. In this situation, the second issuing bank looks to the first bank for reimbursement by securing the second letter of credit with the first letter of credit.

Banks are typically reluctant to issue back-to-back letters of credit, partly because more documents are involved and the likelihood of technical problems is elevated. Generally, banks issue back-to-back letters of credit only when they have recourse to an alternative source of repayment (usually the applicant's general financial resources) in addition to the first letter of credit.

Bankers Acceptances

Most letters of credit are part of ongoing transactions that evolve from letters of credit to sight or time drafts, acceptances, notes or advances. Bankers acceptances are a common method of financing international trade that was facilitated by a letter of credit. These instruments are used to finance the successive stages of transactions that move goods from a point of origin to a final destination. Bankers acceptances are fundamental methods that banks use to finance trade transactions.

Bankers acceptances are orders in the form of time drafts (a.k.a., *bill of exchange*) that have been drawn on and accepted by a banking institution (accepting bank), or its agent, to pay the holder a certain sum on or before a specified date. The drawee bank creating the acceptance is primarily liable for the instrument, while the payee, as first endorser, is secondarily liable for paying the holder. If the drawee (buyer) is other than a bank, the instrument is a trade acceptance, not a bankers acceptance.

Bankers acceptances are sometimes eligible for purchase and rediscount by Federal Reserve banks. The rules governing whether an acceptance meets eligibility requirements are important for two major reasons. First, acceptances meeting the conditions of eligibility for discount or purchase are more readily salable in the secondary market. As such, they provide a greater degree of liquidity for the accepting bank. Second, ineligible acceptances are subject to reserves (eligible acceptances are not), which increases a borrower's costs.

The creation of eligible bankers acceptances is governed by Sections 12A, 13 and 14 of the Federal Reserve Act and Federal Reserve Board (FRB) Regulation A. Bankers acceptances must meet certain criteria established in Regulation A and by the Federal Open Market Committee (FOMC) in order for the instrument to be eligible for either discount or purchase by Federal Reserve banks. Since banks' holdings of acceptances form part of their secondary reserves, it is important that the paper they buy be readily marketable by conforming to all the rules that make the acceptance eligible for discount by a Federal Reserve Bank.

Examiners that review bankers acceptances should develop a fundamental understanding of acceptances and the regulatory rules relating to eligibility. Since acceptances are negotiable and traded in the secondary market, there are applicable lending limit considerations. Lending limit rules affecting bankers acceptances in nonmember banks are controlled by state banking laws, and many states that are oriented toward international banking have adopted pertinent sections of the federal statutes. Under Section 13 of the Federal Reserve Act, acceptances eligible for discount at the Federal Reserve (subject to specific criteria) are exempt from both reserve requirements and federal lending limits. Bankers acceptances that are ineligible for discount at the Federal Reserve become an unsecured obligation of the accepting bank (for the full amount of the draft) and are subject to prevailing lending limits.

Acceptances Discounted

In a typical letter of credit transaction, a draft is presented to the bank (along with other documentation), is stamped *accepted* on its face, and is endorsed by an appropriate officer. By accepting the draft, the bank acquires an unconditional obligation to pay a specified amount of money at maturity, either to the seller or, more frequently, to the holder of the instrument.

The seller/exporter, or holder, may choose to hold the draft until maturity, but typically chooses to receive immediate payment by selling the acceptance at a discount, usually to the accepting bank itself. The acceptance then becomes what is known as an *acceptance discounted*. If the accepting bank purchases or discounts the acceptance, it may elect to hold it in its own portfolio. In this event, it is recorded as a loan to the borrower who bought the goods and must be funded like any other loan. Once the acceptance discounted is created, it appears on the bank's balance sheet statement. Its accounts for *customers' liabilities on acceptances outstanding* (asset) and *liability for acceptances executed and outstanding* (liability) are reduced and the discounted acceptance is recorded with other loans. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, the acceptance should be appropriately recorded in asset and liability accounts.

Foreign Receivable Financing

Foreign receivable financing is a method of trade finance completed through direct advances against foreign collections, which the exporter pledges to the bank. The exporter may borrow from the bank up to a stated maximum percentage of the total amount of receivables lodged with the bank at any one time. Besides having a pledge on the exporter's outward collections, the bank usually retains recourse to the exporter, whose credit strength and reputation are of prime consideration. The bank also maintains control of the merchandise by ensuring the export bill of lading is *to-the-order-of* the shipper and endorsed in blank or to-the-order-of the bank. The bill of lading must not be consigned to the buyer (importer) since this would give them control over the goods.

Banks also finance foreign receivables through bankers acceptances. To obtain acceptance financing against receivables, the exporter draws two drafts. The first is a time draft drawn on the foreign buyer (importer), which, along with the necessary documents, is sent for collection in the usual manner. The second, for the same or a lesser amount and for the same tenor as the first, is drawn on the exporter's bank. The bank accepts the second draft and discounts it, crediting the net amount to the exporter's account. The bank may hold the acceptance in its loan portfolio or may sell it in the market. When payment is received from the importer on the first draft, the bank applies the proceeds to pay its own acceptance. Should the importer default, the bank has recourse to the drawer (exporter) for payment.

Government-guaranteed Trade Finance

Government-guaranteed trade finance is used by international banks to reduce the risk associated with international trade financing. Many governments have export credit agencies (ECAs) that provide subsidized credit to exporters. These entities are often independent agencies or government-authorized, private sector entities. For a fee, these agencies protect banks from commercial and political risk. Although the programs differ in cost and scope of coverage, they are all designed to encourage commercial banks to participate in export financing and mitigate concerns about transfer risk.

In the United States, the official ECA is the Export-Import Bank (Ex-Im Bank), a government chartered corporation. The Ex-Im Bank was founded in 1934 to finance and facilitate exports from the U.S. to other countries by guaranteeing repayment of loans made to foreign buyers of U.S. exports. The Ex-Im Bank offers a wide range of credit insurance policies covering the risk of nonpayment by foreign debtors. The policies, some designed specifically for financial institutions, cover certain percentages of commercial and political risks as well as interest repayment.

Other agencies that provide government-guaranteed trade financing include:

- The Overseas Private Investment Corporation, which provides project financing, investment insurance, and a variety of investor services, insuring investment projects against political risks.
- The Small Business Administration, which provides revolving lines of credit to fund the short-term needs of exporting firms.
- The Agency for International Development, which provides direct funds to emerging market countries and supports development projects.
- The Commodity Credit Corporation, which provides assistance in the production and marketing of U.S. agricultural commodities.

As with any government-guaranteed financing, familiarity with the specific conditions and requirements of each agency and program is paramount. Like domestic transactions, failure by the lender to comply with the program's conditions may allow the agency to rescind the guaranty. Documentation should be maintained for each participating transaction to show compliance with the outstanding guaranty. These documents should be scrutinized by the examiner when reviewing these credits to determine that the loan is compliant with the guaranty. Failure to comply with the terms of the guaranty may warrant adverse classification or criticism by the examiner.

Loans to Foreign Banks

Loans to foreign banks represent an important segment of international credit. Credit to foreign commercial banks may be in the form of direct loans or through deposit placements, which are discussed under a separate heading below. Often interbank loans are used to facilitate transactions by foreign counterparts that are denominated in U.S. dollars. In some instances, loans to foreign banks may be used for trade-related purposes.

Trade-related loans to foreign banks are commonly referred to as *pre-export/import financing*, and the loans usually function like a working capital line with advances requested so that the foreign bank can fund loans to its local clients. Because of improvements in global communication and payment systems, this type of lending has gained in popularity as a form of trade finance. Changes in foreign bank regulations, increased availability of financial information, and higher costs associated with letters of credit have contributed to the growth of pre-export/import financing.

The trade lines are typically unsecured and tend to have longer terms than letters of credit. Because the local clients are not directly obligated to pay the line of credit, bank underwriting and examination assessments of these lines should be based on the creditworthiness of the foreign bank.

An accurate appraisal of the foreign bank's management is the key consideration when evaluating loans to a foreign bank. Also, when granting these trade lines, U.S. banks should consider:

- The ability of the foreign bank to repay (not simply its current financial condition);
- If there is an established relationship with the foreign bank;
- Prior payment histories of the foreign bank;
- The foreign bank's standing within the market;
- The performance of comparable banks (peer group analysis);
- The foreign country and central bank's financial position and political conditions; and
- The foreign country's banking structure, supervisory programs, and method of reporting problem assets.

In some cases, the foreign bank may secure individual transactions, or an entire line, with cash collateral at the U.S. bank. Alternatively, the foreign bank may agree to maintain compensating balances at a percentage higher than the amount of its trade-related lines to mitigate the repayment risk.

Alternatively, loans may be extended directly to a foreign bank for working capital purposes or capital expenditures, but these loans are less common. The lending institution may also extend credit directly to a foreign borrower, based primarily on the foreign bank's guarantee of the loan. Such credit extensions may be for trade-related purposes, but are often accommodations to the foreign bank, with little or no contact between the lending bank and the direct borrower. This type of transaction should be considered as part of the aggregate credit extended to the foreign bank for legal lending limit purposes.

Domestic Loans

Although some loans to domestic borrowers are extended to facilitate international transactions, they are essentially underwritten as domestic loans, but handled by the international department. A typical transaction would be a loan or other form of credit to a domestic customer to finance imports of inventory shipped on open account or under a letter of credit or bankers acceptance facility. The credit would be in U.S. dollars with repayment expected from the sale of the inventory in the U.S. Since the ultimate repayment is based on the borrower's domestic, not foreign sales, the transaction is generally considered to be a domestic loan.

Loans to overseas units of domestic corporations that are guaranteed by a U.S. parent may also be encountered in international lending. These loans may be for purposes such as short-term working capital or long-term capital improvements of the foreign subsidiary. In these cases, the domestic company's guarantee generally has a significant effect on credit underwriting and approvals, but institutions should also conduct thorough country risk analysis because the borrower operates in a foreign jurisdiction and is subject to the political and legal risks associated with that particular country. Proper execution of the guaranty is also a critical factor in underwriting the credit. On the other hand, loans to foreign affiliates of U.S. corporations, not supported by a guarantee of the domestic corporation, must be considered as any other international loan to a foreign borrower and underwritten on its own merits, without consideration of the domestic parent's support.

The same principles may hold true for domestic subsidiaries of foreign corporations, or loans to domestic entities with a high level of international operations, such as import/export companies or companies that are part of an international supply chain. While these loans may be considered domestic loans by the bank because of the location of the borrowers, country risk analysis is generally required if the ultimate source of repayment is foreign. Analysis should also consider whether any form of support from the foreign parent is legally binding or subject to country risk.

Loans to Foreign Business or Individuals

Banks also lend to foreign companies, their subsidiaries, and wealthy individuals (e.g., international private banking customers). Direct loans to foreign businesses and individuals are based on the same credit principles as domestic loans. As with domestic credits, a bank must know its customer, identify the purpose of the loan, and assess the source of repayment. In evaluating these loans, the examiner must consider these factors and also consider the unique conditions related to international businesses that may influence repayment. Country risk, foreign exchange risk, and reliability of financial statements are additional factors that should be considered.

Loans to foreign customers can be granted on an unsecured basis, and are generally reserved for well-established and highly reputable customers of the lending institution. Usually compensating factors, such as large deposit balances at the lending institution, serve to mitigate the risks associated with this type of unsecured lending. These credits are sometimes granted as accommodation facilities for important customers of the bank's personal banking department.

Loans to foreign borrowers are typically not secured by foreign-based collateral given the difficulties of perfecting liens in foreign locations and jurisdictions. The loans are often directly supported by a domestic affiliate, foreign guarantor, or a foreign government, and evaluation of that support is integral to analyzing the credit.

In some cases, loans to foreign borrowers may be secured with assets located in the U.S. These loans could be for consumer purposes, such as residential real estate, or for commercial purposes, such as foreign entities borrowing to invest in commercial, U.S. real estate. The residency of the borrower determines whether these loans are international transactions for the purposes of regulatory reporting. Often, these loans have some type of foreign-based repayment source and are exposed to risks similar to cross-border loans. In these situations, they should also be included in country-exposure risk management systems.

In certain markets, consumer lending to non-resident aliens is a prevalent form of international lending. This form of lending is often handled outside of the international department because of the homogeneous nature of the credits and market-driven pricing. Because the repayment source is often foreign, the loans should be treated as international loans and assessed in a similar way as other types of domestic loans to foreign borrowers.

Loan Syndications

A bank may enter the international loan market quickly by purchasing participations through syndications. Syndication is the typical structure used by multinational banks to offer credit to entities with significant global funding requirements. Loan syndications are typically put together by international groups for borrowers requiring substantial funding, often to finance public works projects, large capital expenditures, or trade in commodities.

These participations tend to be specialized loans, which are often managed by another bank and may or may not involve existing customers. Nevertheless, participation in syndicated loan markets can offer benefits such as allowing for additional loan portfolio diversification and greater selection of loans with desirable features.

The participating bank should have sufficient financial information and documentation to adequately understand the transaction, as well as conduct analysis of the borrower, risks involved, and source of repayment. The bank's systems should be able to handle the unique operational issues of this type of lending and adequately monitor repayments. Examiners should verify that appropriate risk controls are in place and compatible with the risks applicable to this type of international lending.

When entering these markets, management should define and conform to acceptable risk limits. Often, smaller banks participating in syndicated loans may have limited input in structuring or managing the loans. For the largest institutions, certain loan terms and types are a small part of the loan portfolio, and the retained portion of any one transaction may be inconsequential. This may not be the case for smaller institutions, and all banks should exercise appropriate controls and strict monitoring and reporting systems, especially if they are new to the syndicated loan market.

Placements

Banks may maintain interest-bearing time deposits with foreign banks and overseas branches of U.S. banks, often referred as placements, interbank placements, or re-deposits. The maturity of these deposits may range from overnight to several years. Deposit placements are usually connected with foreign exchange markets and international money centers such as New York and London, and are carried in a *due from foreign banks* time account. The placements are generally made in conjunction with a pre-approved placement line that is, in essence, a line of credit.

The majority of these deposits are Eurodollar placements, with smaller amounts in other Eurocurrencies. Eurodollars and Eurocurrencies are simply dollars or foreign currencies domiciled outside the respective country of denomination. Due from bank time deposits contain the same credit and country risks as any extension of credit to a bank in a foreign country; consequently, a prudently managed bank should place deposits only with sound, well-managed banks after thoroughly investigating their creditworthiness.

Placement activity should be governed by a formal bank policy similar to that used for federal funds transactions. The policy should define acceptable terms, designate tolerable concentration levels (in relation to credit and country risks), and identify appropriate banks for placements. Lists of acceptable depositories with prescribed limits should be provided to traders and placement officers and reviewed regularly by credit officers, particularly during periods of money market uncertainty or changing economic and political conditions.

International Lending Policies

Every bank engaged in international lending should be guided by a formal, written, board-approved policy. Content will vary depending on the risk profile of the bank and the extent of its international activities, but certain factors should be addressed in almost all situations. These include basic credit standards for international lending, a statement of the bank's international lending objectives, a description of its system for credit approval, and the establishment of committee and officer lending authorities. In addition, the policy should define procedures that ensure the board of directors is regularly apprised of the size, performance, and risk profile of the international loan portfolio.

Defining geographic loan limits is one of the most significant components of an adequate international lending policy. Limits should be set according to estimates of where the bank can profitably lend (in accordance with its strategic objectives, financial capacity, and personnel resources). Maximum aggregate limits should be established for each political entity where credit is advanced, based on a comprehensive country risk analysis. Banks should also consider establishing country and credit sub-limits by transaction type. Limits should be considered for specific countries, as well as groups of countries (regions) that have close economic ties.

When evaluating international credit risk, special consideration must be given to reviewing foreign financial statements, types of borrowers, and the forms of indirect support provided by parent companies, banks, and financial institutions. Many banks analyze foreign currency statements in U.S. dollar terms (with a single conversion from the foreign currency), versus U.S. dollar equivalents at the end of each period, which could have several different conversion rates. The merits of either approach depend on the currency of repayment and a clear understanding of which approach is used. Nevertheless, lenders should review financial statements that reflect amounts in both dollars and foreign currencies and that are translated into English.

Because financial information from foreign countries is not always reliable, the bank's policies should enable it to determine borrower capacity and reputation by other means. One of the most effective methods is a program of regular visits to borrowers' countries by bank account officers and by obtaining credit references, followed by preparation of candid reports that become significant parts of credit files. When managing the accounts of international borrowers, there is generally no substitute for regular account officer visits in obtaining this type of information. It may also be prudent to send multiple officers or obtain independent assessments. Banks can also consider the Financial Sector Assessment Program, jointly established by the World Bank and the International Monetary Fund, which analyzes a country's adherence to sound financial sector principles such as the Core Principles of Banking Supervision prescribed by the Basel Committee on Banking Supervision.

