

INTRODUCTION

This section of the Manual of Examination Policies looks at international banking from the broadest of perspectives. It begins by addressing the concept of country risk, including transfer risk, which is perhaps the single overarching risk of all international banking operations and impacts all international activities. This section then discusses international activities of U.S. banks, including foreign lending, investments, placements, funds management, and foreign exchange, which are the most significant international products and services offered by financial institutions. Within the foreign lending component, a significant amount of attention is given to trade finance, which is a particularly important segment of U.S. banks' international credit exposures and an especially important part of cross-border lending of state nonmember banks. Foreign exchange activities, on the other hand, are very specialized and only relatively few FDIC-supervised institutions engage in foreign exchange to a significant degree.

The section then turns to international banking from a different point of view. It discusses how U.S. banks may be owned by or otherwise associated with foreign entities, including foreign banks. Supervision of foreign banking organizations (FBOs) is a primary part of this latter discussion. Also discussed are parallel-owned banking organizations (PBOs), where there is common ownership of domestic and foreign banks outside of a bank holding company structure (i.e. similar to chain banks). This section concludes with discussions of certain laws relevant to international banking and a glossary of international banking terms.

This section has been geared to meet the basic needs of an FDIC examiner encountering international banking. Examiners needing more extensive guidance may wish to refer to examination manuals of the Federal Reserve or Comptroller of the Currency. The International Section in Washington may also have additional resources at its disposal to assist with unusual situations.

Overview of U.S. Bank International Activity

The last few decades have witnessed distinct growth in the ability of firms and countries to access the global capital markets. During this time span, access to capital (bank credit, equity and/or fixed income bond issuance) has become more abundant and competitive. However, failure to price, select, and manage international risks, both on- and off-balance sheet, has resulted in well publicized reductions in profitability, operating losses, and sizable capital charges, particularly during the late 1990s through

2001 (Asian Crisis 1997; as well as, Russian-1998, Ecuador -1999, and Argentine-2001 sovereign defaults).

While the number of U.S. banks significantly involved in international finance is relatively small, certain large banks have notable volumes. Moreover, smaller banks have also allocated significant capital and resources to international banking in select markets. Given the extent of risk introduced by a sovereign country, particularly an emerging market economy, it is necessary that the examiner understand and review international activities when assessing a bank's overall condition.

The international operation of a bank may be conducted in a separate division or department even though many of the activities parallel those performed elsewhere in the bank. Large banks typically operate an international division, which may include a network of foreign branches, subsidiaries, and affiliates. Smaller banks or those with limited international activity often use only a separate department in conjunction with a network of foreign correspondent banks. In either case, the international section will usually have its own management and staff, as well as distinct accounting systems and controls.

Examination Objectives

The objectives of examining an international department are basically the same as those of examining other areas of the bank. However, some modification of examination techniques and procedures may be required because of the specialized nature of international banking. Documentation and accounting procedures for international operations may differ from domestic banking, and the department may operate under separate laws and regulations.

The examination of the international department is usually conducted concurrently with the commercial examination of the bank. Pre-examination planning should be used to determine the scope of the examination and personnel requirements. A good starting point is to review a bank's most recent Uniform Bank Performance Report (UBPR), Reports of Condition (for information concerning on-balance sheet assets and liabilities - foreign debt securities RC-B(6b); bankers' acceptances RC 9&18; loans to foreign banks RC-C2; or off-balance sheet instruments, including letters of credit RC-L4 and OTC derivatives RC-L 12) and examination reports. These reports will indicate the existence of an international department, foreign branches or subsidiaries, the volume of international activity, and the nature of the bank's international business. Review of the bank's most current 009, 009a, and 019 Country Exposure Reports can also assist in determining

the level of country exposure if the bank is required to file the reports.

The examination can usually be conducted at the bank's head office or some other centralized location. Banks that operate foreign branches or subsidiaries usually maintain sufficient duplicate records at home offices to permit a centralized international examination. In fact, Part 347 of the FDIC's Rules and Regulations imposes minimum recordkeeping standards upon state nonmember banks that operate foreign branches or subsidiaries. These standards require that a bank maintain at its head office duplicate records of offshore operations which will permit a centralized review of asset quality, funding operations, contingent liabilities, and internal controls. In most cases, it is expected that this duplicate information will be adequate for examination purposes.

On-site examinations of foreign branches will be necessary in some cases because of inadequate information at the head office or unusual features concerning the activities of the branch. Overseas examinations should be planned very carefully in order to use personnel effectively. It is important that the international examiner determine the availability and quality of information maintained at the head office before commencing a foreign branch examination. To do this it may be advisable to conduct a pre-examination visitation or begin the foreign branch examination after commencing the domestic examination.

Examiners will find many similarities between a bank's international and domestic operations. For example, a bank will extend credit, issue and confirm letters of credit, maintain cash and collection items, maintain foreign and domestic correspondent bank accounts, accept and place time deposits, accept customer deposit accounts, and borrow funds both domestically and internationally.

Other activities are unique to international banking. Creating acceptances and trading in foreign exchange are among these activities. Another element of international operations not found in domestic banking is country risk. This refers to the political, economic, and social conditions of countries in which a bank has exposure and it must be taken into consideration when evaluating a bank's international operation.

International banking is a dynamic field that embraces a wide spectrum of financial services and practices. This section of the Manual is not intended to provide exhaustive coverage of the subject; rather, the discussion is limited to the basic functional areas of international banking. Many of the activities of an international department parallel those conducted in other areas of the bank. In these instances treatment of the topic is limited largely to those

features pertinent to international banking. For this reason the examiner will find it necessary to refer to other areas of the Manual. Also, there are a number of laws, regulations and Corporation policy statements which deal wholly or in part with international banking. These are discussed throughout the text of this section and several are reviewed under the Laws and Regulations section. Examiners should be familiar with these laws, regulations, and statements.

COUNTRY RISK MANAGEMENT

Underlying most, if not all, facets of international banking is a component of risk known as country risk. Because of the increasing volume of international lending and other activities at U.S. banks, the three Federal bank regulatory agencies have adopted a uniform policy against which they will assess a bank's country risk management program. This policy is the March 2002 statement entitled "Sound Risk Management Practices for Country Risk" (March 2002 Statement). Examiners should assess a bank's country risk management program by comparing its policies and processes to the standards set forth in this joint statement. The results of the examiner's evaluation should be included, in narrative form, on the report page entitled "Analysis of the Country Exposure Management System."

The remainder of this section briefly describes the concept of country risk; the elements of an effective country risk management process; and how the three Federal agencies evaluate transfer risk, which is a component of country risk, in bank examinations. The foundation for the discussion that follows is the March 2002 Statement and the 1998 Guide to the Interagency Country Exposure Review Committee (ICERC). Examiners should consult these primary documents for further information.

Concept of Country Risk

Along with the risks present in their domestic operations, institutions engaged in international activities are exposed to country risk – the risk that economic, social, and political conditions and events in a foreign country will adversely affect an institution's financial interests. In addition to the adverse effect that deteriorating economic conditions and political and social unrest may have on the rate of default by obligors in a country, country risk includes the possibility of nationalization or expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation.

Country risk has an overarching effect on an institution's international activities and should explicitly be taken into

account in the risk assessment of all exposures (including off-balance sheet) to all public- and private-sector foreign-domiciled counterparties. The risk associated with even the strongest counterparties in a country 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 necessarily limited to an institution's exposures to foreign-domiciled counterparties. In some situations, the performance of domestic counterparties may also be adversely affected by conditions in foreign countries. Where appropriate, and to the extent practicable, country risk factors should be taken into account when assessing the creditworthiness of domestic counterparties.

