Memo 1994-22 Overnight Federal Funds

TO: All Kansas State Chartered Banks
FROM: Frank Dunnick, Bank Commissioner
RE: Overnight Federal Funds
DATE: August 31, 1994

This agency has historically taken the position that overnight federal funds were subject to the lending limitations imposed by K.S.A. 9-1104 and were limited to 15% of capital stock paid in and unimpaired and unimpaired surplus. Those federal funds which were secured by U.S. Government bonds or obligations were exempt from this limitation. This long standing interpretation was prompted by the concern that the bank selling the funds, or making the overnight loan to the correspondent bank, would not thoroughly review the creditworthiness of the obligor, and a failure of a purchaser of large amounts of federal funds (a correspondent bank) could in turn cause the failure of several smaller institutions. The conservative approach was to limit the amount of funds sold to that of the legal lending limit.

Recently, this office completed a review of the Federal Reserve Bank's (FRB) Regulation F, which purpose is to limit the risks that the failure of a depository institution would pose to insured depository institutions. This regulation sets forth standards that a bank must follow before they enter into correspondent banking relationships. Additionally, Regulation F limits a bank's interday credit exposure to 25% of the bank's total capital (the limitation is 50% until June 19, 1995 when it is reduced to 25%), unless the bank can demonstrate that its correspondent is at least adequately capitalized.

The standards set forth in FRB Regulation F diminish the concerns of this department as discussed in paragraph one. Based on this, **this department will no longer consider overnight federal funds sold to a correspondent bank to be a loan and the legal limitations of K.S.A. 9-1104 will no longer apply. The department will closely review the following information during the examination for compliance with Regulation F:**

1. The bank shall maintain a policy which details the method of selecting correspondent banks which takes into account credit and liquidity risk, including operational risks. This policy should cover all types of relationships the bank may have with their correspondent banks, including the selection criterion for demand deposit accounts, federal funds sold, participation of overlines, bond safekeeping, certificates of deposits, etc. Specific approval of each correspondent bank, within the policy, is not mandated.

   If the exposure to a particular correspondent is significant, the policy shall require a periodic review of the financial condition of the correspondent which shall take into account any deterioration in the correspondent's financial condition. Factors which should be reviewed and maintained on file include the capital level of the correspondent, the level of nonaccrual and past due loans and leases, the level of earnings, and other factors affecting the financial condition of the correspondent. **When examining, this office will be looking for the most recent call report and the computation and analysis of key ratios in the areas listed above on all correspondents.** This data will not be required for those correspondent relationships which carry small balances that change infrequently or for those small balances which are only used for clearing purposes.

   The policy established should be reviewed and approved by the bank's board of directors at least annually.

2) The bank shall maintain on file the capital calculations for their correspondent as noted in the most recent Report of Condition and Income. This includes the total risk-based capital ratio, the tier 1 risk-based

capital ratio, and the leverage ratio.

If the above factors are not met, a violation of FRB Regulation F will be cited. Additionally, if the correspondent bank does not meet the adequately capitalized status, as defined in Regulation F, or if they do not keep information on file to support the current capital ratios, overnight federal funds will be subject to the 25% percent limit contained in Regulation F. (Note - Pursuant to Regulation F, the limitation is 50% versus 25% during the phase in period. The limitation will be reduced to 25% on June 19, 1995.)