Other International Activities

Investments

In addition to international loans and deposit placements, international banks may periodically allocate capital, through international capital markets, to investments such as foreign debt securities or debentures. Banks use the international capital markets to invest funds at a competitive advantage to lending. Capital market activities have increased for several reasons, including:

- Excessive loan losses incurred on emerging-market loans,
- Small spreads between the interest earned on loans and the interest expense of foreign deposits,
- Increasingly stringent risk-based regulatory capital standards, and
- Global recessions and regional financial crises.

These factors have de-emphasized banks' commitment to direct foreign lending, but countries and corporations continue to have capital needs, and banks assist them by underwriting and investing through capital market instruments. Banks are exposed to numerous risks when investing in international markets and should have appropriate risk management in place before engaging in these activities.

Foreign debentures may be issued by a foreign bank, corporation, or sovereign government. Banks with foreign offices might hold the securities of foreign government entities to meet various local laws or reserve requirements, reduce tax liability, retain sufficient asset liquidity, or as an expression of goodwill. As with domestic bond issues, the instruments will have varying durations and maturity and usually represent an unsecured obligation of the issuer.

Foreign debt securities held by U.S. banks are often denominated in U.S. dollars and are in the form of Eurobonds, Medium Term Notes, or Yankee Bonds. These instruments provide liquidity in secondary markets (during normal market conditions) and, depending on the country and circumstances of the issuer, may offer much higher yields than would otherwise be obtainable in the highly competitive trade finance market. Higher yields (over comparable U.S. Treasury instruments) are driven by a confluence of factors including credit quality, country risk (including transfer risk), inflation, monetary policy, and foreign exchange movements.

International investments may be internally reported within a bank's domestic bond portfolio, even though they are reported separately for Call Report purposes. To monitor overall country exposures properly, the instruments should also be included in the appropriate country of risk in both internal and regulatory reports.

Banks with foreign branches are permitted a broader scope of investment activities, including investment services and underwriting of debt and equity securities. International investments and permissible activities are governed by the FRB's Regulation K, which is incorporated into Part 347 of the FDIC Rules and Regulations (for state nonmember banks).As with the domestic investment portfolio, the purchase of foreign debt securities for speculation is an unsuitable investment practice. While risk management considerations are similar to those contained within the Securities section of this Manual, the foreign aspect of Eurobonds, notes, and debentures requires greater due diligence, consideration, and monitoring than would otherwise be expected of a non-complex domestic bond portfolio. Jurisdictional issues and legal systems must be considered when investing in securities issued by sovereigns, and resolving defaults and restructurings of sovereign debt can be problematic if not properly underwritten.

Private Banking

Many banks market personalized services to high net worth customers through a separate unit of the bank commonly known as the private- or personal-banking department. Private banking is an important business line for many financial institutions as it encourages wealthy individuals to develop banking relationships and can generate substantial fee income.

U.S. banks manage private banking relationships for both domestic and international customers. Private-banking departments may provide customers typical financial services, or complex assistance such as facilitating the establishment of shell companies and offshore entities (e.g., private investment companies (PIC) or international business corporations). Typical private-banking services include:

- Cash management,
- Funds transfers,
- Asset management (e.g., trust, investment advisory),
- Lending services,
- Financial planning (e.g., tax and estate planning),
- Custody services, and
- Other support as requested.

Privacy and confidentiality are important elements in international private banking, but may increase a bank's vulnerability to money laundering. Risks of money laundering or other illicit activities may be increased due to having operations in jurisdictions with weak anti-money-laundering laws, the use of shell companies or accounts with fictitious names, or the establishment of accounts in the name of a PIC or blind/numbered trust.

International *private banking accounts* are covered by the Bank Secrecy Act, USA PATRIOT Act, and other recordkeeping and reporting rules and regulations. The accounts are generally defined as an account (or any combination of accounts) maintained at a financial institution that requires a minimum aggregate deposit of funds (or other assets) of not less than $1,000,000, is established on behalf of or for the benefit of one or more non-U.S. persons who are direct or beneficial owners of the account, and is assigned to, or is administered by, in whole or part, an officer, employee, or agent of the bank acting as a liaison between a covered financial institution and the direct or beneficial owner of the account.

Typically, private banking accounts are based on minimum deposit levels and require management to implement effective due diligence, monitoring, and reporting systems. Even when the accounts do not meet the required minimum deposit criteria described above, it is expected that the relationships be subject to appropriate internal controls and due diligence under the institution's risk-based Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance program.

Effective risk management policies, procedures, and practices help protect banks from becoming conduits for money laundering and terrorist financing, which may arise through private banking relationships. Such illicit activities can impair an institution's reputation and have significant costs due to litigation expenses, regulatory sanctions, and loss of business. Additional information relating to required due diligence and risk management of these activities is contained in the FFIEC's BSA/AML Examination Manual and other guidance.

Correspondent Banking

Financial institutions can use U.S. banking relationships to provide services to foreign banks, yet limit their overall exposure to foreign activities. Correspondents provide a range of services to banks located in other countries that do not have local offices, or whose local offices are prohibited from engaging in certain types of activities. This arrangement allows the foreign bank to offer these services more efficiently and economically. Banking services performed through a foreign correspondent bank arrangement may include:

- Cash Management,
- International Funds Transfers,
- Check Clearing,
- Pouch Activities,
- Foreign Exchange Services,
- Sweep Accounts/Overnight Investments,
- Trade Financing, and
- Payable-through accounts (PTAs).

Note: PTA activities should not be confused with traditional international correspondent banking relationships, which do not provide correspondent bank customers with direct access to their account at the U.S. bank, as would be the case in a PTA account arrangement.

Foreign correspondent banking is highly scrutinized because of concerns that some foreign financial institutions are subject to less effective regulatory guidelines than U.S. banks and therefore pose a higher risk of money laundering or other illicit activities.

Per existing regulations, a *correspondent account* is established by a bank for a foreign bank to receive deposits or make payments or other disbursements on behalf of the foreign bank, or to handle other financial transactions related to the foreign bank.

Investigations have disclosed that correspondent accounts have been used by criminals to launder funds and facilitate criminal or terrorist activities. Shell companies are sometimes used to hide the true ownership of accounts. Because of these risks, restrictions that are more stringent have been enacted within the regulatory framework to prevent the use of these accounts for illicit purposes. For instance, according to the amended regulations, a bank is prohibited from establishing, maintaining, administering, or managing a correspondent account in the U.S. for, or on behalf of, a foreign shell bank.

Additionally, a bank that maintains a correspondent account in the U.S. for a foreign bank must maintain records in the U.S. identifying the owners of each foreign bank. A bank must also identify a person who resides in the U.S. who is authorized to be an agent to accept *service of legal process*. (Service of legal process means the agent is willing to accept legal documents, such as subpoenas, on behalf of the foreign bank.)

These stringent regulatory restrictions make foreign correspondent banking an area that requires a higher degree of scrutiny than other international banking activities. Examiners should be aware of the heightened risk posed by this activity, and carefully review policies and risk management controls using the guidelines provided by the FFIEC BSA/AML Examination Manual and other examination guidance on the subject.

Deposit Accounts

Deposit gathering and retention activities of international banks arise from the exercise of other banking activities, such as:

- Receipt of wire transfers,
- Compensating or collateral balances required against credit facilities,
- Disbursement of loan proceeds,
- Payments for trade transactions, and
- Savings or cash-management balances of private banking customers.

The various types of deposit instruments used by banks are defined in applicable Federal Reserve and FDIC regulations governing demand, savings, and NOW accounts. The origin, as well as the types and amounts of deposits that international banks can accept, is dependent on the licensing agency's guidelines or applicable state restrictions, FDIC insurance status, and limitations imposed based on the type of banking office being examined. For instance, U.S. branches and agencies of foreign banks may have restrictions on accepting deposits from U.S. citizens or residents under certain conditions. Examiners should become familiar with the regulatory deposit-taking restrictions that may apply to the type of banking structure under review.

In addition, the volatility and composition of the foreign deposit structure are important elements to consider in the examination process. Foreign deposits tend to have a higher degree of volatility than domestic deposits because of strong competition for funds among banks, the needs of individual and corporate account holders to minimize idle funds, and the effects of disintermediation (the movement of deposits to other higher-yielding markets). A comprehensive deposit development and retention program, which is often included in the funds management policy, is a useful tool for mitigating this volatility.

Management should establish appropriate deposit development and retention policies that include reasonable limits on foreign deposits. When establishing the limits, management should consider prudent competition and the bank's scope of international services. Deposit policies and programs should not only be concerned with deposit growth but also address the desired characteristics of the deposit structure and provide for reporting mechanisms to monitor foreign deposits. Management of the international operations must be able to determine what percentage of the overall foreign deposit structure is centered in stable/core deposits, fluctuating/seasonal deposits, and higher-risk/volatile deposits. Management information systems should provide sufficient information to enable bank management and examiners to evaluate the effect that all material, foreign deposit accounts have on the bank's risk profile.

In addition, examiners should consider BSA/AML risks, and other regulatory/compliance risks related to certain types of deposit accounts, when analyzing the bank's foreign deposits. Deposit products and programs that exhibit elevated risk characteristics are discussed below.

Payable-through Accounts (PTAs) are used directly by customers of the correspondent bank to transact business on their own behalf. Under this arrangement, the sub-account holders of the PTA are generally non-U.S. residents or owners of businesses located outside of the United States. PTAs may be prone to higher BSA/AML compliance risk because banks holding the PTA account may not implement the same due diligence requirements on the sub-account holders that they require of domestic customers. Also, the typically high volume of transactions conducted through PTAs, coupled with inadequate oversight by the banks, may increase money-laundering risks and related criminal activities. The inability of the holding bank to identify and adequately understand the transactions of the ultimate users significantly increase risks associated with money laundering, terrorist financing, and OFAC violations.

Brokered Deposits generally represent funds the bank obtains, directly or indirectly, by or through a deposit broker or agent. Historically, internationally active banks have not relied heavily on funds obtained through deposit brokers to supplement their traditional funding sources. But, in some cases, large, out-of-area deposits are obtained because the U.S. bank is offering attractive rates.

When acquiring foreign deposits, internationally active banks often rely on the assistance of affiliated or parent institutions. International banks may also use independent agents to augment their deposit base. Agented deposits may be the product of personal relationships at a related institution abroad or initiated by foreign customers of related institutions, who are interested in the stability of U.S. insured deposits.

Fundamentally, the risks associated with foreign brokered deposits share many similarities with the risks associated with domestic brokered deposits. Examiners should consult with Capital Markets and International Banking subject matter experts as needed when evaluating foreign deposit gathering and retention activities.

Deposit Sweep programs are often offered by internationally active banks. These sweep programs exist primarily to facilitate the cash management needs of customers who might otherwise move their account to an entity offering higher yields. In sweep programs, banks use an agreement with the deposit customers (typically corporate accounts) that permits the bank to transfer, or sweep, funds, which are above a designated level, from a deposit account into an overnight investment product. The money is transferred out of a deposit account before the close of business and transferred back into the account the next morning. (Conversely, banks may also engage in deposit sweep arrangements with risk averse customers that wish to sweep funds into the bank overnight, in part to obtain deposit insurance.) Investment product examples include Eurodollar deposits, money market funds, and reverse repurchase agreements. *Note:* If a sweep is not properly executed, the depositor may become an uninsured general creditor of a foreign branch or have their funds invested in other short-term obligations and have no claim on the institution if the branch or institution fails.

Banking organizations with deposit sweep programs should have adequate policies, procedures, and internal controls to ensure sweep activities are conducted consistent with sound banking practices and in accordance with applicable laws and regulations. Policies and procedures should ensure that deposit customers participating in a sweep program are given proper disclosures and information regarding the insured status of their deposits.

Borrowings

Borrowings generated through the international department include all non-deposit liabilities. Common forms of borrowings include:

- Federal funds purchased (overnight and term);
- Bills payable to the Federal Reserve;
- Notes and trade bills rediscounted with central banks;
- Short sales from trading securities;
- Overdrafts on deposit accounts;
- Notes, acceptances, import drafts, or trade bills sold with the bank's endorsement or guarantee; and
- Notes or other obligations sold subject to repurchase agreements.

All international borrowing transactions should be treated similar to domestic transactions and be properly recorded on the general ledger and reported in Call Reports.

Note: Foreign time deposits are not borrowings and should be reflected as deposits for reporting purposes and borrowing limit calculations. However, for many banks, little difference exists between how time deposits and borrowings are used and obtained, and foreign time deposits are often viewed as borrowing vehicles.

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FOREIGN EXCHANGE

Foreign exchange involves substituting one country's currency for another. Because international trade and investment require the exchange of currencies, the trading of one country's money for another is a necessary function in international banking.

This section provides examiners with basic information regarding foreign exchange activities. While banks of any size can engage in foreign exchange transactions on behalf of their customers, generally only the largest institutions specializing in international business or international capital markets enter into material foreign exchange transactions for their own account. When necessary, examiners reviewing complex foreign exchange activities should seek assistance from regional, Capital Markets, or Large Bank Supervision subject matter experts.

The Foreign Currency Exchange Market

Foreign exchange transactions can be conducted between any business entity, government, or individual. Financial institutions are ideal foreign exchange intermediaries due to their knowledge of financial markets and experience providing financial services. Banks are involved in a majority of worldwide, foreign exchange transactions with the volume of an activity largely dictated by customer demand.

Importers and exporters often rely on banks to facilitate their foreign currency transactions. The transactions are usually processed in the foreign currency exchange market, which has no specific location or hours of business. Instead, it is a loose collection of entities (commercial banks, central banks, brokers, and private investors) joined by near instantaneous communications links.

The foreign exchange market meets the definition given by most economists of perfect competition, as there are large numbers of buyers and sellers with equal access to price information who are trading a homogeneous product with few transportation costs. Foreign exchange is generally traded in an interbank/dealer network, or organized exchanges such as the London International Financial Futures and Options Exchange or the Chicago Mercantile Exchange.

The interbank market, which is by far the largest market, is housed in the foreign exchange departments of larger banks around the world. It is an over-the-counter (OTC) market because it has no single location or fixed listing of products. It provides opportunities for customers to buy and sell currencies in virtually any amount, for immediate or forward delivery, through contracts to exchange one currency for another at a specified exchange rate (price).

Delivery of currencies may be *spot* (short-term contracts of two business days or less) or *forward* (more than two business days). In either case, the rate of exchange may be established prior to the finalization of the transaction with all related costs calculated and often passed on to the customers. Exchange rates are based upon the amount of time required to exchange currencies. For example, the British Pound Sterling is quoted at a certain rate for immediate (spot) transactions and another rate is quoted on the same day for future (forward) transactions.

In general, exchange rates vary depending on the agreed payment date (value date) of the transaction, i.e., overnight, one week, one month, etc. Also, dealers may quote a different exchange rate for a given transaction depending on whether they are buyers or sellers of currency. This applies to both spot and forward transactions and the two rates are usually referred to as the *bid* (buy) or *offer* (sell) price. The spread between the bid and offered rates represents the dealer's profit.

The system for establishing currency prices is virtually unregulated with exchange rates determined by supply and demand. Exchange rates for most major currencies are free to float to whatever level the market is willing to support, a level that often fluctuates significantly over short periods.

Foreign Exchange Trading

As a result of modern communication systems and rapid price movements, opportunities have soared for speculative trading in the exchange markets. In addition to serving the financial needs of importers and exporters, foreign exchange markets support speculation, arbitrage, and sophisticated hedging strategies, which can create profitable opportunities for banks that have the resources and managerial capabilities to participate in the interbank markets as market makers. While the volume of foreign exchange activity varies widely among banks, transaction volumes are increasingly being driven by interbank trading for banks' own accounts. Banks trading for their own account or as a business line present complex risks.

Banks specializing in this complex and specialized field, particularly those banks that trade foreign exchange for their own account, typically maintain a foreign exchange department with qualified dealers. Banks that only execute their customers' instructions and do no business for their own account (essentially maintaining a *matched book*) generally use the services of another bank or foreign exchange intermediary to place customer transactions.

While trading in foreign exchange is usually encountered only in large global institutions, examiners should be familiar with the fundamental risks inherent in foreign exchange trading.

Foreign Exchange Risks

Trading in foreign currency or holding assets and liabilities denominated in a foreign currency entail risks that fall into five main categories: exchange rate risk, maturity gap risk, credit risk, operational risk, and country risk.