Country risk is not limited solely to credit transactions. Investments in foreign subsidiaries, electronic banking agreements, and EDP servicing and other outsourcing arrangements with foreign providers all carry with them the risk that policies or conditions in a foreign country may have adverse consequences for an institution.

Country Risk Management Process

Although the details and complexity of the country risk management process will vary from one institution to the next, such management must be commensurate with the volume and complexity of the institution's international activities. Supervisory expectations will also take into consideration the institution's size and technological capabilities. As more fully described in the March 2002 Statement, a sound country risk management process includes the following nine components:

- Effective oversight by the board of directors;
- Adequate risk management policies and procedures;
- An accurate system for reporting country exposures;
- An effective process for analyzing country risk;
- A country risk rating system;
- Established 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 notes that to effectively control the risk associated with international activities, institutions must have a risk management process that focuses on the broadly defined concept of country risk. A country risk program that is limited to an assessment of transfer risk and especially one that solely relies on transfer risk designations assigned by the ICERC is not acceptable.

Transfer risk and the ICERC program are discussed in subsequent subsections.

Risk Management – Exit Strategies

With regard to regular monitoring of country conditions, external shocks and adverse market conditions during the 1990s, culminating with the Argentine sovereign default in 2001, have underscored the importance to further develop this risk management area. The effectiveness of a bank's monitoring of country conditions and ensuing action plans during episodes of increasing country risk are of paramount importance in ultimately mitigating credit risk and losses.

Inherent to satisfying this objective is the development of board-approved policy guidelines regarding exit strategies (action plans) with defined trigger points to effect the reduction of exposure in a given country portfolio when conditions warrant. The substance of an exit strategy should be commensurate with the degree of sophistication and exposure of a given institution. Items for consideration in the exit plan may include how a bank will reduce exposure to the following:

- **Aggregate** (total country exposures)
- **Asset class** (Loans, Placements, corporate EuroMTN, bonds, CP)
- **Issuer** (sovereign versus private sector for either a bank or corporate issuer),
- **Product risk** (Trade transaction versus Working Capital, Pre-export finance, or off-balance sheet item LCs/derivative), and by
- **Tenor** (generally, consensus should be towards reducing tenor or duration during periods of increasing country risk).

Management can also incorporate risk reduction strategies stemming from contagion risk or the likelihood of economic problems in one country, region or emerging market impacting another.

Trigger points to affect an exit strategy, either gradual or complete elimination of country exposure, will vary with the size and complexity of a given institution. Both quantitative and qualitative data should be used to define, substantiate, and initiate action to reduce risk. Regardless of the forms used, some measures should be formally incorporated into policy that will serve to alert management that risk has escalated beyond an acceptable threshold and that action is now necessary.

With regard to the type of data collected to initiate action, market intelligence garnered from the bank's internal

country studies, representative office, officer visits to the home country central bank or correspondent bank, as well as nationally recognized statistical rating organizations (NRSRO) may be useful sources of information. For instance, Foreign/Local Currency Ceiling Ratings for the Sovereign, Foreign /Local Currency Deposit Ratings for Banks, and Bank Financial Strength Ratings (including credit watch events and outlook changes positive-negative) could be effectively employed.

Such information should serve to stimulate discussion and assessment at senior management levels as to the scope and nature of the bank's current exposure and whether reductions are necessary. Once exit strategies are employed, monthly or quarterly reporting should be provided to the bank's board of directors to update the board on the ongoing nature of exposure and progress towards reducing and/or limiting risk.

Transfer Risk

Transfer risk is a facet of country risk. Transfer risk is 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 external to the country of residence of the obligor. In these circumstances, an obligor must, in the absence of the ability to earn and/or borrow and retain foreign currency outside the country of residence, obtain the foreign currency needed to service an obligation from the central bank of the country. Where a country is beset by economic, political, or social turmoil leading to shortages of foreign currencies at the central bank, the borrower may be unable to obtain the foreign currency and thus default on the obligation to the lending bank or, alternatively, request a restructuring of the debt.

Although a bank's country risk management program must be based on the broadly defined concept of country risk, the Federal banking agencies use transfer risk as a tool to consistently assign classifications and other designations to cross-border exposures, determine minimum reserve requirements on cross-border exposures, and measure cross-border concentrations.

Interagency Country Exposure Review Committee

The ICERC is responsible for providing the uniform transfer risk designations to be used in the Federal banking

agencies' reports of examination. Aided by balance of payments statistics, studies of country conditions and information from other sources, the committee reaches decisions on the extent of transfer risk posed by underlying economic, political and social circumstances in countries where U.S. bank exposure meets the committee's review criteria. Where appropriate, the committee prepares a standard narrative on the country to be used in reports of examination. Refer to the 1998 Guide to the Interagency Country Exposure Review Committee for a detailed explanation of the ICERC program.

Transfer Risk Classifications and Designations

When a country is experiencing political, social, or economic conditions leading to an interruption in debt servicing by obligors within the country or when an interruption in payments appears imminent, credits within the country will be designated as Other Transfer Risk Problems (OTRP), or will be adversely classified using the designation of Substandard, Value Impaired, or Loss. Lesser degrees of transfer risk are identified by the transfer risk designations Strong, Moderately Strong, and Weak. ICERC is responsible for providing the uniform transfer risk classifications and designations. The appropriate criteria for including transfer risk classifications and designations in the Report of Examination are discussed in the Report of Examination instructions. See the 1998 Guide to the Interagency Country Exposure Review Committee for the definitions of the classifications and designations. Examiners can find ICERC's transfer risk designations and write-ups on the International and Large Bank Branch website in the FDIC Intranet.

Contingent liabilities subject to transfer risk (including commercial and standby letters of credit as well as loan commitments) that will result in a concomitant increase in bank assets if the contingencies convert into an actual liability 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 which 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 where exposure is accorded a split classification, the more severe classification should prevail.

Transfer Risk Reserve Requirements

The Federal banking agencies are directed by International Lending Supervision Act of 1983 (ILSA) to require banks

to establish and maintain a special reserve when the value of international loans has been impaired by a protracted inability of the borrowers in a country to make payments on external indebtedness or no definite prospects exist for orderly restoration of debt service. ILSA requires that the special reserves established by a charge against current income be segregated from the bank's general Allowance for Loan and Lease Losses (ALLL), and not be included as a part of bank capital. ILSA also directs each appropriate Federal banking agency to require a banking institution to establish and maintain a special reserve whenever in the judgment of the appropriate Federal banking agency:

1. The quality of such banking institution's assets has been impaired by a protracted inability of public or private borrowers in a foreign country to make payments on their external indebtedness as indicated by such factors as: (i) a failure by such public or private borrowers to make full interest payments on external indebtedness; (ii) a failure to comply with the terms of any restructured indebtedness; or (iii) a failure by the foreign country to comply with any International Monetary Fund (IMF) or other suitable adjustment program; or
2. No definite prospects exist for the orderly restoration of debt service.

The banking agencies refer to this special reserve as the Allocated Transfer Risk Reserve (ATRR). 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 have also the option of charging off the required amount in lieu of establishing an ATRR. ATRR requirements are posted on the International Section website after each ICERC meeting. Examiners should refer to this website to determine if any of the bank's country exposures are subject to an ATRR.

Country Exposure Concentrations

The Federal banking agencies recognize that diversification is the primary method of moderating country risk. Diversification is especially relevant to international lending because the assessment of country risk involves major uncertainties and is subject to considerable margin for error. Diversification provides the best protection against a dramatic change in the economic and/or political fortunes of any particular country.

The adequacy of diversification within a bank's international portfolio is determined by comparing individual country exposure to the bank's capital.

Depending on the economic and political situation within a country and the structure of the bank's portfolio within that country, different concentration levels are used to identify significant country exposures.

The March 2002 Statement notes that concentrations of exposures to individual countries that exceed 25 percent of the institution's Tier 1 capital plus the ALLL are considered significant; however, in the case of particularly troubled countries, lesser degrees of exposure may also be considered to be significant. Report of Examination instructions explain how to use this basic criterion for preparing report commentary and the concentrations schedule. In addition, similar to the March 2002 Statement advice for banks to consider limiting exposures on a broader (i.e. regional) basis, examiners may wish to identify in the Report of Examination concentrations of exposure to broader country groupings when bank or market analyses have identified linkages between countries to which the bank is exposed.

Other ILSA Provisions

In addition to transfer risk reserve requirements, as described above, ILSA and implementing regulations contained within Subpart C of Part 347 of the FDIC Rules and Regulations address several other requirements and matters relating to U.S. banks' international lending. For example, they set forth requirements for accounting for fees on international loans and reporting and public disclosure of international 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. Regarding disclosures on international loans, Part 347 references reporting requirements for FFIEC Form 009 (see Country Risk Exposure Report below).

Country Risk Exposure Report

One of the tools used in monitoring a bank's country risk exposure is the FFIEC's Country Risk Exposure Report (Form 009), which must be filed quarterly by banks that meet certain conditions. Those conditions, as well as the detailed instructions for compiling the report, can be found on the FFIEC webpage under Instructions for Preparing the Country Exposure Report (FDIC Form 6502/03). The examination process should include assurances that banks adhere to reporting requirements, and that such reports are accurate. However, examiners may wish to note that a bank's internal measures of country exposure may be different from that required by the Form 009. This is acceptable. The bank should be able to explain the

differences between internal country exposure reports and the Form 009.

INTERNATIONAL ACTIVITIES

Lending

Banks engaged in international lending are both geographically concentrated and numerically limited. A large percentage of international credits originate at New York City institutions, with most of the remainder are negotiated in secondary money-market centers including Chicago, Miami, and San Francisco.

A bank's major source of profit, both internationally and domestically, remains interest received from lending and securities instruments (either sovereign or corporate sector debentures). Other international department activities, such as cable and foreign exchange operations, are necessary adjuncts to international banking and are part of the capability to service correspondent relationships. However, few of these activities produce income after expenses, and if these were the only services of international banking, few banks would be attracted to the field.

Among those banks that have made a substantive commitment to international activity, international loans have increased considerably in size, complexity, and geographical scope in recent years. Such loans are variously extended to foreign governments, foreign banks, foreign companies, multinational corporations, and U.S. importers and exporters.

International Lending Risks

Few bank loans are completely without risk and bank lending officers must assess the degree of risk in each extension of credit. Foreign loans share most of the same characteristics of domestic credits but, in addition, include several other risks unique to international lending. For convenience, these risks are considered under three categories: credit risk, currency (foreign exchange) risk, and country risk.

Credit Risk refers to the potential inability of a borrower to comply with contractual credit terms and bears the closest resemblance to the primary risk in domestic lending. Evaluation of this risk is similar to any credit decision and involves analysis of appropriate factual information, including credit volume requested, loan purpose, anticipated term and proposed repayment source. In addition, standard credit file information such as

financial statements covering several years and the borrower's performance history on previous loans would be reviewed. The difference in international lending is that applicable information is usually less readily available and less detailed. Foreign financial statements are more likely to be unaudited and their format varies from country to country. Moreover, there are often barriers to acquiring such information from foreign sources. Thus, in the financial evaluation of international loans, the credit decision must frequently be based on information inferior to that available in domestic applications.

Currency Risk pertains to the vulnerability of international lenders to variations in rates of currency exchange, and in every international extension of credit, someone has a currency conversion exposure. U.S. banks attempt to reduce the risk by lending and requiring repayment in U.S. dollars, but the effectiveness of this technique is limited. If a dollar loan is used in a foreign borrower's own country, it will be necessary to convert the proceeds into local currency. Subsequently, when the loan matures, U.S. dollars will be required for repayment. The problem arises when, even though the borrower may have sufficient local currency, the country may not have the dollars available to sell. Thus, the borrower would be at the mercy of the country's central bank and might not be able to make dollar remittance. (Basically, lending and requiring repayment in dollars gives rise to transfer risk, a specific component of country risk, which is covered later in this section.)

Currency risk may manifest itself in credit risk, should adverse currency movements ensue. In this scenario, a speculative attack on a foreign currency or other exogenous economic factors might precipitate foreign currency depreciation/weakness versus the U.S. dollar. This can lead to the inability of a foreign borrower to meet debt service requirements in U.S. dollars, even if U.S. dollars are available within the local financial system.

For example, say a foreign borrower, while generating revenue in local currency (Venezuelan Bolivar) must fulfill its debt service requirement to a U.S. bank in U.S. dollars. A gradual or protracted weakening of the Bolivar (all other factors remaining equal) will require a commensurate rise in revenue, profit margins, and/or reduction in costs to service the same amount of U.S. dollar debt upon currency conversion/translation.

This is considered a facet of the credit decision process that should be factored in under varying currency scenarios and loans should be priced accordingly given the inherent degree of uncertainty and risks with regard to currency movements.

Country Risk is the primary factor that differentiates international lending from domestic lending. In broad terms, country risk encompasses an entire spectrum of risks arising from economic, social, legal, and political conditions of a foreign country that may result in favorable or unfavorable consequences for borrowers in that country. Specifically, country risk analysis includes assessment of the likelihood of political or social upheaval, nationalization or expropriation, and government repudiation of external debts. A discussion of country risk and country risk management is provided elsewhere in this section.

Forms of International Lending

Trade Financing via Letters of Credit and Bankers' Acceptances

The most important single function of international banking departments is the financing of international trade. Several kinds of trade credit facilities are used, depending on circumstances, but the most prevalent are letters of credit and bankers' acceptance financing. In view of its widespread use, this credit procedure is discussed in some detail. Letters of credit are issued in many forms for many different circumstances and types of transactions, but the two most common types are the commercial documentary letter of credit and the unsecured standby letter of credit.

Commercial documentary letters of credit are instruments in which a bank (issuing bank) undertakes to pay a party (the beneficiary/seller/exporter) named in the instrument a sum of money on behalf of the bank's customer (account party/buyer/importer). The beneficiary will be paid when he submits to the issuing bank specific documents 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 letters of credit are governed by the "Uniform Customs and Practice for Documentary Credits" of the International Chamber of Commerce presently in effect (currently version 500). All letters of credit must be issued in favor of a definite beneficiary; for a fixed or determinate amount; in a form clearly stating how payment to the beneficiary is to be made and under what conditions; and with a definite expiration date. The usual routing of a letter of credit is from the issuing bank, through its correspondent bank in the country of the exporter, to the exporter. The two basic forms in which the correspondent bank will receive the letter of credit are either the "revocable" or the "irrevocable" form.

The "revocable" form is, in principle, 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 amend its 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 his bank to rescind or change the letter of credit without first securing the consent of the exporter. When the exporter presents his 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.

The advantages of financing exports by way of an "irrevocable" letter of credit are obvious. The buyer arranges issuance of the credit with his bank and by the terms of the credit, lists the proof of shipment needed for the merchandise for which he is paying. The exporter, by presenting documents in accordance with the letter of credit terms, will receive payment from a 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 bank that is a correspondent 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 these credits reading, "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 not familiar with the issuing bank, require an undertaking from bankers in their own country. For this purpose the correspondent bank will "confirm" irrevocable credits by its correspondent (the issuing bank) upon the latter's authorization and the former's willingness to do so. Now the exporter has a definite undertaking from a bank in his country that it will pay upon presentation of documents in accordance with the terms of the letter of credit. This is evidenced by a printed clause by the confirming bank reading, "We undertake that all drafts drawn and presented as above specified will be honored by us."