Exchange rate risk arises when a bank takes an open position in a currency. An open position occurs when a bank holds or agrees to buy more foreign currency than it plans to sell, or agrees to sell more foreign currency than it holds or plans to buy. Open positions are either long or short. When a bank buys more of a currency, either spot or forward, than it sells, it has a long position. Conversely, if more currency is sold than bought, a short position is created. Until an open position is covered by the purchase or sale of an equivalent amount of the same currency, the bank is exposed to adverse movements in exchange rates.

Banks often hedge open positions with a forward contract, thereby matching a requirement to deliver with a future contract to receive. The hedging of open positions can be very complex, sometimes using swaps or options, multiple contracts, different types of contracts, or even different currencies. It is important to remember that the level of exchange rate risk is not necessarily dependent on the volume of contracts to deliver or receive foreign currency, but rather the extent that these contracts are not hedged either individually or in aggregate.

All banks that engage in foreign exchange activity should monitor their open positions at least daily. Banks that actively trade foreign currencies should monitor intra-day open positions, closing out or matching exposures at various times during the day.

Maturity-gap risk is the foreign exchange term for interest rate risk. It arises when there are mismatches, or gaps, in a bank's total outstanding spot and forward contracts. Gaps may be present in intra-day, daily, or longer periods of uneven cash inflows or outflows. For example, a maturity spread of a bank's assets, liabilities, and future contracts may reflect a prolonged period over which large amounts of a particular currency will be received in advance of scheduled offsetting payments. The bank's earnings are therefore exposed to adverse shifts in interest rates on the funds provided by cash inflows or on the rates paid on the funds required to meet cash outflows.

In these situations, generally, the bank must hold the currency, invest it short term, sell it for delivery at the time the gap begins and repurchase it for delivery at the time the gap closes, or use a combination of the techniques. The problems of managing gaps are complex; however, banks can mitigate interest rate risks by closely monitoring positions and establishing limits on the volume of mismatches in total foreign exchange positions. Decisions to close a gap when it is created or to leave it until a later date should be based upon a thorough analysis of money market interest rates and spot and forward exchange rates.

Institutions should have firm policies on the maximum gap exposure permitted in certain currencies. The decision to close a gap when it is created, or to let it remain open for a time, will generally depend on money market interest rates as well as the difference between applicable spot and forward exchange rates (commonly known as the swap rate) or the deviations between two forward exchange rates. Estimated movement in the swap rate (primarily determined by interest rate differentials between the two countries) is the customary measure of profit potential or loss exposure during the period within which the gap exists.

Credit risk involves the ability of a bank's customer, or counterparty in a foreign exchange transaction, to meet their financial obligations. Two types of credit risk exist in foreign exchange trading. The first is that a customer might not be able to deliver the currency as promised in order to settle the contract. In this case, the potential mark-to-market profit on the transaction is at risk. The second is delivery or settlement risk. Delivery or settlement risk refers to the possibility a counterparty will take delivery of currency from the bank, but not deliver the counterpart currency. In this situation, the bank is exposed to loss of the entire transaction, not just from currency fluctuations.

To limit both risks, banks must carefully evaluate customers' creditworthiness. The credit reviews should be used to establish an overall limit for exchange contracts for each customer. In order to limit settlement risk, major dealers and third parties also participate in the CLS (Continuous Linked Settlement) system. The CLS reduces risks by facilitating foreign exchange settlements between dealer institutions on a simultaneous or daily basis.

Operational risk reflects the possibility that ineffective controls and operations for foreign exchange activities may result in unanticipated losses to the bank. Banks that engage in foreign exchange transactions must have systems and personnel capable of identifying, controlling, and reporting risks.

Banks should have systems in place to accurately record transactions, perform daily mark-to-market adjustments, reconcile currency positions daily, and assess compliance with established limits. Personnel should also ensure that all confirmations are received or sent to counterparties daily. Appropriate separations of duty are essential in managing operational risk, with the responsibilities of the traders and back-office personnel being strictly segregated. While the form of trades and trade confirmations have changed with the advent of new technology, the independence and appropriate control of these functions remains of paramount importance regardless of the extent of a bank's trading operations.

Country risk reflects potential political changes or adverse economic trends in a country. These types of events are often accompanied by changes in policies that could affect such factors as interest rates, balance of payments, foreign exchange reserves, and capital flows. The policies, whether based on economic necessity or changed attitudes, might affect the availability or transfer of currency to the bank's customers or to the bank itself, and could even affect the convertibility of that country's currency in foreign exchange markets. Exchange controls imposed by a country's central bank may limit the amount of currency that can be exchanged in any single transaction, by any given customer, or within a particular period, and the sources for covering desired currency positions may vanish. Additionally, the exchange rate for the currency may be subject to additional supply and demand influences.

Due-From Nostro Accounts

Domestic banks must be able to make and receive payments in a foreign currency in order to meet the needs of international customers. Since physical movement of currency is impractical, financial institutions maintain accounts or inventories of foreign currency in correspondent banks located in the countries where the institution and its customers conduct business. These accounts are commonly called due-from or *nostro* accounts. Conversely, *vostro* accounts are due-to accounts (demand deposits) representing foreign currency owned by a foreign bank maintained at a U.S. bank.

Close supervision of nostro accounts is required to ensure adequate balances are available to meet customers' needs while avoiding excessive idle funds or overdrawing the nostro account and incurring service charges. Transactions occur in foreign currency denominations, but deposits and withdrawals are normally recorded on a bank's ledgers in both the foreign currency and its U. S. dollar equivalent. All foreign currency transactions, except over-the-counter cash trades, are settled through nostro accounts. Therefore, the volume of activity may be substantial and must be adequately controlled.

Examination objectives are similar to those of domestic correspondent accounts with the additional problem of exchange risk. Nostro account balances are included with other general ledger accounts to determine the department's *position* in each foreign currency. Some banks do not include foreign currency in their net position reports or monthly valuations. Currencies of other countries are foreign assets held in nostro accounts and should be included in position reports.

Conversely, physical control over foreign currencies kept in cash should also be maintained and complemented with adequate accounting systems and controls. Accounting reports should include the U.S. dollar equivalent of foreign currency balances. Separate controls for cash items should be maintained in the general ledger, supported by subsidiary records that permit an evaluation of each item.

Dealing in foreign notes and coins can involve more risk than engaging in foreign currency activity through a due-from account because institutions may unknowingly accept counterfeit currency, and because the physical movement of notes and coins is expensive and time-consuming. Appropriate internal controls should be instituted to compensate for these additional risk factors.

Examination Guidance for Foreign Exchange

An examination of a bank's foreign exchange activities seeks to assess the impact of the foreign exchange activities on the financial condition of the bank. Large, global banks with extensive foreign exchange trading operations earn substantial fee income from this activity, while banks that conduct trades entirely on behalf of their customers generally do not. The nature of foreign exchange trading, wherein a single trader can commit a bank to substantial forward commitments in a short time, makes examinations of related risks and controls important for banks of any size and level of activity. At a minimum, examiners should:

- Determine the extent of foreign exchange activities,
- Identify the types of exchange contracts used by the bank,
- Consider the risks presented by each exchange activity,
- Assess the adequacy of internal controls and risk management systems, and
- Evaluate the overall impact of foreign exchange activities on earnings and capital.

Another important examination objective is to assess the quality of personnel, systems, and controls in relation to the volume of activities and complexity of transactions. When assessing foreign exchange activities and controls, examiners should consider the bank's compliance with Part 349 (Retail Foreign Exchange Transactions) of the FDIC Rules and Regulations.

Examiners should also review compliance with internal exchange limits and note any unusual concentrations or lines of credit to banks with known market problems. Examiners should obtain a current report of all outstanding foreign exchange contracts and determine if there are any contracts in excess of approved limits, other than those reported on the exceptions report. If contracts that exceed approved limits are identified by examiners or included on exception reports, examiners should assess the adequacy of management's plans to bring contract levels into conformance with approved limits.

Banks that are active in foreign exchange trading should have internal controls commensurate with their risk profile. Banks with limited foreign exchange activity and low-risk profiles (e.g., most state nonmember institutions) may not need the sophisticated monitoring/reporting systems and internal controls maintained by larger institutions or that are required by minimum regulatory standards. However, it is incumbent upon management to maintain adequate systems and controls, and to demonstrate to examiners that their systems provide adequate protection for their risk profile.

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STRUCTURE AND SUPERVISION

Foreign Banking Organizations (FBOs) in the U.S.

Foreign banks that conduct operations in the U.S. are known as foreign banking organizations. The FBOs have a longstanding presence in the U.S. and their operations encompass a wide variety of banking and non-banking activities. The activities of FBOs can generally be divided into four main categories: branches, agencies, foreign-owned U.S. bank subsidiaries, and representative offices.

Parallel-owned banking organizations are similar to U.S. bank subsidiaries of FBOs. The critical difference is that a PBO does not have comprehensive, consolidated supervision of all banking entities by the home country. PBOs pose unique supervisory concerns and are covered in more detail under a separate sub-heading.

Branches and Agencies of Foreign Banks

Branches and agencies of foreign banks in the U.S. are extensions of a foreign bank, much like a domestic branch of a U.S. bank. All U.S. branches of foreign banks are required to be licensed at either the state or federal level and are subject to separate insolvency laws. The International Banking Act (IBA) of 1978 established uniform federal requirements for U.S. branches of foreign banks. The main principle of the IBA is one of non-discrimination or *national treatment*, which eliminates the advantages and disadvantages that foreign branches previously faced compared to domestic branches.

U.S. branches of foreign banks may perform all banking functions permissible in the U.S., including accepting deposits and extending loans (unlike a representative office); however, the deposits may not be insured by the FDIC. The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA)[2] effectively prohibits the FDIC from granting deposit insurance to U.S. branches of foreign banks except for those that were insured prior to FBSEA's enactment.

Agencies, similar to branches, may be licensed under state[3] or federal law, but, unlike a branch, an agency may not accept deposits. Agencies are permitted to have occasional credit balances under certain conditions. Such credit balances must be incidental to, or arise from the exercise of other lawful banking powers. Credit balances must be for a specific purpose and should be withdrawn within a reasonable period of time after the specific purpose has been accomplished. These balances are not to be solicited from the general public or used to pay for routine operating expenses in the U.S.

Edge and Agreement Corporations

Edge and Agreement corporations are subsidiaries of financial institutions organized for the purpose of engaging solely in certain international financial and investment activities. There are two types of Edge corporations - *banking* (which accepts deposits) and *investment* (which are essentially holding companies for foreign investments).

Agreement corporations are similar to Edge corporations, except that they are chartered under state law rather than by the FRB. Both Edge and Agreement corporations may be located anywhere in the U.S., can establish branches in the U.S. or overseas, and are permitted to engage in a broad range of banking activities, provided that the transactions are international in nature or directly related to international transactions. Operations of Edge and Agreement corporations are governed by Section 211.6 of the FRB's Regulation K.

Although the operations of Edge and Agreement corporations are governed by Regulation K, the entities are not members of the Federal Reserve System. The FDIC does not insure their deposits, but the entities are required to maintain reserves against deposits. They are also required to maintain capital adequate to support their operations.

Representative and Commercial Lending Offices

Representative offices are usually an organization's first form of entry into a foreign market because of lower operating costs. Representative offices are established under state law with the prior approval of the FRB. These offices have limited presence, as they are mainly a marketing facility for their foreign parent. Unlike branches, they cannot provide traditional banking services, such as accepting deposits or lending funds. Commercial lending offices are similar to representative offices. They are state licensed and cannot accept deposits, but they may borrow and lend on behalf of their parent companies.

FBO Supervision and Examination Guidance

FBOs are supervised under the Interagency Program for Supervising the U.S. Operations of FBOs (FBO Program). The FBO Program is a risk-focused supervisory framework designed to focus on an organization's principal risks and its internal systems and processes for managing and controlling these risks. The FBO Program consists of four primary and interrelated components:

- Understanding the FBO,
- Assessing FBO risks and how they relate to U.S. operations,

[2] The FBSEA was enacted in 1991 to improve the degree of supervision of foreign banks operating in the U.S. As a result, the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations (the FBO Supervision Program) was established and applied to all FBOs that have a presence in the U.S.

[3] Twenty-six states and the District of Columbia currently authorize the establishment of agencies by foreign banks.

- Planning supervisory activities in the U.S., and
- Determining the overall condition of its U.S. operations.

The FBO program is designed to coordinate the regulatory efforts of both domestic and foreign supervisors and to promote a consolidated, comprehensive supervisory approach to analyzing an organization's overall condition.

While the examination of the U.S. bank subsidiary of an FBO is similar to the examination of a domestic institution, the FBO program enables the examiner to understand the FBO's U.S. operations in the context of the entire banking organization. In order to streamline FBO supervision, enhance cooperation, and reduce regulatory costs, the federal regulatory agencies have entered into examination coordination agreements with state banking agencies that protect the confidentiality of information shared by all participants. The information is shared through a secure software platform. When planning the examination of an FBO, the examiner should contact their region's International subject matter expert (SME) and review available information. These parties may have access to more recent information that should be considered in the overall assessment of the FBO.

As part of its oversight responsibility, the FRB coordinates the examinations of FBOs with other federal agencies and with various state banking authorities. FBO oversight requires that the parent company be evaluated through a strength-of-support assessment (SOSA). The purpose of the SOSA is to determine the parent company's ability to support its U.S. operations and the FBO's overall risk profile, as well as to develop an examination strategy and frequency that is commensurate with the risk profile.

As part of the SOSA process, regulatory agencies gain a better understanding of the FBO by also reviewing its home country financial system, supervisory practices, and accounting standards. An assessment of these components result in a combined assessment of an FBO's banking activities in the U.S., which is shared with the FBO's home country supervisors in order to enhance their consolidated supervisory programs.

The Core Principles[4] of the Basel Committee on Banking Supervision (BCBS) recommends that cross-border banking groups be supervised on a consolidated basis. The consolidated approach helps ensure banks within the group are adequately capitalized, risks are managed on a group-wide basis, and contagion risks within a banking group are adequately mitigated. An important principle within this framework is one of the *home-host relationship*, which considers the relationship between the home supervisor where the FBO is headquartered, and the host supervisor where the foreign operations are conducted, e.g., the U.S. branch of an FBO.

[4] Basel Committee on Banking Supervision-Core Principles for Effective Banking Supervision, September 2012.

The U.S. Banking Agencies' emphasis on consolidated, comprehensive supervision programs have served as the benchmark for many current and evolving international standards for the consolidated supervision of financial groups. Key concepts that have been part of the Agencies' approach to consolidated supervision for many years are reflected in the BCBS Minimum Standards for Internationally Active Banks, capital accords, and Core Principles for Effective Banking Supervision. The concepts are now used by the International Monetary Fund and the World Bank in connection with their assessments of countries' bank supervisory regimes. Refer to the Glossary for additional information on the BCBS.

Insured Branches

Much like the Uniform Financial Institutions Rating System (a.k.a., CAMELS), ratings assigned to domestic banks, branches, and agencies of foreign banks are assigned a ROCA rating. The ROCA rating is a confidential management information and supervisory tool designed to assess the condition of a branch and to identify significant concerns in a systematic, consistent fashion.

The ROCA rating system rates four areas:

- **R**isk Management,
- **O**perational Controls,
- **C**ompliance, and
- **A**sset Quality.

Similar to CAMELS, each ROCA component rating is based on a scale of 1 through 5 in ascending order of supervisory concern, with the risk management component generally considered to be the most important factor. A single component rating (called a *Combined U.S. Operations Rating*) between 1 and 5 is assigned for Operational Controls on a combined basis with the FBO. Unlike CAMELS, ROCA does not rate capital, earnings, or liquidity, as these areas are difficult to separately evaluate at a branch. And, while liquidity is not a separate rating, examiners should be aware of supervisory concerns regarding the nature and tenor of borrowings that could put depositors at risk.

Examination findings must be addressed in a Summary of Condition Letter to senior management. The letter should highlight overall strengths and supervisory weaknesses in the FBO's combined U.S. operations, and be shared with the foreign bank's home country supervisor.

Because there are so few FDIC-supervised branches, the FDIC does not maintain a specific examination program in this area. Therefore, examiners may refer to the International Banking Examination Documentation module or other regulatory examination manuals for additional guidance.

FBO Reporting Requirements

The regulatory agencies rely on the timely and accurate filing of regulatory reports by domestic and foreign financial institutions to monitor FBO financial trends. Data collected from regulatory reports facilitate the early identification of problem situations. Some of the reports required for submission by foreign branches and agencies include:

- The Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC Form 002);
- Report of Assets and Liabilities of Non-U.S. Branches that are Managed or Controlled by a U.S. Branch or Agency of a Foreign (Non-U.S.) (FFIEC Form 002s);
- Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (FFIEC Form 019);
- Foreign Branch Report of Condition/Abbreviated Foreign Branch Report of Condition (FFIEC Forms 030/030s); and
- Report of Transaction Accounts, Other Deposits, and Vault Cash (Federal Reserve 2900).