Payment terms of a letter of credit usually vary from sight to 180 days, although special forms of letters of credit allowing for other terms exist. 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 his behalf until maturity. Alternatively, the accepted draft can usually be discounted or sold at going market rates. (Refer to the section on Bankers' Acceptances.)

The importance of documentation is paramount in all letter of credit transactions. The bank is required to examine all documents with care to determine that they conform to all of the terms and conditions of the letter of credit. Many letters of credit are part of continuous transactions evolving from letters of credit to sight drafts or acceptances or to notes and advances, collateralized by trust receipts or warehouse receipts. Letters of credit negotiations rarely occur without document discrepancies. Banks actually charge a fee to resolve the discrepancies. Ultimate repayment often depends upon the eventual sale of the goods involved. Although the transaction passes through various sections of the international department, the proper handling and accuracy of the documents required under the letter of credit is of primary concern.

All commercial documentary letters of credit are contingent liabilities and are included as such in Reports of Condition. Banks should also monitor the volume outstanding through a general ledger memorandum account or contra accounts.

Standby letter of credits guarantee payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the bank's customer). 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, a standby letter of credit is normally unsecured and payable against a simple statement of default or nonperformance. Some of the most common purposes for which this instrument may be used are listed below.

- Standby credit for the account party's performance under a contract award. In this case the beneficiary would present to 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 would be obliged to pay the beneficiary and then look to the account party (customer) for reimbursement.
- Standby credit for the account party's borrowing or advances from another bank. This arrangement calls for the issuing bank to reimburse the lending bank if the account party (customer) does not repay his loan.
- Standby credit to back commercial paper or other obligations of the bank's customers.

A standby letter of credit transaction involves a higher potential risk for the issuing bank than a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of this instrument retains nothing of value to protect it against loss. A commercial documentary

letter of credit provides the bank with title to the goods being shipped. Therefore, to reduce the unsecured credit risk of standby letters of credit, the issuing bank's credit analysis of the account party or customer should be equivalent to that applicable to a borrower in an ordinary loan. Unsecured standby letters of credit are included, along with loans, within a bank's unsecured legal lending limit to one borrower.

For reporting purposes, standby letters of credit are reflected as contingent liabilities in the issuer's Report of Condition. Once drawn upon, the amount of the standby letter of credit becomes a direct liability of the issuing bank.

Other direct liabilities by a bank may arise during the course of business. Court cases and interpretive rulings have held that banks may issue enforceable guarantees when a direct interest of the bank is served. An instance in which this authority is exercised is in the issuance of steamship guarantees and airway releases. These instruments request a transportation carrier to release merchandise shipped under a letter of credit, but before a bill of lading has been received, and provides indemnity protection against future liability. All such guarantees are to be combined with standby letters of credit for the purpose of determining a customer's legal lending limit.

Bankers' acceptances are a common method of financing international trade. These are used to finance all of the successive stages of the movement of goods through the channels of trade from the point of origin to the final destination.

A bankers' acceptance is an order in the form of a time draft (also referred to as a bill of exchange or an issuance draft) drawn by one party (the drawer) in favor of itself or another party (the payee), addressed to (drawn on) a bank (the drawee) and accepted by that bank to pay the holder a certain sum on or before a specified date. The bank's acceptance of this order from the drawer, by stamping across the face of the draft "ACCEPTED" and dating and signing the stamp, is a formal acknowledgment of the obligation and constitutes an unconditional promise by that bank to honor the time draft at maturity. 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 in due course. If the drawee (acceptor) is other than a bank, the instrument is a trade acceptance, not a bankers' acceptance.

Most bankers' acceptances are used to finance trade transactions. Accordingly, acceptances are most often created in connection with letters of credit, although they may arise in connection with collection or open account

transactions (refer to Commercial Documentary Letters of Credit).

In general, acceptance credit is considered self-liquidating; i.e. it must provide the means for its own payment at maturity. In order to accomplish this, the acceptance must be based on an underlying business transaction in which goods are being shipped prior to entering the channels of trade. It is therefore reasonable to expect satisfactory evidence to be available indicating that the draft, when created, is based on an actual shipment or storage and that, at maturity of the draft, the proceeds from the sale of the goods will be used to settle the draft. To a lesser extent, acceptances also finance the domestic shipment of goods and domestic or foreign storage of readily marketable staples.

The payee of the acceptance may hold an acceptance until maturity, discount it with his bank, or sell it in the acceptance market. When a bank discounts (purchases) its own acceptance from the payee, its "Customers Liabilities on Acceptances Outstanding" (asset) and "Liability for Acceptances Executed and Outstanding" (liability) accounts are reduced and the discounted acceptance is recorded with other loans. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, that acceptance should be rebooked in both the asset and liability accounts. The asset and liability accounts may differ on occasion when the asset account is reduced by the customer's prepayment (anticipation). In that case, the bank's liability, which exists so long as the draft is still outstanding in the market, is not reduced.

Creation of eligible bankers' acceptances is governed by Sections 12A, 13 and 14 of the Federal Reserve Act and Regulation A issued by the Board of Governors of the Federal Reserve System. Bankers' acceptances must meet certain criteria described 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. Federal Reserve Banks have not, however, "discounted" acceptances of member banks for many years. In addition, the Federal Reserve Bank of New York, which conducts acceptance operations for the Federal Reserve System under the direction of the FOMC, have discontinued "purchasing" acceptances for its own account.

Despite the fact that acceptances are currently not being either discounted or purchased by Federal Reserve Banks as a matter of policy, the rules governing whether an acceptance meets the eligibility requirements continue to be important for two major reasons. First, acceptances meeting the conditions of eligibility for discount or purchase are more readily salable in the market than are

acceptances which do not satisfy these conditions. 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 raises the cost to the borrower over that of an eligible acceptance.

Bankers' acceptances as a source of finance and investment offer significant advantages to borrowers, accepting banks, and investors alike. Over the years, the bankers' acceptance has often been a cheaper financing vehicle than a loan or advance since it is readily marketable and considered an important secondary reserve for the accepting bank and is a relatively secure instrument to the investor because of its two-name backing.

The market for bankers' acceptances is made by dealer firms recognized by the Federal Reserve System. Participants in the market, in addition to recognized dealers, are domestic and foreign accepting banks, nonrecognized dealers, Edge Act Corporations, and investors of all types, ranging from individuals to foreign central banks. Although most trading is now done on a negotiated basis, published bid and asked prices can be useful indicators of actual negotiated prices. Generally, secondary market activity in acceptances has not been substantial. Most investors who buy acceptances do not resell them, but hold them until maturity so that, once placed with the investor, relatively few find their way back into the market. Thus, accepting banks are the major source of supply to the acceptance market and their willingness to sell their acceptances varies significantly with changes in general money market conditions. Both accepting and non-accepting banks are also important buyers of other banks' acceptances as an investment when rates on acceptances are attractive compared with other short-term obligations. Since the 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 which make the acceptance eligible for discount by a Federal Reserve Bank.

Lending limits affecting bankers' acceptances in nonmember banks are controlled by State banking laws but most of the States which are oriented toward international banking have adopted the appropriate sections of the Federal statutes. Under Section 13 of the Federal Reserve Act, eligible acceptances 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 (do not meet criteria) become an unsecured obligation of the accepting bank for the full amount of the draft and thus subject to prevailing unsecured lending limit requirements.

Trade Financing – Other Methods

While most bank trade financing is provided through letters of credit and bankers' acceptances, several other methods are used in various circumstances. Some of the more common are current account advances, foreign receivable financing, discounting trade acceptances, and forfaiting.

Current account advance is the American substitute for the European method of financing by overdraft. Current account advances are extensions of credit in which no instrument of specific indebtedness is used. Instead, a signed agreement is on file stating the conditions applicable for payment by the obligor.