In addition to the reporting requirements for branches and agencies, additional reporting requirements for FBOs include:

- Annual Report of Foreign Banking Organizations (Federal Reserve Form FY-7),
- Financial Statements of U.S. Nonbank Subsidiaries Held by FBOs (Federal Reserve Form Y-7N/Y-7NS),
- The Capital and Asset Report for FBOs (Federal Reserve Form Y-7Q), and
- Changes in Organizational Structure (Federal Reserve Form Y-10).

Parallel-Owned Banking Organization (PBO)

Parallel-owned banking organizations are another form of foreign bank ownership in the U.S. A PBO exists when a U.S. depository institution[5] and a foreign bank[6] are controlled, either directly or indirectly, by an individual, family, or group of persons[7] with close business dealings, or that are otherwise acting in concert. PBOs do not include structures in a recognized financial group[8] subject to comprehensive consolidated supervision via the FBO Supervision Program.

PBOs are not included in the FBO Supervision Program because the parent organization is not a foreign bank or holding company. PBOs present unique challenges to the supervisory process. One key challenge involves assessing risks at PBOs where control is vested in individuals or companies located in a foreign country where U.S. regulatory agencies are unable to obtain reliable, organization-wide information.

Supervisory Control Definition

Identifying a PBO is difficult because control based on common ownership, management, or decision-making authority, often is not clear. The lack of a globally accepted and easily understood definition of control complicates the identification of PBOs. A supervisory definition of presumed control is derived from applying the criteria in the April 2002 Joint Agency Statement on PBOs. The statement indicates, in part, that the U.S. banking agencies consider whether an individual, family, or group of persons acting in concert *control*[9] a depository institution if the individual, family, or group of persons controls 10 percent or more of any class of the voting shares of the bank. In general, 10 percent ownership of voting shares typically results in a rebuttable presumption of control, whereas 25 percent ownership is not rebuttable.

The presence of certain other characteristics may indicate that a PBO relationship exists. These criteria may include situations where the individual, family, or group of persons acting in concert:

- Constitutes a quorum or a significant presence on the board of directors of both the U.S. depository institution and the foreign bank;

[5] References to *U.S. depository institution* represent all banks and savings associations insured by the FDIC.

[6] References to *foreign bank* include a holding company of the foreign bank and any foreign or U.S. non-bank affiliates of the foreign bank.

[7] The term *persons* includes both business entities and natural persons, which may or may not be U.S. citizens.

[8] The term *recognized financial group* refers a structure in which a bank is a subsidiary of another bank, or an entity that is controlled by a company subject to the Bank Holding Company Act or the Savings and Loan Holding Company Act.

[9] A variety of presumptions and technical rules apply to determinations of control. See 12 CFR 5.50, 225.41, 303.82, 391.43.

- Controls, in any manner, the election of a majority of the directors of both the U.S. depository institution and the foreign bank;
- Constitutes a quorum or a significant portion of the executive management of both the U.S. depository institution and the foreign bank;
- Exercises a controlling influence over the policies and/or management of both the U.S. depository institution and the foreign bank;
- Engages in an unusually high level of reciprocal correspondent banking activities or other transactions or facilities between the U.S. depository institution and the foreign bank;
- Requires the U.S. depository institution to adopt particular/unique policies or strategies similar to those of the foreign bank, such as common or joint marketing campaigns, cross-selling of products, sharing customer information, or linked web sites;
- Obtains financing to purchase the stock of either the U.S. depository institution or the foreign bank from, or arranged through, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan;
- Names the U.S. depository institution in a similar fashion to that of the foreign bank; or
- Presents any other factor(s) or attribute(s) that indicate that a PBO relationship exists.

While the presence of any single condition listed above may not demonstrate that an individual, family, or group controls the U.S. depository institution and foreign bank, the existence of multiple conditions may indicate that a PBO relationship exists.

An individual, family, or group of persons acting in concert can rebut both the objective and subjective criteria considered in reaching this conclusion. Therefore, examiners must weigh each factor in relation to all of the other available information in determining whether a PBO relationship does or does not exist, especially when evaluating control relationships that are rebuttable.

PBO versus Affiliate Relationships

An individual, family, or group acting in concert may exercise sufficient control to meet the supervisory definition of presumed control for establishing that a PBO exists; however, they may not meet the criteria to be considered affiliates, as specified in Section 23A of the Federal Reserve Act. Thus, the entities that comprise a PBO may or may not be affiliates. In instances where a PBO relationship exists, but an affiliate relationship does not exist, the transactions between the U.S. bank and the foreign bank may not be subject to the Federal Reserve Act (FRA). However, non-affiliated PBOs cannot be disregarded because such relationships can pose the same or greater risks than those from affiliated PBOs.

The FRA provides a definition of control that serves as a legal basis for determining if an affiliate relationship exists between a U.S. bank and a foreign institution. Section 23A(b)(1)(C) defines an affiliate of a U.S. bank to include any company that is controlled directly or indirectly by shareholders who also directly or indirectly control the bank. In general, Section 23A(b)(3)(A) defines control as:

1. Owning, controlling, or having the power to vote 25 percent or more of any class of voting securities of the U.S. bank;
2. Controlling in any manner, the election of a majority of the directors of the U.S. bank; or
3. Receiving a determination from the FRB that the shareholder or company exercises a controlling influence over the management or policies of a U.S. bank.

Based on this definition, if an individual, family, or group of persons acting in concert collectively has the power to vote 25 percent or more of any class of stock of a U.S. bank and a foreign bank, then a PBO and an affiliate relationship exist. All transactions between the affiliated entities would be subject to the restrictions in the FRA. In addition, the affiliated entities in a PBO cannot take advantage of the sister bank exemption, as it requires ownership by a holding company.

For example, Mr. Smith owns 51 percent of a U.S. depository institution and 30 percent of a foreign bank. This scenario reflects that these two entities are both PBOs and affiliates, and subject to the restrictions in the FRA. If Mr. Smith owned/controlled 12 percent of each institution's outstanding stock, then the two entities would not be affiliated per the FRA, but a PBO may still exist.

If the beneficial owner's stock ownership or voting rights are less than 25 percent, but the criteria in item (2) is met, or the beneficial owner(s) constitute a majority of the boards at both the U.S. bank and the foreign bank, then a PBO and an affiliate relationship exist and the FRA is applicable.

For example, Mr. Jones, Mr. Smith, and Mr. Williams each own 12 percent of a U.S. depository institution. Each person also owns 10 percent of a foreign bank. The minutes of the shareholders meeting of both the U.S. and the foreign bank reflect that these three individuals constitute a quorum of each institution's board. This scenario reveals that these two entities are both PBOs and affiliates subject to the restrictions in the FRA. If these three individuals did not represent a quorum of each institution's board, then the two entities may not be affiliated per the FRA, but a PBO would still exist.

Lastly, if the FRB determines that the shareholder/company exercises a controlling influence over the management or policies of the bank, as stated in Item (3) above, then a PBO and an affiliate relationship exist and the FRA applies.

It is important to note that transactions between the U.S. bank and any person, where the proceeds of the transaction are used for the benefit of, or are transferred to, an affiliated entity, is considered a covered transaction for purposes of Section 23A(a)(2). In situations where regulations do not apply to transactions between a U.S. bank and a foreign affiliate, examiners should still review material transactions for reasonableness and identify any questionable practices.

PBO versus Related Interests of Insiders

An individual, family, or group acting in concert may exercise sufficient control to meet the preceding supervisory definition of presumed control for establishing that a PBO exists; but, they may not meet the criteria to be considered affiliates as specified by FRB Regulation O.[10] Regulation O restricts extensions of credit to the related interests of executive officers, directors, and principal shareholders, collectively known as bank insiders. Related interests are companies controlled by one or more bank insiders, or a political or campaign committee that is controlled by one or more bank insiders or the funds or services of which will benefit bank insiders.

Congress made virtually all of these restrictions applicable to state nonmember banks in Section 18 of the Federal Deposit Insurance Act (FDI Act).[11] Thus, extensions of credit from a state nonmember bank to a domestic or foreign company commonly controlled, as defined by Regulation O, by a bank insider are generally subject to the limitations in Regulation O.

Regulation O defines control as directly or indirectly:

1. Owning, controlling, or having the power to vote 25 percent or more of any class of voting securities of the company or bank;
2. Controlling in any manner the election of a majority of the directors of the company or bank; or
3. Having the power to exercise a controlling influence over the management or policies of the company or bank.

Note that the first two items are very similar to those on the previous page from the FRA. The third item is different. Also, these criteria are not as expansive as the preceding supervisory definitions of control.

If an individual, family, or group of persons acting in concert collectively has the power to vote 25 percent or more of any class of stock of both the U.S. depository institution and the foreign bank, then the same situation exists as under Item (1) of the FRA control definition and all transactions with related interests would be subject to Regulation O.

If the beneficial owner's stock ownership/voting rights are less than 25 percent, the next criteria must be reviewed. Item (2) considers whether the beneficial owner(s) controlled the election of a majority of the directors. For example, Mr. Jones, his son, and his brother each own 20 percent of a U.S. depository institution. Each individual also owns 10 percent of a foreign bank. Minutes of the shareholder meetings of both the U.S. and the foreign bank reflect that these three individuals nominated the candidates for each institution's Board and voted their shares in a block. This scenario reveals that these two entities are PBOs and subject to the restrictions of Regulation O. If these three individuals had voted their shares independently or in a different manner from each other, then it would indicate that these two entities are not subject to Regulation O, but a PBO does exist.

If neither the beneficial owner(s)'s stock ownership/voting rights percentage nor control of the board's election thresholds are met, then Item (3) must be reviewed. Regulation O also states that a person is presumed to have control, including the power to exercise a controlling influence over the management or policies of a company or bank, if the person:

- Is an executive officer or director of the company or bank; and directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; or
- Directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; and no other person owns, controls, or has the power to vote a greater percentage of that class of voting securities.

Ascertaining whether an individual, family, or group acting in concert exercises a controlling influence over the management or policies of the bank is difficult. If the criteria in either item (a) or item (b) above are met, then a

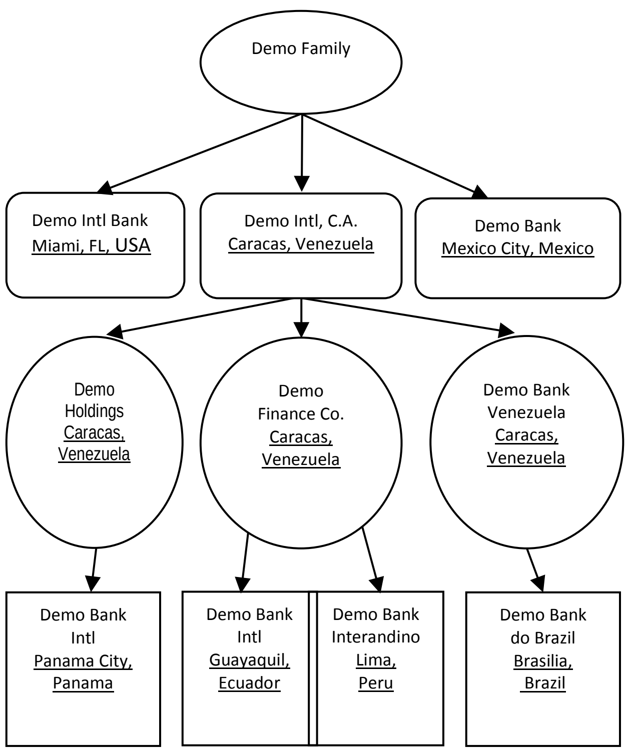
[10] 12 CFR Part 215.
[11] See generally 12 CFR § 337.4, which implements Section 18(j)(2) of the FDI Act (12 U.S.C. § 1828(j)(2).

PBO exists and all transactions with related interests would be subject to the restrictions of Regulation O.

An individual, family, or group acting in concert may exercise sufficient control to meet the supervisory definition of presumed control for establishing that a PBO exists; but not meet the level of control required by Regulation O. In these instances, the transactions between the U.S. bank and the bank insiders' related interests would not be subject to the restrictions of Regulation O. In situations where these types of transactions are not subject to Regulation O, examiners should still review material transactions for reasonableness and identify any questionable practices.

Business Structure of PBOs

A PBO can have a simple or complex organizational structure. A simple PBO business structure consists of an individual who directly controls both a U.S. depository institution and a foreign bank. A complex organizational structure may include multiple domestic and foreign shareholders working in concert, who individually do not have direct control of the U.S. and the foreign bank, but collectively exercise a controlling influence throughout the PBO. The following illustration is an example of a complex PBO structure.



The existence of cross-border organizations compounds the difficulty of supervisory oversight because foreign organizations are often not as transparent as U.S. companies, and U.S. bank supervisors may be unable to effectively evaluate their ownership structure or conduct on-site evaluations of the foreign entities.

Complex PBOs also could be part of privately held multi-national conglomerates that service a particular business sector or geographic region. These privately held PBOs often are the most challenging to understand because public information on their ownership structure, operations, and affiliations is generally difficult to obtain. Conversely, PBOs can be part of large multi-national conglomerates that are publicly traded but do not provide financial services as a main enterprise activity. In these structures, information on ownership, operations, and affiliations is generally easier to obtain.

Supervisory Risks

An examiner's main priority, and frequently greatest challenge, is to gain a comprehensive understanding of a PBO's structure and risk profile. The organizations are complex and often involve cross-border, multi-tiered companies that can be difficult to analyze. Therefore, initial discussions with management are important elements in determining whether the bank is part of a PBO.

The fundamental risk posed by PBOs is that they may act in a de facto organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision.

PBOs present supervisory risks similar to those arising from a chain banking organization (CBO) with the added dimension that part of the chain is in a foreign country or multiple foreign countries. From a regulatory perspective, the risks presented by PBOs may be greater than the risks presented by domestic CBOs because a portion of the PBO structure is subject to the laws and jurisdiction of one or more foreign countries.

The lack of a globally accepted supervisory approach to evaluate risk on an organization-wide basis makes it more difficult to obtain information from foreign regulatory agencies. Additionally, coordinated examinations of the U.S. depository institution and the foreign bank may not be a viable option. Therefore, relationships between the U.S. depository institution and the foreign bank may be difficult to understand and monitor.

PBOs may foster other management and supervisory risks. In 2002, the U.S. bank regulatory agencies issued the Joint Agency Statement on PBOs to assist banks in identifying these entities and managing the risks that PBOs present. Examiners should refer to this guidance when examining PBOs.

In all instances where a PBO relationship exists, examiners should complete the Parallel-Owned Banking Organizations report page; refer to the ROE Instructions for additional guidance.

U.S. Banking Activities Abroad

U.S. banks conduct international banking activities abroad through overseas branches, representative offices, subsidiaries, Edge and Agreement corporations, IBFs, export trading companies (ETCs), consortium banks, offshore branches, and correspondent banking. These structures enable the U.S. banking organizations to serve the needs of their customers in the U.S. and abroad and to compete with foreign banks in the U.S. and foreign markets. The choice of structure is often driven by market opportunity vis-à-vis the laws of the host country, or by tax considerations. U.S. banks' investments in subsidiaries around the world are frequently held in investment Edge corporations that are often managed at the banks' headquarters.

International strategies and vehicles for market entry differ among the numerous types of U.S. banks and are influenced by the banks' structure, strategy and, scale of operations. The largest U.S. banks (money-center and multinational banks) are most likely to utilize the full range of vehicles available to conduct international operations. These banks typically have an extensive network of branches, subsidiaries, and representative offices abroad, and they often maintain correspondent relationships around the world. In the U.S., these banks may have a banking Edge corporation subsidiary located in a major city with branches in other key U.S. locations.

Regional banks in the U.S. that engage in international activities generally have a more limited structure, strategy, and scale of operations. While larger banks can offer international services through their own operations worldwide, banks with limited or no international structure are not precluded from these activities. Smaller banks generally serve their customers' global needs through correspondent banking relationships.

Offshore U.S. Branches

As international trade and foreign exchange trading increased in the 1960s, most major U.S. banks actively expanded their worldwide network to capitalize on this growth. Some banks established full-service branches in important business centers. Many other banks, that could not justify the cost of such branches, established offshore or *shell* branch operations. Many smaller regional banks established offshore branches to obtain a low-cost entry into the Eurodollar market to finance international trade and fund a growing portfolio of purchased international loans.

An offshore, or shell, branch is an overseas branch established for a special purpose, often to take advantage of a favorable tax or regulatory environment in a foreign country. Many of these branches are banking vehicles for booking Eurodollar deposits and loans originated through the home office. These branches generally are no more than a post office box number with few or no personnel. The administration of the branch's assets and liabilities is maintained at either the head office or a designated branch or agency in the U.S. The offshore office is governed by the laws and regulations of its home country and the host country from which it operates.

The passage of the USA PATRIOT Act of 2001 gave the U.S. government expanded authority to combat money laundering, with a particular emphasis on activities conducted through shell banking operations. As such, there have been recent efforts by the international community for offshore banking centers to improve supervision, transparency, disclosure, and cooperation with other bank regulators. For more details, refer to the Bank Secrecy Act, Anti-Money Laundering and Office of Foreign Assets Control sections of this Manual.

International Banking Facilities (IBF)

An IBF is a set of asset and liability accounts, segregated on the books and records of the establishing entity, which reflect international transactions. An IBF is established in accordance with the terms of FRB Regulation D after appropriate notification to the FRB. The establishing entity may be a U.S. depository institution, a U.S. office of an Edge or Agreement Corporation, or a U.S. branch or agency of a foreign bank established pursuant to FRB Regulation D.

An IBF is permitted to hold only certain assets and liabilities. In general, IBF accounts are limited to residents of foreign countries, residents of Puerto Rico and U.S. territories and possessions, other IBFs, and U.S. and non-U.S. offices of the establishing entity. An IBF is an attractive tool for banks because its deposits are not subject to reserve requirements or deposit insurance premiums since they are not FDIC insured. This provides a lower cost of funds and facilitates banking activities. An IBF may also serve to diversify the bank's liability mix and prove less volatile to changes in interest rates.

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LAWS AND REGULATIONS

Several laws and regulations govern international activities of banks. Some are discussed briefly in this section; however, examiners should be familiar with the entire body of laws and regulations that deal with international banking. These can be found in the various examination resource tools available within the FDIC's online library and training materials.

Part 347-International Banking

Part 347 of the FDIC Rules and Regulations specifically covers international banking activities of state nonmember banks; its provisions are similar to FRB Regulation K, which is applicable to state-member banks, as well as Edge and Agreement corporations of state nonmember banks.

Subpart A of Part 347 (and corresponding sections of Part 303) implements Sections 18(d) and 18(l) of the FDI Act and outlines the application process by which state nonmember banks may be given permission to operate foreign branches or invest in foreign banks or other financial entities. The powers or permissible activities of overseas branches are defined by the regulations and, generally, these branches are allowed a wider range of financial activity than is permitted domestically. The regulations also establish minimum standards for accounting and internal controls in foreign branches or subsidiaries. In certain circumstances, state nonmember bank applicants may be granted expedited processing of their applications.

Subpart B of Part 347 implements Sections 6, 7, and 15 of the International Banking Act of 1978 and governs FDIC-insured branch operations of FBOs. This subpart establishes asset pledging and maintenance requirements for insured branches of foreign banks. Subpart B also provides for examinations of these branches and establishes minimum recordkeeping requirements.

Subpart C of Part 347 implements the provisions of the International Lending Supervision Act of 1983 (ILSA). This section deals with the establishment of an Allocated Transfer Risk Reserve (ATRR) and the accounting and reporting of international loans and assets. As with other loan fees, Part 347 requires banks to follow generally accepted accounting principles (GAAP) for the amortization of fees on international loans.

Part 349-Retail Foreign Exchange Transactions

On July 12, 2011, the FDIC adopted rules regarding state nonmember banks' involvement with retail foreign exchange transactions, defined by the regulation as foreign exchange transactions other than traditional spot and forward contracts. Retail foreign exchange transactions include *rolling-spot* transactions, which are spot transactions that are not settled within two days (they are instead perpetually renewed). Retail customers do not include eligible customer participants (such as other financial institutions) as defined by the Commodity Exchange Act. The regulation has requirements in six different areas: disclosure, recordkeeping, capital and margin, reporting, business conduct, and documentation. The regulation does not apply to retail foreign exchange activity conducted between foreign branches of state nonmember banks and non-U.S. customers.

Dodd-Frank Act

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was signed into federal law. Specific to international banking, Sections 165 and 166 of the Dodd-Frank Act affect the oversight of FBOs. Under Section 165(d), *systemically important financial institutions* (SIFIs) and bank holding companies over $50 billion in worldwide assets must create a detailed plan for rapid and orderly resolution (living will) in the event of material financial distress or failure. In the case of FBOs, worldwide assets are used to determine the applicability of planning requirements, but the actual plans must cover only assets in the U.S. Plans must be credible and are to be reviewed jointly by the Federal Reserve and the FDIC. Part 381 of the FDIC Rules and Regulations implements section 165(d) of the Dodd-Frank Act for the purpose of establishing rules and requirements regarding the submission and content of a resolution plan for FBOs, as well as procedures for its review by the FDIC.

The FDIC monitors FBOs to better understand their U.S. operations and to assess their resolution plans in order to facilitate rapid and orderly resolutions in the event of material financial distress or failure.

Regulation YY - Enhanced Prudential Standards

Capital Stress Tests

Foreign banking organizations with total consolidated assets between $10 and $50 billion are required to conduct internal capital stress tests. Annually, the FBO's home-country supervisor must directly conduct a capital stress test or review an internal company-run stress test. If the FBO does not meet the stress-testing requirement, it must conduct a stress test of its U.S. subsidiaries, as well as maintain eligible assets of not less than 105 percent of the total liabilities (asset maintenance) in its U.S. branches and agencies.

A publicly traded FBO of this size is also required to maintain a committee of its global board of directors (either on a standalone basis or as part of its enterprise-wide risk committee) to oversee the risk management policies of its combined U.S. operations. At least one member should have experience identifying, assessing, and managing risk exposures of large, complex firms.

Increased Requirements

Regulation YY has increased requirements for FBOs with assets greater than $50 billion. These FBOs must certify that they meet, on a consolidated basis, the capital adequacy standards established by their home-country supervisor that are consistent with the regulatory capital framework published by the Basel Committee on Banking Supervision. If an FBO's home-country supervisor has not established capital standards consistent with the Basel framework, the FBO must demonstrate that it would meet or exceed the Basel capital standards at the consolidated level if it were subject to them. In addition, these FBOs must maintain a U.S. risk committee that approves and periodically reviews the risk management policies of the combined U.S. operations of the FBO and oversees the risk management framework of the combined U.S. operations of the FBO.

All FBOs of this size must report the results of an internal liquidity stress test for either the consolidated operations of the FBO or the combined U.S. operations of the FBO on an annual basis to the Federal Reserve. The stress tests must be conducted consistent with the Basel Committee principles for liquidity risk management and must incorporate 30-day, 90-day, and one-year stress-test horizons. An FBO that fails to comply with this requirement must limit, on a daily basis, the net aggregate amount owed by its non-U.S. affiliates to the combined U.S. operations to 25 percent or less of the third party liabilities of its combined U.S. operations.

Regulation YY also implements more stringent requirements for FBOs with combined U.S. Assets of $50 billion or more, including more intensive risk committee and liquidity requirements. Companies with U.S. non-branch assets of $50 billion or more are subject to the intermediate holding company requirement in Section 252.153 of Regulation YY. This section requires these FBOs to establish an intermediate holding company organized in the U.S. to hold all ownership interests in any U.S. subsidiary.

Regulation K - International Banking Operations

As explained above, Regulation K is similar to Part 347, but has been revised periodically to implement new laws and amendments and to keep pace with developments in supervisory and regulatory policy. In its last major revision, October 2001, the FRB streamlined application requirements for foreign banks seeking to expand operations in the U.S. and procedures for U.S. banking organizations to branch into foreign countries. Changes were also made to provisions governing: permissible foreign activities of U.S. banking organizations, including securities and investment activities; investments by U.S. banking organizations under the general consent procedures; and the qualification of FBOs for exemption from the nonbanking prohibitions of the Bank Holding Company Act. Lastly, changes were implemented authorizing a bank, with prior Federal Reserve approval, to invest up to 20 percent of capital and surplus in Edge corporations.

Joint Agency Statement on PBOs

The Joint Agency Statement on Parallel-Owned Banking Organizations discusses the characteristics of PBOs, reviews potential risks associated with these banking organizations, and sets forth the supervisory approach of the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System, and the FDIC to monitor those risks. It also provides information on the applications process for proposals involving PBOs.

USA PATRIOT Act

In 2001, Congress enacted the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act, which contains several provisions designed to deter and combat the financing of terrorism and international money laundering. This law substantially increases anti-money laundering responsibilities of financial institutions, including U.S. bank subsidiaries of FBOs and U.S. branches and agencies of FBOs.

Financial Crimes Enforcement Network (FinCEN) and Office of Foreign Assets Control (OFAC)

The FinCEN issues advisories to inform banks and other financial institutions operating in the U.S. of the risks of money laundering and financing of terrorism associated with jurisdictions identified by the Financial Action Task Force, as having deficiencies in their anti-money laundering practices. A listing of FinCEN advisories can be found on FinCEN's website at www.fincen.gov.

Similarly, the OFAC administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries and regimes; terrorists; international narcotics traffickers; those engaged in activities related to the proliferation of weapons of mass destruction; and other threats to the national security, foreign policy, or economy of the U.S. Banks are expected to closely scrutinize transactions with these individuals and countries.

Refer to RMS Manual, Section 8.1, Bank Secrecy Act for additional details regarding the specific laws that would be cited for infractions/non-compliance with FinCEN or OFAC regulations.

Foreign Corrupt Practices Act

Public disclosure of improper payments made by U.S. companies to foreign officials led Congress to enact the Foreign Corrupt Practices Act of 1977 (the Act). The Act is designed to prevent the use of corporate assets for corrupt purposes and applies to all U.S. companies, including banks, bank holding companies, and Edge Corporations.

The Act applies to all state nonmember insured banks, among other U.S. corporations, but does not apply directly to foreign subsidiaries. However, Congress has made it clear that any U.S. corporation that engages in bribery of foreign officials indirectly through any other person or entity, including a foreign subsidiary, would itself be liable under the Act. Since 1998, the Act also applies to foreign firms and persons who take any act in furtherance of corrupt payments while in the U.S.

All violations of the Act are criminal in nature and should be reported following the procedures for reporting apparent criminal violations. Violations of the Act may also result in civil fines and, in the case of private actions under the Racketeer Influenced and Corrupt Organizations (RICO) Act, treble damages. For more information, refer to the Internal Routine and Controls section of this Manual.

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GLOSSARY

Acceptance – A time draft (bill of exchange or usance draft) drawn by one party and acknowledged by a second party. The drawee, known as the *acceptor*, stamps or writes the word *accepted* on the face of the draft and, above their signature, the place and date of payment. Once the draft is accepted, it carries an unconditional obligation on the part of the acceptor to pay the drawer the amount of the draft on the date specified. A *bank acceptance* is a draft drawn on and accepted by a bank. A *trade acceptance* is a draft drawn by the seller of goods on the buyer, and accepted by the buyer.

Account-dealing – Foreign-exchange dealing that involves settlement from bank to bank in the due from accounts. No third party (bank) is involved.

Account Party – The party, usually the buyer, who instructs the bank to open a letter of credit and on whose behalf the bank agrees to make payment.

Ad Valorem – A term meaning *according to value*, used for assessing customs duties that are fixed as a percentage of the value stated on an invoice.

American Depository Receipt (ADR) – ADRs are depository receipts for shares of stock in a foreign company held in safekeeping by a U.S. bank. The ADRs are purchased and sold through listed exchanges.

Advance Against Documents – An advance made on the security of the documents covering a shipment.

After Sight – When a draft bears this name, the time to maturity begins at its presentation or acceptance.

Agent Bank – The bank that leads and documents a syndicated loan.

Allocated Transfer-risk Reserve (ATRR) – A special reserve established and maintained for specified international assets pursuant to the International Lending Supervision Act of 1983 to cover country risk. At least annually, the OCC, FRB, and FDIC determine which international assets are subject to transfer risk, the amount of ATRR for the special assets, and whether an ATRR previously established for specified assets may be reduced.

Anticipation – A deposit of funds to meet the payment of an acceptance prior to the maturity date. Should be applied to reduce customer's liability on acceptances.

Amortizing Swap – A transaction in which the notional value of the agreement declines over time.

Arbitrage – Simultaneous buying and selling of foreign currencies, or securities and commodities, to realize profits from discrepancies between exchange rates prevailing at the same time in different markets, between forward margins for different maturities, or between interest rates prevailing at the same time in different markets or currencies.

Article IV – To facilitate the exchange of goods, services, and capital between countries, members of the IMF (International Monetary Fund) signed the Articles of Agreement. Article IV identifies members' obligations regarding exchange arrangements. To promote stable exchange rates, members agree to foster orderly economic growth with reasonable price stability, to promote economic and financial conditions that do not tend to create erratic disruptions, to avoid exchange rate or international monetary system manipulation, and to follow exchange rates compatible with these goals. Under Article IV, an IMF member country notifies the IMF of its exchange arrangement. The member country has three exchange rate options. First, the country can select an exchange rate in terms of special drawing rights, gold, or some other denominator. Second, the member, by cooperative arrangement, can peg the value of their currency to the currency of another member. Typically, the country will pick its major trading partner's currency. Third, the country can select another exchange arrangement of the member's choice. The member country must notify the IMF of its selected exchange arrangement. Article IV also allows the IMF to conduct surveillance of the member country's exchange rate policies and to offer suggestions for improvement under principles of guidance. Members agree to provide the information necessary to the IMF to conduct this surveillance.

Article IV Consultations – Under the Articles of Agreement, the IMF holds discussions with member countries at least once per year. The IMF typically sends a team of experts to collect various financial and economic information. The IMF staff then discusses its findings with the member country and prepares a consultation report for the IMF's Executive Board. The Article IV Consultation report is returned to the member country and certain aspects of these reports are made publicly available on the IMF's website.

At Sight – A term indicating that a negotiable instrument is payable upon presentation or demand.

Authority to Pay – An advice from a buyer, sent by their bank to the seller's bank, authorizing the seller's bank to pay the seller's (exporter's) drafts up to a fixed amount. The seller has no protection against cancellation or modification of the instrument until the issuing bank pays the drafts drawn on it, in which case the seller is no longer liable to its bank. These instruments are usually not confirmed by the seller's U.S. bank.

Authority to Purchase – Similar to an authority to pay, except that drafts under an authority to purchase are drawn directly on the buyer. The correspondent bank purchases them with or without recourse against the drawer and, as in the case of the authority to pay, they are usually not confirmed by a U.S. bank. This type of transaction is unique to Far Eastern trade.

Baker Plan – Proposed in 1985, this initiative encouraged banks, the International Monetary Fund, and the World Bank to jointly increase lending to less developed countries that were having difficulty servicing their debt, provided the countries undertook prudent measures to increase productive growth.

Balance of Payments – The relationship between money flowing into and out of a country for a given period of time. Directly affected by the country's foreign trade position, capital inflows and outflows, remittances into and out of the country, grants and aid, and tourism. A deficit balance occurs when outflows exceed inflows with the converse situation reflecting a balance of payments surplus.

Balance of Trade – The difference between a country's total imports and total exports for a given period of time. A favorable balance of trade exists when exports exceed imports. An unfavorable trade balance is reflected when imports exceed exports.

Band – The maximum range that a currency may fluctuate from its parity with another currency or group of currencies by official agreement.

Bank for International Settlements (BIS) – Established in 1930 in Basel, Switzerland, the BIS is the oldest functioning international financial organization. It provides a forum for frequent consultation among central bankers on a wide range of issues. The BIS board consists of representatives from the G-10 countries.

Basel Capital Accords – An agreement among the central banks of leading industrialized countries, including those of Western Europe, Canada, the U.S., and Japan, to impose common capital requirements on their internationally active banks.

Basel Committee on Bank Supervision (BCBS) – The Committee was established by the central bank Governors of the G-10 countries in 1975. Its members include senior representatives from banking supervisory authorities and the central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, the U.S., and other countries. The Committee usually meets at the BIS in Basel, where its permanent Secretariat is located.

The BCBS provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.

The Committee has developed international regulatory capital standards through a number of capital accords and related publications that have collectively been in effect since 1988. In June 2010, the Committee published a comprehensive reform package known as Basel III (or the Third Basel Accord), which is a global, voluntary and comprehensive set of reform measures designed to improve regulation, supervision and risk management within the banking sector. BASEL III aims to establish a global regulatory standard on bank capital adequacy, stress testing, and liquidity risk.

Beneficiary – The person or company in whose favor a letter of credit is opened or a draft is drawn. In a documentary letter of credit or acceptance, beneficiary may also be referred to as exporter or seller of goods.

Bid-ask Spread – The difference between a bid and the ask price, for example, the difference between 0.4210 and 0.4215 would be a spread of 0.0005 or 5 points.

Bid Price – A buyer's quote for the purchase of a trading unit from a prospective seller.