Financing foreign receivables through advances against foreign collections, the exporter pledges his outward collections to the bank. The exporter may then 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 that the export bill of lading is "to the order of" the shipper and endorsed in blank or to order of the bank. The bill of lading must not be consigned to the buyer (importer) since this would give him control over the goods.

Discounting trade acceptances may also be used by a bank to finance foreign receivables. The exporter's draft accepted by the foreign buyer becomes a trade acceptance with the full credit obligation of the importer. The acceptance is returned to the exporter. If the exporter does not need bank receivable financing, he simply asks the collecting bank to present the draft to the acceptor (importer) for payment at maturity. If the exporter needs the funds before maturity of the trade acceptance, he may ask the bank to discount the draft with or without recourse to himself (exporter). For the most part, however, the lending bank retains the right of recourse to the exporter, if the primary obligor (importer) defaults.

Banks also finance foreign receivables by 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.

Similar to factoring, *forfaiting* is discounted longer term financing for the importer on a non-recourse basis to the exporter. Forfaiting typically involves amounts over \$250,000 for terms of 180 days to 8 years. Under forfaiting, notes, bills of exchange, receivables, or deferred payments under letter of credit guarantees are discounted to the forfaiter. The exporter arranges the transaction with the forfaiter subject to its credit approval. The importer must provide an irrevocable letter of credit or notes or bills of exchange to draw in favor of the exporter. The importer arranges for its bank to guarantee the notes or bills of exchange. The exporter arranges the terms of the agreement with the discounter (forfaiter) to determine the documents necessary to close the deal at a pre-determined price. After shipping the goods to the importer and by delivery of the proper documentation to the forfaiter, the exporter then receives cash. Exporters typically will use forfaiting because they may not want to maintain an open account with a counterparty in certain areas of the world, particularly when government export credits or credit guarantees are not available. The importer finds forfaiting attractive because expensive capital goods can be purchased and put to use generating income before the items have to be paid for.

Domestic Loans

Although some loans to domestic corporations are extended to facilitate international transactions, they are essentially domestic loans. 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 is in U.S. dollars and repayment is expected through the sale of the inventory in the U.S.

Loans to overseas units of domestic corporations are sometimes guaranteed by the domestic corporation. The loans may be made for several purposes such as short-term working capital or long-term capital improvements. The domestic company guarantees generally play a much stronger role in international banking than in domestic lending, and their proper execution is a critical factor in granting 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 on their own merits. There may be a verbal agreement between the parent company and the bank or an informal commitment, such as a comfort letter, keepwell letter, or letter of

assurance that is not legally binding. Therefore, such loans to overseas affiliates should be evaluated as loans to independent entities.

Loans to Foreign Governments

Loans to foreign governments and government-controlled entities cover not only government-controlled banks, financial institutions, and agencies, but also nationalized industries. Repayment of such loans depends ultimately upon the government of the country. The evaluation of risk inherent in such country exposure represented in the international loan portfolio is discussed within this section, under Country Risk Management.

Direct Credit to Foreign Banks

Direct credit to foreign commercial banks may be in the form of loans or deposit placements (discussed in more detail below under a separate heading). Loans are of the normal business type, similar to domestic loans made to local correspondent banks. In some cases, these loans may be used for trade-related transactions commonly referred to as pre-export financing. These trade-related lines of credit work like a working capital line for the foreign bank with advances requested to fund loans for local clients of the foreign bank. The lines are unsecured and based on the creditworthiness of the foreign bank, although repayment may be affected by the ability of the foreign bank's client to reimburse the foreign bank. However, the foreign bank certifies to the U.S. bank the nature of the transaction and the parties involved.

Indirect Loans to Foreign Banks

Indirect loans to foreign banks are loans extended to a foreign borrower based primarily on the foreign bank's guarantee of the loan. In fact, such credit extensions are often accommodations to the foreign bank, with little or no contact between the lending bank and the direct borrower. For all practical purposes, such loans are part of the credit extended to the foreign bank for funding purposes.

Loans to Foreign Business or Individuals

Direct loans to foreign businesses and individuals are based on the same credit principles as domestic commercial loans. However, the examiner must consider them in the special environment of international business that may influence their repayment. Country risk, foreign exchange risk, and reliability of financial statements are some of the factors that need to be considered in this environment.

Syndicated Project Loans

Project loans put together by international consortia and participations in syndications are specialized loans which are often managed by another bank and may or may not involve existing customers. Nevertheless, the bank under examination should have sufficient financial information and documentation on hand to ensure an adequate understanding of the transaction, the borrower, the risks involved, and the source of repayment.

International Lending Policy

Every bank engaged in international lending should be guided by a formal statement of policy approved by its board of directors. Content will vary depending on the size of the bank and the extent of its international commitment, but certain factors should be addressed in almost all situations. These would most often include a summary of management's basic credit standards, a statement of the bank's international lending objectives, a description of its system for credit approval, a recital of loan processing procedures, and establishment of specific personnel lending authorities. In addition, the policy should establish procedures that ensure that the board of directors will regularly be apprised of the condition of the international loan portfolio. It will be appropriate to indicate the major differences in international versus domestic lending. These differences have been summarized under the categories set forth below.

Credit Standards and Information

In the evaluation of international credit risk, special consideration must be given to a review of foreign financial statements, types of borrowers, and the forms of indirect support provided by parent companies, banks, and official financial institutions. Bank personnel should be alerted to the need of reviewing, with caution, financial statements prepared in other countries, since accounting practices vary widely and even some highly developed countries have surprisingly lax auditing standards compared to the U.S. Foreign financial statements may be prepared in either U.S. dollar equivalents or in a borrower's local currency. Most banks analyze the foreign currency statement, particularly if that currency is unstable and the comparability of figures stated in U.S. dollar equivalents at various dates would be distorted by the fluctuating exchange rates. Nevertheless, banks should also translate and spread the foreign financial statement into English, with the foreign currency converted to U.S. dollars and the applicable exchange rate indicated. Since 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 visitations to borrowers' countries by bank account officers, obtaining credit references, followed by preparation of candid reports which become significant parts of credit files.

Loans to Foreign Banks

Loans to foreign banks represent an important segment of international credit. Lending to these institutions involves the same uncertainties as other foreign borrowers, particularly regarding the usual absence of information concerning their asset quality. Within this framework, the key to evaluating a foreign bank is an accurate appraisal of its management. Other important factors are an understanding of the country's banking structure, including method of reporting problem assets, and supervisory program, the central bank's financial position, the economic and political condition of the country, and the position of comparable banks (peer group analysis). As with international borrowers, generally, there is no substitute for regular bank account officer visitations in developing this type of information. Banks may also consider World Bank and International Monetary Fund (IMF) Financial Sector Stability Assessments (FSSAs), which describe 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 (BCBS).

Another factor in international credit analysis is a consideration of the type of domestic borrowers with which international departments do business. Some domestic borrowers are major companies that enjoy excellent credit standings, while others may include sole proprietorship import/export companies operating on modest capital and narrow spreads. Loans to foreign borrowers are often directly or indirectly supported by a party of substantial financial strength such as a domestic parent or affiliate, a foreign correspondent bank guarantor, or foreign government. An evaluation of that support will be basic to a given credit's analysis.

Geographic Limits

Defining geographic loan limits is probably the most significant component in the establishment of an adequate international lending policy. It requires bank management to intelligently estimate where it can lend profitably in accordance with its strategic objectives, financial capacity, and personnel resources. Maximum credit lines should be established for each individual borrower, and maximum aggregate lines established for each political entity where credit is advanced, based on country risk analysis. Banks may also consider assigning limits based on the potential for contagion issues, meaning adverse events in one

country may lead to similar adverse events in another. This may occur, for example, in the case of two or more countries with close trading ties, such as in the case of Mercosur countries in South America. Banks should also consider establishing country and credit sub-limits by transaction type (loans versus investments) and tenor (short-term versus long-term).

Detailed in a preceding paragraph is the notion of currency risk. This refers to the potential loss on loans made in foreign currencies that may decline relative to the U.S. dollar or to the impact of foreign currency devaluations. Aggregate country loan limits should include a currency sub-limit in order to control currency loss exposure.

Investments

In addition to international loans and deposit placements, U.S. banks may periodically allocate capital and risk to investments in foreign debt securities and/or debentures. The debentures may be issued by a foreign bank, corporation, or sovereign government for their respective capital needs. Banks with foreign offices might hold securities of foreign governmental entities to meet various local laws or reserve requirements, reduce tax liability, or as an expression of goodwill. As with domestic bond issues, duration and maturity of the instruments will vary and, in the case of debentures, represent an unsecured obligation of the issuer.

Foreign debt securities held by U.S. banks, typically U.S. dollar-denominated in the form of Eurobonds, Medium Term Notes (MTNs), or Yankee Bonds provide some liquidity in the secondary markets (during normal market conditions) and, depending on the country and circumstances of the issuer, may offer much higher yields than what would otherwise be feasible 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), as well as foreign currency fluctuations.

Examination Guidance

International investments may be internally reported within a bank's domestic bond portfolio, even though they are slotted differently for call report purposes. Banks with foreign branches are permitted a broader scope of investment activities, including investment services and underwriting of debt and equity securities. Limitation of international investments and definition of permissible activities are governed by the Federal Reserve Board's Regulation K which is incorporated into the FDIC Rules

and Regulations through Part 347. As with the domestic investment portfolio, the purchase of foreign debt securities with speculative characteristics merely to generate higher short-term income is an unsuitable investment practice.

While policy considerations with respect to managing risk are very similar to those contained within the Securities section of this Manual, the foreign aspect of Eurobonds, notes, and debentures requires greater diligence, consideration, and monitoring than would otherwise be expected of a plain vanilla domestic bond portfolio. As with international loans or other credit products, foreign debt securities should be purchased under a board-approved country exposure line. Moreover, policy guidelines should prescribe permissible investments, minimum credit quality standards, and maximum duration. All investment selection activities should be consistent with the bank's broader strategic plan, including its risk appetite regarding transfer, credit, interest rate, liquidity, and price risks.

Before purchasing a foreign security, the institution should analyze the following factors relative to the investment: legal implications, credit soundness, marketability, exchange rate risk, and country risk. Credit soundness considerations for foreign debt instruments also include all the qualitative and quantitative considerations for domestic debt instruments (including, for example, credit measures that isolate the extent of leverage and cash flow of the debtor). For non-rated foreign debt issues, it is especially important to adopt conservative minimum thresholds for credit evaluation criteria (i.e. earnings coverage of debt service requirements). Particularly important is a bank assessment of the reasonableness of the risk-reward tradeoff, using, for example, an analysis of the credit spread between the issue and comparable U.S. Treasury instrument as a benchmark.

Regarding pre-purchase analyses of foreign debt securities in countries with a low sovereign rating ceiling (endemic within many emerging market instruments), enhanced diligence is necessary to preclude the introduction of higher risk securities into the portfolio. Examiners may wish to note that nationally recognized statistical rating organizations (NRSRO) have historically not rated certain debentures above the foreign currency rating for the sovereign (sovereign ceiling). However, a company's credit metrics (ability to repay) in an emerging market may have been better represented by a credit grade that was higher than its host government for a variety of factors, including:

- Foreign company's overall importance to the sovereign economy.

- Extent to which company has direct or indirect access to foreign exchange and/or ability to export product/services and realize U.S. currency within its operations.
- Company's access to the international capital markets.
- Extent of foreign ownership and implied support.

Supporting documentation of the pre-purchase analysis should be retained in the institution's files for examiner review. To ensure adherence to written policies and procedures, the international portfolio should be reviewed at least annually by the bank's board of directors and more frequently by its investment or asset/liability management committee. To properly determine overall country exposure, the instruments should also be incorporated within the bank's country exposure report under the appropriate country of risk.

Placements

Banks may maintain interest-bearing time deposits with foreign banks and overseas branches of U.S. banks. Referred to by various terms such as placements, interbank placements or redeposits, maturities of these instruments may range from overnight to several months or even years. Deposit placements are usually connected with foreign exchange markets and international money centers such as New York, London, Frankfurt, Singapore, and Nassau and carried in the account "Due From Foreign Banks-Time." They involve both foreign banks and overseas branches of U.S. banks and are made under a pre-approved placement line that, in essence, is a line of credit.

The bulk of due from time deposits consists of Eurodollar placements, with smaller amounts in other Eurocurrencies. Eurodollars and Eurocurrencies are simply dollars or foreign currencies domiciled outside the respective country of denomination. The Eurodollar market has grown significantly since 1960 with increased interbank activity stemming from the desire to put idle Eurodollar balances to work or to fund Eurodollar loan requests. Although treated as deposits in the Reports of Condition, 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 and well-managed banks after a thorough investigation of their creditworthiness. Placement activity should be governed by a formal bank policy similar to that used for Federal funds transactions. The policy should define terms, designate acceptable levels of concentration in relation to credit and country risks, and identify those banks acceptable for placement activity. Lists of acceptable depositories with prescribed limits should be provided to the traders or placement officers and

reviewed regularly by credit officers, particularly during periods of money market uncertainty or changing economic and political conditions.

The primary examination objective is to determine adequacy of bank policies. Examination procedures are similar to those performed in the domestic operations and should focus on a review of written policies, internal controls, and audit programs. In those instances where a formal policy has not been developed, or credit analysis is nonexistent or deficient, the matter should be discussed with management. Unless the depository institution clearly exhibits pronounced financial deficiencies, in which case the placement can be criticized for its poor credit quality, the examiner's objective is to advise the bank of the potential risks of its practices. The need for correction of any deficiencies should be reinforced through the examiner's comments and conclusions. In the case of due from bank time deposits or placements, prevailing procedures on interbank liabilities should be referenced as contained within Section 3.3 (Cash and Due from Banks) of the Manual of Examination Policies.

If the bank's total exposure with any one institution via Eurodollar placements, Federal funds sold, and demand or time balances with the U.S. offices meets the criteria for a concentration of credit, it should be listed on the appropriate examination report schedule. Also, in the case of placements with foreign banks, these amounts should be included with other foreign extensions of credit for purposes of evaluating country or transfer risk.

Funds Management

Cash Accounts

International departments, like their domestic counterparts, maintain cash accounts which may vary from nominal sums to large amounts depending on customer needs. These accounts will include U.S. and foreign currencies, collection items, and unposted debits. Examination objectives for these accounts are the same as those in domestic operations. Physical control over cash should be maintained and complemented with adequate accounting systems and controls. The department's 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 which 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 maintained at a correspondent bank because: 1) The institution may unknowingly accept counterfeit currency and 2) The physical movement of

notes and coins is expensive and time-consuming. Appropriate internal controls should be instituted to compensate for these additional factors.

Some banks do not include foreign currency in their net position reports or monthly reevaluations. However, currencies of other countries are foreign currency assets as are loans or nostro accounts and should be included in position reports.

Due-From or Nostro Accounts

A bank must be prepared to make and receive payment in a foreign currency in order to meet the needs of its international customers. Since physical movement of currency is impractical, these transactions are accomplished by maintaining accounts or "inventories" of foreign currency in correspondent banks located in the countries where the bank and its customers conduct business. Nostro accounts or due from accounts are accounts established in correspondent banks located in the countries where the bank conducts business. The bank will maintain an inventory of currency, i.e. British Pound Sterling in London, in order to complete transactions requiring the receipt or payment of Pounds. Account transactions occur in the foreign currency, and normal procedure is to record deposits and withdrawals on the department's ledgers in both the foreign currency and its U. S. dollar equivalent. Conversely, "vostro" accounts are due-to demand deposit accounts maintained by a bank in a foreign country at a U.S. bank.