Bid Rate – The price at which the quoting party is prepared to purchase a currency or accept a deposit. If the bid rate is accepted by the party to whom it was quoted, then that party will sell currency or place or lend money at that price. The opposite transaction takes place at the offer rate.

Bilateral Trade – Commerce between two countries, usually in accordance with specific agreements on amounts of commodities to be traded during a specific period of time. Balances due are remitted directly between the two nations.

Bill of Exchange – An instrument by which the drawer orders another party (the drawee) to pay a certain sum to a third party (the payee) at a definite future time. The terms *bill of exchange* and *draft* are generally used interchangeably.

Bill of Lading – A receipt issued by a carrier to a shipper for merchandise delivered to the carrier for transportation from one point to another. A bill of lading serves as a receipt for the goods, a document of title, and a contract between the carrier and the shipper, covering the delivery of the merchandise to a certain point or to a designated person. It is issued in two primary forms: an *order bill of lading*, which provides for the delivery of goods to a named person or to their order (designee) but only on proper endorsement and surrender of a bill of lading to the carrier or its agents; and a *straight bill of lading*, which provides for delivery of the goods to the person designated by the bill of lading and no other.

Blocked Currency – A currency that is prohibited by law from being converted into another foreign currency.

Blocked Exchange – Exchange that cannot be freely converted into other currencies.

Brady Plan – Proposed in 1989 and named after then U.S. Treasury Secretary Nicholas Brady, the Brady Plan sought to reduce the debt-service requirements of various developing countries and to provide new loans (Brady bonds) to service existing obligations.

Break-even Exchange Rate – The particular spot exchange rate that must prevail at the maturity of a deposit or debt in a foreign currency, which has not been covered in the forward market, so that there will be no advantage to any party from interest rate differentials.

Buyer's Option Contract – When the buyer has the right to settle a forward contract at their option any time within a specified period.

Buying Rates – Rates at which foreign exchange dealers will buy a foreign currency from other dealers in the market and at which potential sellers are able to sell foreign exchange to those dealers.

Capital Controls – Governmental restrictions on the acquisition of foreign assets or foreign liabilities by domestic citizens or restrictions on the acquisitions of domestic assets or domestic liabilities by foreign citizens.

Capital Flight – A transfer of investors' funds from one country to another because of political or economic concerns about the safety of their capital.

Central Bank Intervention – Direct action by a central bank to increase or decrease the supply of its currency to stabilize prices in the spot or forward market or move them in a desired direction to achieve broader economic objectives (e.g., weaken currency to a given point in order to boost export activity). On occasion, the announcement of an intention to intervene might achieve the desired results.

Certificate of Inspection – A document often required for shipment of perishable goods in which certification is made as to the good condition of the merchandise immediately before shipment.

Certificate of Manufacture – A statement, sometimes notarized, by a producer who is usually also the seller of merchandise that manufacture has been completed and that goods are at the disposal of the buyer.

Certificate of Origin – A document issued by the exporter certifying the place of origin of the merchandise to be exported. The information contained in this document is needed primarily to comply with tariff laws that may extend more favorable treatment for products from certain countries.

Chain – A method of calculating cross rates. For example, if a foreign-exchange trader knows the exchange rate for euros against U.S. dollars and for Mexican pesos against U.S. dollars, the *chain* makes possible the calculation of the cross rates for euros against Mexican pesos.

Charter Party – A contract, expressed in writing on a special form, between the owner of a vessel and the one (the charterer) desiring to employ the vessel setting forth the terms of the arrangement such as freight rate and ports involved in the trip.

Clean Bill of Lading – A bill of lading in which the described merchandise has been received in *apparent good order and condition* and without qualification.

Clean Collection – A collection in which a draft or other demand for payment is presented without additional attached documentation.

Clean Draft – A sight or time draft to which no other documents such as shipping documents, bills of lading, or insurance certificates are attached. This is to be distinguished from a documentary draft.

Clean Risk at Liquidation – A type of credit risk that occurs when exchange contracts mature. There may be a brief interval (usually no more than a few hours) during which one of the parties to the contract has fulfilled its obligations, but the other party has not. During this period, the first party is subject to a 100 percent credit risk, on the chance that, in the interval, an event may prevent the second party from fulfilling its obligations under the contract.

Clearinghouse – A subdivision of an exchange or an independent corporation through which all trades must be confirmed, matched, and settled daily until offset.

Clearinghouse Funds – Funds used in settlement of a transaction that are available for use or that become good funds after one business day.

Closing a Commitment – Allowing a covered foreign-exchange position to expire on maturity or reversing it before maturity by a swap operation.

Combined Transport Document – A through bill of lading that applies to more than one mode of transport.

Commodity Credit Corporation – An agency of the U.S. Department of Agriculture that promotes the export of U.S. surplus agricultural commodities. It provides the necessary financial services to carry forward the public price-support activities, including government lending, purchasing, selling, storing, transporting, and subsidizing certain agricultural commodities.

Consortium Banks – A group of banks forming a joint alliance to enter a new market, in order to reduce the capital requirements and risks involved in new ventures. While they were popular in the 1970s, they have since fallen into disfavor.

Consular Documents – Bills of lading, certificates of origin, or special forms of invoice that carry the official signature of the consul of the country of destination.

Consular Invoice – Detailed statement regarding the character of goods shipped which is duly certified by the consul at the port of shipment. Required by certain countries, including the U.S., its principal function is to record accurately the types of goods and their quantity, grade and value for import duty, balance of payments, and other statistical purposes.

Convertibility – Freedom to exchange a currency, under certain circumstances, without government restrictions or controls.

Core Principles for Effective Bank Supervision (also known as the Core Principles Methodology) – A summary of 25 principles for prudential regulation and supervision prepared by the Basel Committee on Banking Supervision. This document benchmarks the best practices for effective bank supervision. Countries are expected to use the Core Principles Methodology to assess their current bank supervisory environments to identify weaknesses that need to be addressed. The IMF utilizes the Core Principles Methodology when assessing bank regulation and supervision during its Article IV surveillance.

Cost, Insurance, and Freight. (**C.I.F.)** – A price quotation under which the seller defrays all expenses involved in the delivery of goods.

Counterpart Funds – Local currencies deposited in a special account by recipient governments that represent grant aid extended by another government. Those funds, while remaining the property of the recipient government, can generally be used only by agreement of the donor government.

Countertrade – A system of trade, like bartering, when goods or services are accepted in lieu of payment in currency for the purchase of goods or services. Such trade schemes are attractive in developing countries to promote reciprocal trade in a nation's local products as a precondition for consummating an international transaction. Countertrade was popular in East-West dealings during the Cold War and in defense and aerospace contracts. Countertrade may also be useful where foreign exchange is limited or unavailable. The quality and marketability of the goods traded can be a real concern. Other risks involved in countertrade include government intervention, cancellation of contract, and seller insolvency**.**

Country Exposure – A measurement of the volume of assets and off-balance sheet items considered to be subject to the risk of a given country. This measurement is based, in part, on identifying the country of domicile of the entity ultimately responsible for the credit risk of a particular transaction.

Country Risk – Refers to the spectrum of risks arising from the economic, social, and political environment of a given foreign country, which could have favorable or adverse consequences for foreigners' debt and/or equity investments in that country.

Cover – The execution of an offsetting foreign exchange trade to close or eliminate an open exposure.

Covered Interest Arbitrage – The process of taking advantage of a disparity between the net accessible interest differential between two currencies and the forward exchange premium or discount on the two currencies against each other.

Crawling Peg System – An exchange rate system in which the exchange rate is adjusted every few weeks, usually to reflect prevailing inflation rates.

Credit Risk – The possibility that the buyer or seller of a foreign exchange or some other traded instrument may be unable to meet their obligation at maturity.

Cross-border Exposure – The risk that arises when an office of a bank, regardless of its location or currency, extends credit to a borrower that is located outside the booking unit's national border.

Cross-currency Risk – The risk associated with maintaining exchange positions in two foreign currencies as the result of one transaction. For example, if a U.S. operator borrows Swiss francs at 5 percent and invests the proceeds in British pounds at 12 percent, the cross-currency risk is the chance that the pounds will depreciate in values against the Swiss francs to such an extent that there will be a loss on the transactions in spite of the favorable interest-rate differential.

Cross Rate – The ratio between the exchange rate of two foreign currencies in terms of a third currency.

Current Account – Those items in the balance of payments involving imports and exports of goods and services as well as unilateral transfers. Includes trade, travel, military spending and other short-term financial flows. Short- and long-term capital flows are excluded, as they are included in the capital account balance. A surplus or deficit in the current account is commonly referred to as a trade deficit or surplus.

Customs Union – An agreement between two or more countries in which they arrange to abolish tariffs and other import restrictions on each other's goods and to establish a common tariff for the imports of all other countries.

Date Draft – A draft drawn to mature on a fixed date, irrespective of acceptance.

Demand Draft – Draft payable immediately upon presentation to the drawee. Also called a *sight* or *presentation* draft.

Depth of the Market – The amount of currency that can be traded in the market at a given time without causing a price fluctuation. Thin markets are usually characterized by wide spreads and substantial price fluctuations during a short period of time. Strong markets tend to be characterized by relatively narrow spreads of stable prices.

Devaluation – An official act wherein the official parity of a country's currency is adjusted downward to the dollar, gold, special drawing rights, or a currency. After devaluation, there are more devalued currency units relative to the dollar, gold, special drawing rights, or other currency.

Direct Quote – The method of quoting fixed units of foreign exchange in variable numbers of the local currency unit. Also called a *fixed* or *certain* quotation.

Dirty Float – A floating exchange-rate system in which some government intervention still takes place. A government may announce that it will let its currency float, that is, it will let the currency's value be determined by the forces of supply and demand in the market. But, the government may secretly allow its central bank to intervene in the exchange market to avoid too much appreciation or depreciation of the currency.

Discount – In foreign exchange, the amount by which the forward exchange rate of one currency against another currency is less than the spot exchange rate between the two currencies. If a dealer quotes $2.40 and $2.45 (bid and asked) for sterling and the discounts for six months forward are .0300 and .0275, the forward quotes would be adjusted to $2.3700 and $2.4225. This discount usually represents differences between interest rates in the U.S. and Britain. In periods of crisis, the discount for a currency can represent market anticipation of a lower price.

Documentary Credit – A commercial letter of credit providing for payment by a bank to the named beneficiary, who is usually the seller of the merchandise, against delivery of documents specified in the credit.

Documentary Draft – A draft with documents attached delivered to the drawee when it accepts or pays the draft, and which ordinarily controls title to the merchandise.

Documents – Shipping and other papers attached to foreign drafts, consisting of ocean bills of lading, marine insurance certificates, and commercial invoices. Certificates of origin and consular invoices may also be required.

Documents Against Acceptance (D/A) – Instructions given by an exporter to a bank that the documents attached to a draft for collection are deliverable to the drawee only against their acceptance of the draft.

Documents Against Payment (D/P) – Instructions given by an exporter to their bank that the documents attached to a draft for collection are deliverable to the drawee only against their payment of the draft.

Dollar Exchange Acceptance – Time draft drawn by central banks in specific foreign countries and accepted by banks in the U.S. for the purpose of furnishing foreign exchange. These instruments do not arise from specific commercial transactions, rather they are designed to alleviate shortages of dollar exchange for certain countries specified in a list published by the Federal Reserve System. It is anticipated that the acceptance will be liquidated subsequently from dollar funds acquired by the central bank. Limits are placed on initial maturity of drafts (three months). Member banks may not accept drafts in an amount exceeding 50 percent of paid-in and unimpaired capital and surplus.

Domicile – Place where a draft or acceptance is made payable.

Draft – A draft is an order in writing signed by one party (the drawer) requesting a second party (the drawee) to make payment in lawful money at a determinable future time to a third party (the payee). Drafts occasionally may be written to be non-negotiable, in that they will not meet all the requirements of the Uniform Negotiable Instruments Act. Drafts generally arise from a commercial transaction, whereby the seller makes an agreement with a buyer in advance for the transfer of goods. It may be accompanied by a bill of lading, which the bank will surrender to the buyer upon payment of the draft. The buyer may then claim the goods at the office of the carrier who transported them to the buyer's place of business. Drafts may be classified as to time element, such as sight or presentation drafts. A time draft is presented at sight, accepted, and then paid on the agreed upon date which may be 30, 60, 90 days or longer after presentation and acceptance.

Drawee – The addressee of a draft, that is, the person on whom the draft is drawn.

Drawer – The issuer or signer of a draft.

Eligible Acceptance – A bankers acceptance that meets Federal Reserve requirements related to its financing purpose and term.

Embargo – A partial or total prohibition on trade initiated by the government of one country against another for political or economic reasons.

Eurobank – A bank that regularly accepts foreign currency denominated deposits and makes foreign currency loans.

Eurobond – A medium or long-term debenture underwritten by an international syndicate that is denominated in a currency other than that of the country of origin. Usually, a bond issued by a non-European entity (Sovereign, large multinational company, or bank) for sale in Europe. Instrument may also be called a global bond.

Eurocurrency – Currency deposited in banks outside the home country.

Eurodollars – Dollar deposit claims on U.S. banks that are deposited in banks located outside the U.S., including foreign branches of U.S. banks. These claims, in turn, may be redeposited with banks or lent to companies, individuals, or governments outside the U.S.

Eurodollar Bond – A Eurobond denominated in U.S. dollars.

European Central Bank (ECB) – The ECB is the central bank for the Euro. Collectively, the ECB and member national central banks (NCBs) constitute the Eurosystem. The main function of the Eurosystem is to maintain price stability while supporting the general economic practices of the EU members. Together the ECB and NCBs conduct monetary policy, foreign exchange operations, and maintain the EU payment systems for the Eurozone. The ECB is headed by the Governing Council (composed of the Executive Board and the governors of each of the NCBs).

Exchange Contracts – Documents issued by foreign exchange dealers, by banks dealing in foreign exchange, and by foreign exchange brokers confirming foreign exchange transactions.

Exchange Control or Restrictions – Limits on free dealings in foreign exchange or of free transfers of funds into other currencies and other countries.

Exchange Control Risk – The possibility of defaults on obligations by the imposition of exchange control or restrictions.

Exchange Rates – The price of a currency in terms of another.

Exchange Reserves – The total amount of foreign assets (generally currencies) held by a country's central bank.

Exchange Risk – The risk of market fluctuation of an asset or liability denominated in a foreign currency, such as the ownership of a currency (spot or forward) or trade accounts payable in foreign currency.

Export Credit Insurance – A system to insure the collection of credits extended by exporters against various contingencies. In some countries, only non-commercial risks can be insured.

Export-Import Bank of the U.S. (Ex-Im Bank) – Established in 1934 as an independent federal agency, the Ex-Im Bank provides intermediate and long-term nonrecourse financing for U.S. exports when such facilities are not available from commercial banks. Ex-Im Bank guarantees working capital and other loans for U.S. exporters. Ex-Im Bank also offers other programs such as export credit insurance.

Export Management Company – A domestic firm that provides marketing, distributing, and other international business services for exporters in overseas markets through established networks or contacts in the targeted country.

Export Trading Company (ETC) – A company organized under the Export Trading Company Act of 1982 that facilitates U.S. exports. An ETC may be an affiliate of a bank holding company. ETCs offer a wide range of export-related services such as consulting, international market research, advertising, marketing, insurance, transportation, freight forwarding, and warehousing. This is not an actively used vehicle. Subpart C of Regulation K provides guidance and restrictions for these companies.

External Debt – Total debt owed to creditors outside the country, including both private and public sector debt. In some emerging market countries, this debt may be issued under foreign law (American or English) and payable in foreign currencies.

Financial Stability Board – Established by the G-20 countries to coordinate the development of financial regulatory policies between international standard setters, multilateral organizations, and members' national authorities for financial regulation.

Fixed Exchange Rate System – A system in which the exchange rate of a country's currency is tied to one major currency, such as the U.S. dollar.

Fixed Rate of Exchange – A rate of exchange set by a foreign government relative to the dollar, gold, another currency, or perhaps special drawing rights. It remains in effect as long as that government is willing and/or able to buy or sell exchange at the set rates.

Flexible Rate of Exchange – A rate of exchange subject to relatively frequent changes. It is determined by market forces but subject to various floors or ceilings relative to the dollar, gold, special drawing rights, or another currency when the rate fluctuates beyond certain parameters.

Floating Exchange Rate System – A system in which the values of the currencies of various countries relative to each other are established by supply and demand forces in the market without government intervention.

Floating Rate – A rate of exchange that is determined completely by market forces with no floor or ceiling in relation to the dollar, gold, special drawing rights or any other currency.

Force Majeure – A standard insurance clause in a marine contract that relieves the parties from nonfulfillment of their obligations due to circumstances beyond their control such as earthquakes, floods, or war.