Close supervision of nostro accounts is required to provide adequate balances to service the needs of customers while avoiding excessive idle funds, or overdrawing the nostro account and incurring service charges. All foreign currency transactions, except over-the-counter cash trades, are settled through the nostro accounts. Therefore, the volume of activity may be substantial and must be adequately controlled. Incoming confirmations of transactions should be carefully reviewed by the institution to protect against fraud and error. Similarly, timely follow-up procedures should be in place for non-receipt of confirmations.

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. Spot and forward contracts taken to cover excessive nostro overages should be combined with all other exchange contracts to discover "gaps" or maturity mismatches. The institution's credit evaluation of foreign banks with which demand deposit accounts are maintained should also be carefully reviewed.

Borrowings

All international department transactions that constitute borrowings should be properly recorded on the general ledger, in reports to shareholders, and in published Reports of Condition. International borrowings exist in the same forms as in domestic banking and are commonly composed of direct borrowings from the Export-Import Bank of the U.S., short-term call money from foreign banks, and overdrawn nostro accounts. Other forms of borrowing include: notes and trade bills rediscounted with central banks of various countries; 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.

Certificates of deposit and due-to foreign banks - time (takings) have not been defined as borrowings and continue to be reflected as deposits for reporting and borrowing limitation purposes. However, the fundamental distinction between these instruments as deposits or as borrowings is at best nebulous; in fact, they are widely recognized as borrowing vehicles for many banks.

Guidelines presented elsewhere in this Manual for evaluating domestic borrowing activity should be used for any borrowings found in the international department. Any unjustified borrowing policy being pursued in the international department should be reviewed with management and appropriate comments included in the Report of Examination.

Foreign Exchange**The Foreign Exchange Market**

Foreign exchange is the exchange of money of one country for money of another. Foreign exchange transactions arise out of international trade or the movement of capital between countries. Foreign exchange transactions can be conducted between any business entity, government, or individual; but banks, by virtue of their position as financial intermediaries, have historically been ideal foreign exchange intermediaries, as well. Banks are on one side or the other of the majority of the transactions in the foreign exchange market worldwide.

Bank foreign exchange transactions take place between other banks (referred to as interbank trading) and between banks and their customers (generally referred to as corporate trading). The volume of foreign exchange activity varies widely among banks. The degree of a bank's involvement is largely dictated by customer demand

but increasingly is being driven by interbank trading for a bank's own account. Multinational or global banks are the most active in terms of both trading volume and the number of currencies traded. These banks trade foreign exchange across virtually any currency. Other banks may trade actively in only a few currencies, while other banks will have only limited activity. While banks of any size can and do engage in foreign exchange transactions on behalf of their customers, generally only the world's largest banks and certain smaller banks specializing in international business enter into transactions for their own account.

Foreign Exchange Trading

Foreign exchange trading is an integral part of international trade and can be an important activity and source of income for banks. However, only banks specializing in this complex and specialized field, particularly those banks which trade foreign exchange for their own account, will maintain a foreign exchange department with qualified dealers. It is these banks which present the most complex risks. Banks that only execute their customer's instructions and do no business on their own account – essentially maintaining a “matched book” – will generally use the services of another bank or foreign exchange intermediary to place customer transactions. While these banks present less supervisory risk, examiners of these institutions should still be familiar with the fundamentals outlined in this section. This section is intended to present only the most basic fundamentals of foreign exchange in order to provide the examiner with a minimum understanding for evaluating the risks in this business. Examiners are encouraged to study the subject in more detail, especially when examining banks with more complex foreign exchange operations. A number of books about foreign exchange are available and several major U.S. banks have published books or pamphlets on the subject. In addition, the FFIEC has a Foreign Exchange section within the International Self Study Modules that provides useful guidance for examiners.

Exchange Rates

When currencies of different countries are exchanged, it is done at an exchange rate which is simply the price of one currency in terms of another. Many political and economic factors influence exchange rates. A government may attempt to fix the rate of exchange for its currency or allow it to fluctuate freely or within established limits. Trade and investment flows affect the supply and demand for currencies, which, in turn, influence exchange rates. Banks also quote different rates 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, rates vary depending on the agreed payment date (value date) of the transaction, i.e. overnight, one week, one month, etc. Also, banks quote a different exchange rate for a given transaction when they are buyers or sellers of currency. This applies to both spot and forward transactions and the two rates are usually referred to as bid (buy) and offer (sell). The spread between the bid and offered rates represents the bank's profit margin, if the bank is acting as dealer.

Exchange rates can be quoted either as direct rates or cross rates. Direct rates are simply the value of a currency in terms of another, i.e. the value of the Japanese Yen in U.S. dollar terms. A cross rate is defined as the price of one currency in terms of another currency in the market of a third country, i.e. a Japanese Yen rate in Sterling terms calculated from the respective U.S. dollar rates.

Spot and Forward Exchange

Customers buying or selling foreign exchange may ask their bank to provide that service for immediate delivery (spot transaction) or they might contract to buy or sell a specified amount of foreign currency for delivery at a future date (forward transaction). The date on which payment is effected is referred to as the value date. The value date for a spot transaction is generally two working days after the date the transaction originated. For example, a spot contract originating on Monday would have a value date of Wednesday.

The market for foreign exchange for future delivery is called the future or forward market as opposed to trading for two-day delivery which takes place in the spot market. A forward contract for foreign exchange is a transaction in which one currency is bought or sold against another for delivery at some future date. It differs from the spot market in that settlement occurs in the future, usually in increments of thirty days out to one year for most currencies. However, the liquidity in the market decreases beyond three months and differs across currency pairs, with small country currencies and currencies of emerging market countries having significantly less liquidity and wider spreads. Liquidity is important both for offsetting or hedging a transaction and replacing a transaction should there be a problem with settlement. The exchange rate for a specific currency will differ between spot and future transactions because of the time difference in settlement dates.

An exchange rate is fixed or agreed upon when the forward contract is entered into but no money is exchanged until the agreed future date (value date or settlement date) arrives.

This type of contract enables a company or an individual who has a future commitment in a foreign currency to eliminate the risk of an adverse move in the rate of exchange prior to the maturity of the commitment. Forward exchange rates are usually quoted in terms of their premium or discount over the spot rate. As described above, there is a specific exchange rate for each forward contract and that rate will usually differ from the spot exchange rate. If the forward exchange rate for a currency is higher than the current spot rate for the same currency, the currency is said to be trading at a premium for the forward maturity. If the forward rate is below the spot rate, the currency is said to be trading at a discount. The amount of the premium or the discount is generally determined by the interest rate differential for similar money market instruments that exists between the two countries.

Swaps

One of the most widely used types of foreign exchange transaction is known as a financial swap or cross currency swap, which is a simultaneous purchase and sale of a certain amount of foreign currency for two different value dates. It is generally the combination of a spot contract and a forward contract. For example, an exchange trader buys a currency for spot value and at the same time sells it back for a value date in the future. The swap permits a temporary exchange of currencies and is often used to acquire a foreign currency that is then used to make a short-term investment. The maturity of the investment will coincide with the forward value date and the currency will be returned at that time. The exchange rate for the forward delivery is fixed at the outset, avoiding the risk of fluctuations in the exchange rate over the life of the investment, and the swap spread is the cost of this protection.