Foreign Bonds – Bonds issued by nonresidents but underwritten primarily by banks registered in the country where the issue is made.

Foreign Deposits – Those deposits that are payable at a financial institution outside the jurisdiction of the U.S. government and in the currency of the country in which the depository is located. See also Nostro Account.

Foreign Draft – An official bank order drawn on a foreign correspondent bank to pay on demand to a designated payee a specific sum of foreign money or U.S. dollars at the drawee's buying rate.

Foreign Exchange – The trading or exchange of a foreign currency in relation to another currency.

Foreign Exchange Rationing – A government requirement that all holders of bills of exchange relinquish them at a stipulated rate.

Foreign Exchange Reserves – The reserves maintained by a central bank that should only include foreign currency deposits and bonds; however, in popular usage may include gold, special drawing rights, and IMF Reserve positions. This larger figure is referred to as International Reserves.

Foreign Exchange Risk – The risk associated with exposure to fluctuation in spot exchange rates.

Foreign Investment Advisory Service (FIAS) – Established in 1986, FIAS counsels developing countries on attracting foreign capital. FIAS operates under the aegis of the World Bank and its affiliates the International Finance Corporation and the Multilateral Investment Guarantee Agency.

Foreign Trade Zone – An area where goods may be received and stored without entering a country's customs jurisdiction and without paying duty. Sometimes called a *free trade zone*.

Forward Book – The aggregate of all forward contracts for a given currency or all currencies.

Forward Exchange – Foreign currency traded for settlement beyond two working or business days from today.

Forward Exchange Position – The long or short position that a dealer may have in the forward market, as compared to spot dealing.

Forward Exchange Risk – The possibility of a loss on a covered position as a result of a change in the swap margin.

Forward-Forward Dealing – The simultaneous purchase and sale of a currency for different forward dates.

Forward Premium – A phrase used to describe a currency with a forward price that is more expensive than its spot price. Also referred to as *at a forward premium*.

Forward Purchase – An outright purchase of a forward contract.

Forward Rates – The rates at which foreign exchange for future delivery are quoted, bought, and sold.

Free Alongside Ship (F.A.S.) – A term for a price quotation under which the seller delivers merchandise free of charge to the steamer's side and pays shipping-related expenses up to that destination, if necessary.

Free On Board (F.O.B.) (destination) – A term for a price quotation under which the seller undertakes at their own risk and expense to load the goods on a carrier at a specified location. Expenses subsequent thereto are for account of the buyer.

Free On Board (F.O.B.) (vessel) – A term for a price quotation under which the seller delivers the goods at their own expense on board the steamer at the location named. Subsequent risks and expenses are for account of the buyer.

Free Port – A foreign trade zone open to all traders on equal terms where merchandise may be stored duty-free pending its re-export or sale within that country.

Free Trade Area – An arrangement between two or more countries for free trade among themselves, although each nation maintains its own independent tariffs toward nonmember nations. It should not be confused with free trade zone, which is synonymous with *foreign trade zone*.

Future (or Forward) Exchange Contract – A contract usually between a bank and its customer for the purchase or sale of foreign exchange at a fixed rate with delivery at a specified future time. A future contract is due later than a spot contract, which is settled in one to ten days depending on the bank or market. Future exchange contracts are generally used by the customer to avoid the risk of fluctuations in rates of foreign exchange.

G-7 (Group of Seven) – A group of industrialized countries comprising Canada, France, Germany, Great Britain, Italy, Japan, and the U.S.

G-10 Countries – The informal term for the Group of ten countries, which consists of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the U.S. Switzerland joined in 1984, but the name remains as is. Luxembourg is an associate member.

Global Bond – A temporary debt certificate issued by a Eurobond borrower, representing the borrower's total indebtedness. The global bond will subsequently be replaced by individual bearer bonds.

Global Line – A bank-established aggregate limit that sets the maximum exposure the bank is willing to have to any one customer on a worldwide basis.

Guidance Line – An authorization, unknown to the customer, or a line of credit. If communicated to the customer, the guidance line becomes an advised line of credit commitment.

Hawalas – Informal exchangers and money transmitters commonly used in Arab and other Islamic countries and in India. The system relies on dealings with a trusted party who has financial connections with another individual in another country. Because of the discreteness and informality of the dealings between the parties, hawalas represent a high risk for money laundering. Furthermore, terrorists have used these networks to transfer funds around the world.

Heavily Indebted Poor Countries (HIPCs) – A designation by the IMF to identify nations targeted that need to reduce external debt to more sustainable levels. To determine sustainability, the net value of a country's debt burden is divided into its export earnings. An HIPC is identified as a nation that has a debt to export ratio one and one-half times the amount considered by the IMF to be sustainable. Under this debt reduction initiative for these poor developing countries, the IMF, the World Bank and other multilateral organizations will get together with all of the creditors of these HIPCs. The creditor group then develops a plan to reduce the HIPC's debt to a more sustainable level. To qualify for HIPC assistance, the country must have adopted a Poverty Reduction Strategy Paper and made progress in initiating this strategy for one year. Then the HIPC must adopt adjustment and reform programs supported by the IMF and the World Bank. The IMF and World Bank will conduct periodic debt sustainability analysis to determine ongoing qualification for assistance. As of March 2015, the IMF identified 39 countries as HIPCs.

Interagency Country Exposure Review Committee (ICERC) – A nine-member joint committee of three federal regulatory agencies established to administer the country risk supervision program. ICERC determines the creditworthiness of individual countries and the proper Allocated Transfer Risk Reserve to be used by U.S. banks in mitigating cross-border exposure within a specific country.

International Banking Act of 1978 (IBA) – The principal legislation pertaining to the activities of foreign banks in the U.S. It established a regulatory framework for foreign banks operating in the U.S.

International Banking Facility – A set of asset and liability accounts segregated on the books and records of a depository institution, U.S. branch or agency or a foreign bank, or an Edge Act or agreement corporation. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. IBFs may receive certain tax advantages from individual states.

International Monetary Fund (IMF) – A specialized agency of the United Nations. It encourages monetary cooperation, establishes international standards for a currency exchange policy, promotes stable foreign exchange rates among member nations, and makes short-term advances and standby credits to members experiencing temporary payments difficulties. In some cases, the IMF advances money subject to conditions that must be met by the borrowing country. Its resources come mainly from subscriptions of members.

International Money Market of the Chicago Mercantile Exchange (IMM) – The IMM is one of the world's largest markets for foreign currency and Eurodollar futures trading.

Intervention – The actions of a central bank designed to influence the foreign exchange rate of its currency. The bank can use its exchange reserves to buy its currency if it is under too much downward pressure or to sell its currency if it is under too much upward pressure.

Intra-country Foreign Currency Position – The risk that exists whenever a subsidiary or a branch lends, invests, places, or extends credit to entities that are located within the same country as the booking unit, but in a currency different from that of the country where the borrower and booking unit are located.

Intra-day Position – The size of spot or forward positions allowed for a dealer during the business day, which may be larger than that allowed for the end of the day. Also called *daylight* limits.

Latin American Integration Association (**LAIA) –** The purpose of the LAIA is to reduce tariff barriers between member countries. The member countries are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela. LAIA is also known under ALADI (its Spanish Acronym).

Letters of Credit-Advised – An export letter of credit issued by a bank that requests another bank to advise the beneficiary that the credit has been opened in its favor. This occurs when the issuing bank does not have an office in the country of the beneficiary and uses the facilities of the advising bank. The advising bank is potentially liable only for its own error in making the notification.

Letters of Credit (Back-to-Back) – A letter of credit issued on the strength (or *backing*) of another letter of credit, involving a related transaction and nearly identical terms. For example, ABC company in the U.S. is designated as the beneficiary of an irrevocable letter of credit confirmed by a U.S. bank to supply XYZ company in Bolivia, whose bank issued the letter of credit, with goods to be purchased from a third company. The third company, however, will not fill ABC's order unless it receives prepayment for the goods either through cash or through some other type of financing. If ABC is unable to prepay in cash, it will request its bank to issue a letter of credit in favor of the third company. If ABC's bank agrees, the domestic credit is then *backed* by the foreign letter of credit and a back-to-back letter of credit transaction exists.

Letter of Credit (Cash) – A letter addressed from one bank to one or more correspondent banks making available to the party named in the letter a fixed sum of money up to a future specific date. The sum indicated in the letter is equal to an amount deposited in the issuing bank by the party before the letter is issued.

Letter of Credit (Commercial) – A letter of credit addressed by a bank, on behalf of a buyer of merchandise, to a seller authorizing the seller to draw drafts up to a stipulated amount under specified terms and undertaking conditionally or unconditionally to provide payment for drafts drawn.

Letter of Credit (Confirmed) – A letter of credit issued by the local bank of the importer and to which a bank, usually in the country of the exporter, has added its commitment to honor drafts and documents presented in accordance with the terms of the credit. Thus, the beneficiary has the unconditional assurance that, if the issuing bank refuses to honor the draft against the credit, the confirming bank will pay (or accept) it. In many instances, the seller (exporter) may ask that the letter of credit be confirmed by another bank when the seller is not familiar with the foreign issuing bank or as a precaution against unfavorable exchange regulations, foreign currency shortages, political upheavals, or other situations.

Letter of Credit (Deferred Payment) – A letter of credit under which the seller's draft specifies that the draft is payable at a later date, for example, 90 days after the bill-of-lading date or 90 days after presentation of the documents.

Letter of Credit (Export) – A letter of credit opened by a bank, arising from the financing of exports from a country. The issuing bank may request another bank to confirm or advise the credit to the beneficiary. If confirmed, the credit becomes a confirmed letter of credit, and, if advised, it becomes an advised (unconfirmed) letter of credit.

Letter of Credit (Green Clause) – Similar to the red clause letter of credit below, except that advance payment is made, generally upon presentation of warehouse receipts evidencing storage of the goods.

Letter of Credit (Guarantee) – A letter of credit guaranteed by the customer (applicant) and often backed by collateral security. In domestic banks, the payment of drafts drawn under this credit is frequently labeled in the general ledger asset account *Customer Liability – Drafts Paid under Guaranteed L/C.*

Letter of Credit (Import) – A letter of credit issued by a bank on behalf of a customer who is importing merchandise into a country. Issuance of an import letter of credit carries a definite commitment by the bank to honor the beneficiary's drawings under the credit.

Letter of Credit (Irrevocable) – A letter of credit that cannot be modified or revoked without the customer's consent or that cannot be modified or revoked without the beneficiary's consent.

Letter of Credit (**Negotiation)** – A letter of credit requiring negotiation (usually in the locality of the beneficiary) on or before the expiration date. The engagement clause to honor drafts is in favor of the drawers, endorsers, or bona fide holders.

Letter of Credit (Nontransferable) – A letter of credit that the beneficiary is not allowed to transfer, in whole or part, to any party.

Letter of Credit (Red Clause) – A clause permitting the beneficiary to obtain payment in advance of shipment so that the seller may procure the goods to be shipped.

Letter of Credit (Reimbursement) – A letter of credit issued by one bank and payable at a second bank that, in turn, draws on a third bank for reimbursement of the second bank's payment to the beneficiary. Those credits are generally expressed in a currency other than that of the buyer (issuing bank) or the seller, and, because of wide acceptability, many are settled in the U.S. through yet another bank as the reimbursing agent. Upon issuance, the correspondent sends the reimbursing bank an authorization to honor drawings presented by the negotiating bank.

Letter of Credit (Revocable) – A letter of credit that can be modified or revoked by the issuing bank up until the time payment is made.

Letter of Credit (**Revolving)** – A letter of credit issued for a specific amount that renews itself for the same amount over a given period. Usually, the unused renewable portion of the credit is cumulative as long as drafts are drawn before the expiration of the credit.

Letter of Credit (Standby) – A letter of credit or similar arrangement that represents an obligation to the beneficiary on the part of the issuer to repay money borrowed by or advanced to or for the account party, make payment on account of any indebtedness undertaken by the account party, or make payment on account of any default by the account party in the performance of an obligation.

Letter of Credit (Straight) – A credit requiring presentation on or before the expiration date at the office of the paying bank. The engagement clause to honor drafts is in favor of the beneficiary only.

Letter of Credit (Telegraphic Transfer Clause) – A clause in which the issuing bank agrees to pay the invoice amount to the order of the negotiating bank upon receipt of an authenticated cablegram from the latter confirming that the required documents have been received and are being forwarded.

Letter of Credit (Transferable) – A credit under which the beneficiary has the right to give instructions to the bank called upon to effect payment or acceptance to make the credit available in whole or in part to one or more third parties (second beneficiaries). The credit may be transferred only upon the express authority of the issuing bank and provided that it is expressly designated as transferable. It may be transferred in whole or in part, but may only be transferred once.

Letter of Credit (Traveler's) – A letter of credit addressed to the issuing bank's correspondents, authorizing them to negotiate drafts drawn by the beneficiary named in the credit upon proper identification. The customer is furnished with a list of the bank's correspondents. Payments are endorsed on the reverse side of the letter of credit by the correspondent banks when they negotiate the drafts. This type of letter of credit is usually prepaid by the customer.

Letter of Credit (Usance) – A letter of credit that calls for the payment against time drafts, or drafts calling for payment at some specified date in the future. Usance letters of credit allow buyers a grace period of a specified number of days, usually not longer than six months.

Local Currency Exposure – The amount of assets and off-balance sheet items that are denominated in the local currency of that country.

Lock-up – The term used to refer to procedures followed in a Eurobond issue to prevent the sale of securities to U.S. investors during the period of initial distribution.

London Interbank Offered Rate (LIBOR) – Key rate in international bank lending. LIBOR is an average of the interest rates that major international banks charge each other to borrow U.S. dollars in the London money market. Like the U.S. Treasury the CD indexes, LIBOR tends to move and adjust quite rapidly to changes in interest rates.

London International Financial Futures Exchange (LIFFE) – A London exchange where foreign currency and Eurodollar futures, as well as foreign currency options, are traded.

Long Position – An excess of assets (and/or forward purchase contracts) over liabilities (and/or forward sales contracts) in the same currency. A dealer's position when net purchases and sales result in a net-purchased position.

Loro Accounts – An account that a bank in one country maintains for a bank in another country. It usually holds foreign currency on behalf of the owner-bank's customers.

Maquiladoras – A program where imports are shipped duty and license free to Mexican firms for assembly and then exported back to the U.S.

Marine Insurance – Insurance for losses arising from specified marine casualties. Marine insurance is more extensive than other types, because it may provide for losses arising from fire, piracy, wreckage, and injuries sustained at sea.

Matched – A forward purchase is matched when it is offset by a forward sale for the same date, or vice versa. As a practical necessity, when setting limits for unmatched positions, a bank may consider a contract matched if the covering contract falls within the same week or semi-monthly period.

Maturity Date – The settlement date or delivery date for a forward contract.

Mercosur – The Mercosur was created by Argentina, Brazil, Paraguay and Uruguay in March 1991 with the signing of the Treaty of Asuncion. It originally was set up with the ambitious goal of creating a common market/customs union between the participating countries based on various forms of economic cooperation that had been taking place between Argentina and Brazil since 1986. The Treaty of Ouro Preto of 1994 added much to the institutional structure of Mercosur and initiated a new phase in the relationship between the countries, when they decided to start to implement/realize a common market. A transition phase was set to begin in 1995 and to last until 2006 with a view to constituting the common market. In 1996, association agreements were signed with Chile and Bolivia establishing free trade areas with these countries based on a *4 plus 1* formula. During this period, Mercosur also created a common mechanism for political consultations, which was formalized in 1998, in which the four countries plus Bolivia and Chile all participate as full members of the so-called *Political Mercosur*.

Multi-currency Line – A line of credit giving the borrower the option of using any readily available major currency.

Multilateral Exchange Contract – An exchange contract involving two foreign currencies against each other, for example, a contract for U.S. dollars against British pounds made in London. Also called an arbitrage exchange contract.

Nationalization – A process where a nation's central government assumes ownership and operation of private enterprises within its territory.

Net Accessible Interest Differential – The difference between the interest rates that can actually be obtained on two currencies. This difference is usually the basis of the swap rate between the two currencies and, in most cases, is derived from external interest rates rather than domestic ones. These external rates or Euro-rates are free from reserve requirements, which would increase the interest rate, and from exchange controls, which would limit access to the money.

Net Exchange Position – An imbalance between all the assets and purchases of a currency, and all the liabilities and sales of that currency.

Net Position – A bank has a position in a foreign currency when its assets, including future contracts to sell, in that currency are not equal. An excess of assets over liabilities is called a net *long* position and liabilities in excess of assets result in a net *short* position. A long net position in a currency that is depreciating results in a loss because, with each day, that position (asset) is convertible into fewer units of local currency. A short position in a currency that is appreciating represents a loss because, with each day, satisfaction of that position (liability) costs more units of local currency.

Netting Arrangement – Arrangement by two counterparties to examine all contracts settling in the same currency on the same day and to agree to exchange only the net currency amounts. Also applies to the net market values of several contracts.

Non-tariff Trade Barriers – Barriers other than tariffs that tend to restrict trade. For example, setting higher inspection standards for imports than for domestically produced items, giving preference to domestic companies in bidding on contracts, import substitution programs, import licensing requirements, additional product labeling requirements, export subsidizing, inadequate protection of intellectual property rights, or limitations on services.

North American Free Trade Agreement (NAFTA) – A free trade area consisting of Canada, Mexico, and the U.S. The goal is to reduce trade barriers between the member countries thereby creating jobs and economic prosperity for the citizens of all three countries.

Nostro Accounts – Demand accounts of banks with their correspondents in foreign countries in the currency of that country. These accounts are used to make and receive payments in foreign currencies for a bank's customers and to settle maturing foreign exchange contracts. Also called *due from foreign bank - demand accounts*, *our balances with them*, or *due from balances*.

Ocean Bill of Lading – A document signed by the captain, agents, or owners of a vessel furnishing written evidence for the conveyance and delivery of merchandise sent by sea. It is both a receipt for merchandise and a contract to deliver it as freight.

Odd Dates – Deals within the market are usually for spot, one month, two months, three months or six months forward. Other dates are odd dates, and prices for them are frequently adjusted with more than a mathematical difference. Hence, most market deals are for regular dates, although commercial deals for odd dates are common.

Offer Rate – The price at which a quoting party is prepared to sell or lend currency. This is the same price at which the party to whom the rate is quoted will buy or borrow if it desires to do business with the quoting party. The opposite transactions take place at the bid rate.

Official Rate – The rate established by a country at which it permits conversion of its currency into that of other countries.

Offshore Branch – Banking organization designed to take advantage of favorable regulatory or tax environments in another country. Many of these operations are shell branches with no physical presence.

Offshore Dollars – Same as Eurodollars, but encompassing the deposits held in banks and branches anywhere outside of the U.S., including Europe.

Open Contracts – The difference between long positions and short positions in a foreign currency or between the total of long and short positions in all foreign currencies. Open spot or open forward positions that have not been covered with offsetting transactions.

Open Market Operations – Purchases or sales of securities or other assets by a central bank on the open market.

Open Position Limit – A limit placed on the size of the open position in each currency to manage off-balance sheet items.

Order Bill of Lading – A bill of lading, usually drawn to the order of the shipper that can be negotiated like any other negotiable instrument.

Order Notify Bill of Lading – A bill of lading usually drawn to the order of the shipper or a bank with the additional clause that the consignee is to be notified upon arrival of the merchandise. The mention of the consignee's name does not confer title to the merchandise.

Organization for Economic Cooperation and Development (OECD) – An organization of 34 countries that fosters democracy and free market development throughout the world. The OECD also researches issues having international implications. The OECD publishes its research findings and international statistics on various countries at its website at http://www.oecd.org. The OECD also benchmarks best practices on economic, social, and governance issues. The OECD supports other international groups such as the FATF that have similar goals.

Outright – Forward exchange bought and sold independently from a simultaneous sale or purchase spot exchange.

Outright Forward Rate – A forward exchange rate that is expressed in terms of the actual price of one currency against another, rather than, as is customary, by the swap rate. The outright forward rate can be calculated by adding the swap premium to the spot rate or by subtracting the swap discount from the spot rate.

Override Limit – The total amount of money measured in terms of a bank's domestic currency that the bank is willing to commit to all foreign exchange net positions.

Parallel Banking Organizations – A PBO exists when a U.S. depository institution and a foreign bank are controlled, either directly or indirectly, by an individual, family, or group of persons with close business dealings, or that are otherwise acting in concert.

Parity – A term derived from par, meaning the equivalent price for a certain currency or security relative to another currency or security, or relative to another market for the currency or security after making adjustments for exchange rates, loss of interest, and other factors.

Parity Grid – The system of fixed bilateral par values in the European Monetary System. The central banks of the countries whose currencies are involved in an exchange rate are supposed to intervene in the foreign exchange market to maintain market rates within a set range defined by an upper and lower band around the par value.

Par Value – The official parity value of a currency relative to the dollar, gold, special drawing rights, or another currency.

Payable Through Accounts – Accounts used directly by customers of a correspondent bank to transact business on their own behalf.

Placement Memorandum – A document in a syndicated Eurocredit that sets out details of the proposed loan and gives information about the borrower.

Political Risk – Political changes or trends often accompanied by shifts in economic policy that may affect the availability of foreign exchange to finance private and public external obligations. The banker must understand the subtleties of current exchange procedures and restrictions as well as the possibilities of war, revolution, or expropriation in each country with which the bank transacts business, regardless of the actual currencies involved.

Position – A situation created through foreign exchange contracts or money market contracts in which changes in exchange rates or interest rates could create profits or losses for the operator.

Position Book – A detailed, ongoing record of an institution's dealings in a particular foreign currency or money market instrument. Also known as position sheet.

Position Limits – The maximum net debit or credit foreign currency balance either during the day (daylight limits) or at close of business (overnight limits) as stipulated by bank management.

Premium – The adjustment to a spot price that is made in arriving at a quote for future delivery. If a dealer were to quote $2.00 and $2.05 (bid and asked) for sterling and the premiums for six months forward are .0275 and .0300, the forward quotes would be adjusted to $2.0275 and $2.0800. The premium usually represents differences in interest rates for comparable instruments in two countries. In periods of crisis for a currency, the premium may represent the market anticipation of a higher price.

Price Quotation System – A method of giving exchange rates in which a certain specified amount of a foreign currency (1 or 100, usually) is stated as the corresponding amount in local currency.

Privatization – The selling of a government owned business (power, gas, communications) to the public. Governments privatize businesses to raise money for fiscal operations or to improve the efficiency of a firm.

Quota – A government-imposed restriction on the quantity of a specific imported good.

Rate Risk – In the exchange market, the chance that the spot rate may rise when the trader has a net oversold position (a short position), or that the spot rate may go down when the operator has a net overbought position (a long position).

Reciprocal Rate – The price of one currency in terms of a second currency, when the price of the second currency is given in terms of the first.

Representative Office – A facility established in the U.S. or foreign markets by a foreign bank to sell its services and assist clients. In the U.S., these offices cannot accept deposits or make loans.

Reserve Account – Those items in the balance of payments that measure changes in the central bank's holdings of foreign assets (such as gold, convertible securities, or special drawing rights).

Reserve Currency – A foreign currency held by a central bank (or exchange authority) for the purposes of exchange intervention or the settlement of intergovernmental claims.

Revaluation – An official act wherein the official parity of a currency is adjusted relative to the dollar, gold, special drawing rights, or another currency, resulting in less revalued units relative to those currencies. Also, the periodic computations of the current values (reevaluations) of ledger accounts and unmatured, future purchase and sales contracts.

Rollover – The process of extending a maturing forward foreign exchange contract.

Sanctions – A coercive governmental action that restricts trade with a specific country (e.g., embargo) for a political purpose rather than for an economic need.

Seller's Option Contract – When the seller has the right to settle a forward contract at their option anytime within a specified period.

Shell Branch – See *Offshore Branch*.

Short Position – An excess of liabilities (and/or forward sale contracts) over assets (and/or forward purchase contracts) in the same currency. A dealer's position when the net of purchases and sales leaves the trader in a net-sold or oversold position.

Sight Draft – A draft payable upon presentation to the drawee or within a brief period thereafter known as *days of grace*.

Society for Worldwide Interbank Financial Telecommunications (SWIFT) – A telecommunications network established by major financial institutions to facilitate messages among SWIFT participants. These messages typically result in a monetary transaction between institutions. The network is based in Brussels.

Soft Currency – A currency that is not freely convertible into other currencies.

Soft Loans – Loans with exceptionally lenient repayment terms, such as low interest, extended amortization, or the right to repay in the currency of the borrower.

Sole of Exchange – A phrase appearing on a draft to indicate that no duplicate is being presented.

Sovereign Risk – The risk that the government of a country may interfere with the repayment of debt.

Space Arbitrage – The buying of a foreign currency in one market and selling it for a profit in another market.

Special Drawing Rights – International paper money created and distributed to governments by the IMF in quantities dictated by special agreements among its member countries. The value of special drawing rights is determined by the weighted value of a *basket* of major currencies.

Spot Contract – A foreign exchange contract traded in the interbank market in which the value date is two business days from the trade date.

Spot Exchange (or Spot Currency) – Foreign exchange purchased or sold for immediate delivery and paid for on the day of delivery. Immediate delivery is usually considered delivery in one or two business days after the conclusion of the transaction. Many U.S. banks consider transactions maturing in as many as ten business days as spot exchange. Their reasons vary but are generally to facilitate reevaluation accounting policies and to initiate final confirmation and settlement verification procedures on future contracts nearing maturity.

Spot Transaction – A transaction for spot exchange or currency.

Spread – The difference between the bid rate and the offer rate in an exchange rate quotation or an interest quotation. This difference is not identical with the profit margin because traders seldom buy and sell at their bid and offer rates at the same time.

Square Exchange Position – To make the inflows of a given currency equal to the outflows of that currency for all maturity dates. This produces a square exchange position in that currency.

Sterilization – Intervention in the foreign exchange market by a central bank in which the change in the monetary base caused by the foreign exchange intervention is offset by open market operations involving domestic assets.

Stale Bill of Lading – A bill of lading that has not been presented under a letter of credit to the issuing bank within a reasonable time after its date, thus precluding its arrival at the port of discharge by the time the ship carrying the related shipment has arrived.

Straight Bill of Lading – A bill of lading drawn directly to the consignee and therefore not negotiable.

Swap – The combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another; merely trading one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures.

Swap Arrangement (Reciprocal) – A bilateral agreement between the central banks enabling each party to initiate swap transactions up to an agreed limit to gain temporary possession of the other party's currency.

Swap Cost or Profit – In a swap transaction, the cost or profit related to the temporary movement of currency into another currency and back again. That exchange cost or profit must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. Furthermore, the true trading profits or losses generated by the foreign exchange trader cannot be determined if swap profits or costs are charged to the exchange function rather than being allocated to the department whose loans or investments the swap actually funded.

Swap and Deposit – A combination of swap transactions that enable the borrower to have use of both currencies for the duration of the transaction.

Swap Position – A situation where the scheduled inflows of a given currency are equal to the scheduled outflows, but the maturities of those flows are purposely mismatched. The expectation in a swap position is that the swap rate will change and that the gap can be closed at a profit.

Swap Rate – The difference between the spot exchange rate of a given currency and its forward exchange rate.

Swap Swap – A swap transaction involving one forward maturity date against another forward maturity date.

Swaption – An option on a swap. It gives the buyer the right, but not the obligation, to enter into an interest-rate swap at a future time period.

Telegraphic Transfer (TT) Rate – The basic rate at which banks buy and sell foreign exchange. Buying rates for mail transfers, foreign currency drafts, traveler's checks, and similar instruments are all based on the TT rate. The TT rate may be slightly less favorable than other rates because of the time required for collection.

Telex – Direct communication between two banks or companies and organizations via satellite or underwater cable.

Terms of Trade – Relative price levels of goods exported and imported by a country.

Test Key – A code used in transferring funds by cable or telephone so that the recipient may authenticate the message. For example, a test key may consist of a series of numbers, including a fixed number for each correspondent bank; a number for the type of currency, a number for the total amount; and, possibly, numbers for the day of the month and day of the week. A single number code indicates whether the total amount is in thousands, hundreds, tens, or digits. To arrive at a test number, the indicated numbers are totaled, and the total amount usually precedes the text of the message.

Third Country Bills – Bankers acceptances issued by banks in one country that finance the transport or storage of goods traded between two other countries.

Through Bill of Lading – A bill of lading used when several carriers are used to transport merchandise, for example, from a train to a vessel or vice versa.

Tied Loan – A loan made by a governmental agency that requires the borrower to spend the proceeds in the lender's country.

Time Draft – A draft drawn to mature at a fixed time after presentation or acceptance.

Tomorrow Next – The simultaneous purchase and sale of a currency for receipt and payment on the next and second business day, respectively, or vice versa.

Tradable Amount – The minimum amount accepted by a foreign exchange broker for the interbank market, for example, 100,000 Canadian dollars or 50,000 pounds sterling.

Trade Acceptance – A draft drawn by the seller (drawer) on the buyer (drawee) and accepted by the buyer. Also called a trade bill, customer acceptance, and two-name trade paper.

Trade Accounts – Those parts of the balance of payments that reflect money spent abroad by the citizens of a country on goods and services and the money spent by foreigners in the given country for goods and services.

Trader's Ticket or Dealer's Slip – The handwritten record of a foreign exchange trade and/or placing and taking of deposits that is written by the dealer who executed the transaction.

Trading Position Worksheet – A record of incomplete transactions in a particular currency.

Tranche – A term sometimes used when referring to the number of drawings of funds by a borrower under a term loan.

Transfer Risk – The risk arising when a borrower incurs a liability in a currency that is not the currency in which revenues are generated. The borrower may not be able to convert its local currency to service an international loan if foreign exchange is not generated.

Trust Receipt – Used extensively in letter of credit financing, this is a document or receipt in which the buyer promises to hold the property received in the name of the releasing bank, although the bank retains title to the goods. The merchant is called the trustee and the bank the entruster. Trust receipts are used primarily to allow an importer to take possession of the goods for resale before paying the issuing bank.

Two-way Quotation – A simultaneous quotation of foreign exchange buying and selling rates implying the willingness of the bank to deal either way.

Two-way Rate – An exchange rate or an interest rate quotation that contains both a bid rate and an offer rate. The size of the spread between the two rates indicates the relative quality of the quotation.

Unclean Bill of Lading – A bill of lading across the face of which exceptions to the receipt of goods ''in apparent good order'' are noted. Examples of exceptions include burst bales, rusted goods, and smashed cases.

Undervalued – Decline in the spot rate below purchasing power parities, so that goods of one country are cheaper than in another country. In relation to foreign exchange, *undervalued* means that forward premiums are narrower or forward discounts are wider than the interest parities between the two financial centers.

Uniform Customs and Practices for Documentary Credits – Sets of rules governing documentary letters of credit formulated by the International Chamber of Commerce. Includes general provisions, definitions, forms, responsibilities, documents, and the transfer of documentary letters of credit.

Unmatched – A forward purchase is unmatched when a forward sale for the same date has not been executed or vice versa.

Usance – The period of time between presentation of a draft and its maturity.

Value Date – The date on which foreign exchange bought and sold must be delivered and on which the price for them in local currency must be paid.

Value-impaired – A category assigned by ICERC that indicates a country has protracted debt problems.

Value Today – An arrangement by which spot exchange must be delivered and paid for on the day of the transaction instead of two business days later.

Value Tomorrow – An arrangement by which spot exchange must be delivered and paid for on the business day following the transaction instead of two business days later.

Volume Quotation System – A method of giving exchange rates in which a certain specified amount of local currency (usually 1 or 100) is stated as the corresponding amount in foreign currency.

Vostro Account – A demand account maintained for a bank by a correspondent bank in a foreign country. The nostro account of one bank is the vostro account of the other bank. See also nostro account.

Warehouse Receipt – An instrument that acknowledges the deposit of goods or commodities in the warehouse that issues the receipt. These receipts may be negotiable or non-negotiable. A negotiable warehouse receipt is made to the *bearer*, and a non-negotiable warehouse receipt specifies precisely to whom the goods shall be delivered. There are several alternatives for releasing goods held under warehouse receipts: (1) the delivery of goods may be allowed only against cash payment or substitution of similar collateral; (2) some or all of the goods may be released against a trust receipt without payment; or (3) a warehouseman may release a stipulated quantity of goods without a specific delivery order. Banks will accept a warehouse receipt as collateral for a loan only if the issuer of a receipt is a bonded warehouseman. The bank must have protected assurances for the authenticity of the receipt and the fact that the commodities pledged are fully available as listed on the warehouse receipt.

Within-line Facility – Subfacilities of the line of credit that establish parameters, terms, and conditions of various other facilities available for specific additional purposes or transactions. The aggregate sum of all outstanding amounts under within-line facilities must not exceed the total of the overall line of credit.

World Bank – An international financial organization whose purpose is to aid the development of productive facilities in member countries, particularly in developing countries. The chief source of funds is capital contributions made by member countries, which vary with the financial strength of the country. Another funding source is the sale of long-term bonds.

Yankee Bond – A U.S. dollar-denominated foreign bond issued in the U.S. market.