Forward Options

Another type of forward is the forward option contract. A forward exchange transaction is often based on expectations of payments involved in future trade or financial operations, where the exact date of payment is unknown. If the customer knows the approximate date when the currency will be received or needed he can enter into a forward option contract. The contract gives the purchaser the option of completing a transaction in the first ten days, the middle ten days, or the last ten days of the month. The bank agrees to deliver payment or receive delivery of payment of exchange on any day within the ten-day option period. The customer is charged a less favorable rate for the advantage of leeway or option in timing the execution of the contract than he would be for a

regular forward contract. Swaptions, an option on a swap contract, works similarly.

Foreign Exchange Risk

Trading in foreign exchange (FX) or holding assets and liabilities denominated in foreign currency entail certain risks. These risks fall into five categories: exchange rate risk, interest rate risk, credit risk, operational risk, and country risk.

Exchange Rate Risk

Exchange Rate Risk occurs when a bank takes an open position in a currency. When a bank holds, buys, or agrees to buy more foreign currency than it sells, or agrees to sell more than it buys, an exposure is created which is known as an open position. 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 of a 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 risks an adverse move in exchange rates. A long position in a depreciating currency results in exchange loss relative to book value. As the foreign currency depreciates, it is convertible into fewer units of local currency. Similarly, a short position in a currency that is appreciating results in an exchange loss relative to book value because, as the foreign currency increases in value it costs more units of local currency to close or square the position. To control exchange risk, bank management should establish limits for net open positions in each currency. See Trading Limits under the "Written Policies and Procedures" section.

To cover or match trade open positions, banks will generally hedge these positions with a forward contract, matching an expected requirement to deliver with a future contract to receive. The hedging of open positions can be very complex, sometimes using multiple contracts, different types of contracts, and even different currencies. Such hedging will not be detailed in this guidance. However, it is important to remember that the amount of exchange rate risk a bank is exposed to 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. Also, while various types of forward contracts are typically used for hedging open positions resulting from commercial or financial transactions, forward contracts are also ideal for speculative purposes (called outright deals or single forward transactions) because often no funds are actually exchanged at the time the contract is entered into. All banks which engage in FX activity should monitor their

open positions at least daily. Banks which actively trade FX will monitor their open positions constantly, closing out or matching exposures at various times during the day.

Maturity-Gap Risk

Maturity-Gap Risk is the foreign exchange term for interest rate risk. It arises whenever there are mismatches or gaps in a bank's total outstanding spot and forward contracts. Gaps result in days 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 any scheduled offsetting payments. The exposure to the bank is that of shifts in interest rates earned on funds provided by cash inflows or on interest rates paid on funds required to meet cash outflows. In this situation, the bank must decide whether: (1) to hold the currency in its "nostro" accounts (refer to the "International Activities" section for more details); (2) to invest it short term; (3) to sell it for delivery at the time the gap begins and repurchase it for delivery at the time the gap closes; or (4) to use any combination of the above. Banks control interest rate risk by establishing limits on the volume of mismatches in its total foreign exchange position. The problems of managing gaps are complex. The decision whether to close a gap when it is created, or to leave it until a later date, is based upon analysis of money market interest rates, and spot and forward exchange rates.

Credit Risk

When entering into a foreign exchange transaction, the bank must be confident that its customer or counterparty (individual, company, or bank) has the financial means to meet its obligations at maturity. Two types of credit risk exist in FX trading, one is called the 10-20 percent risk or the cost cover, the second is delivery or settlement risk. The 10-20 percent risk is that a customer might not be able to deliver the currency as promised in order to settle the contract. The bank's FX position is suddenly unbalanced and the bank is exposed to any movements in exchange rates. The bank must either dispose of the currency it had acquired for delivery under the contract, or it must purchase the currency it had expected to receive and probably had contracted to sell to a third party. In either case, the bank must enter into a new transaction and may suffer a loss if there has been an adverse change in exchange rates. Generally, exchange rates will fluctuate no more than 10-20 percent in the short-term and usually much less, hence the term 10-20 percent risk.

Delivery or settlement risk refers to the risk of a counterparty taking delivery of currency from the bank but

not delivering the counterpart currency. In this situation the bank is exposed not just to currency fluctuations but for 100 percent of the transaction.

To limit both types of risk, a careful evaluation of the customer's creditworthiness is essential. The credit review should be used to establish an overall limit for exchange contracts for each customer. For example, after careful analysis of the customer's financial soundness, the bank may determine an overall limit for foreign exchange contracts for the customer in the equivalent amount of, say, \$2 million.

With this total limit the bank might establish a settlement limit of no more than the equivalent of \$200,000 in any one day. In this manner it has limited its 10-20 percent risk to 10 percent of any outstanding contracts to a maximum of \$2 million. At the same time it has limited its delivery or settlement risk by imposing a \$200,000 settlement limit. If the customer fails to deliver counterpart funds, the bank can cancel remaining contracts and limit its risk of loss.

Operational Risk

Banks that engage in foreign exchange transactions must have systems and personnel capable of controlling and reporting transactions. The absence of an effective operations department may result in unanticipated losses to the bank. Generally, the bank will have an Operations Manager whose responsibility is to ensure that systems are in place to record transactions, perform daily mark-to-market, reconcile currency positions daily, and assess compliance with limits. The Back Office or Operations Department should also ensure that all confirmations are received or sent to counterparties daily. In more sophisticated foreign exchange trading rooms, there may be a middle office as well that interacts with front office (traders) as well as back office personnel. Separation of duties is 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 of these functions remains of paramount importance irrespective of the extent of a bank's trading operations.

Country Risk

Political changes or adverse economic trends within a country are likely to be accompanied by changes in policies which could affect such factors as interest rates, balance of payments, foreign exchange reserves, and capital flows. These 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 control regimes imposed by a country's central bank can limit the amount of currency that can be exchanged in any single transaction, by any given customer, or within a particular period. In any case, the exchange rate for the currency may be subject to additional supply and demand influences, and sources of covering the desired currency may vanish.

Examination Guidance

An examination of a bank's foreign exchange activities seeks to appraise 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 which conduct trades entirely on behalf of their customers generally do not. However, the nature of foreign exchange trading wherein a single trader can commit a bank to huge forward commitments in a short time makes evaluation of risks important for banks of any size and perceived level of activity. At a minimum, examiners should:

- Determine the extent of the bank's FX activities in relation to the sophistication of their policies and strategies, expertise, operations, internal controls, management information systems, and internal audit coverage.
- Evaluate the overall FX risk position of the bank, its potential impact on future earnings, and management's ability to manage the risk.
- Determine the type of FX contracts in which the bank is engaged (spot, forward, swaps, options, futures) and the risks presented by the bank's FX activities (maturity gaps, financially weak counterparties, illiquid currency contracts, currencies with greater country risk).
- Evaluate the quality of personnel, risk controls, and operational systems in the context of the volume of the bank's activities and the complexity of transactions.

Guidance on Internal Control for Foreign Exchange Activities

The FDIC recognizes that most banks maintaining their own FX dealers already have adequate controls in place for foreign exchange trading. These internal policies and procedures, along with any relevant Federal Reserve and Office of the Comptroller of the Currency (OCC) examination guidance, may be used by FDIC examiners as a basis for evaluating a bank's FX practices in order to supplement the guidelines below. It should be noted that

the Federal Reserve and OCC guidelines may not be all-encompassing and banks which are active in FX trading perhaps should have controls which exceed regulatory standards. Banks with limited foreign exchange activity and limited risk profiles (most state nonmember institutions) may not need all the systems and controls maintained by larger institutions or even all of the minimum FDIC standards. However, it is incumbent upon the management of these banks to demonstrate to examiners that their systems provide adequate protection for their level of risk.

Written Policies and Procedures

The bank's policies and procedures should, at a minimum, address the following:

- Scope of trading activity authorized and types of services offered.
- Trading and credit limits and limit exception approval and reporting process.
- Clear standards for trading with affiliated entities, members of the board of directors, and employees.
- Specific officer responsibility for and authority over functional trading desks (i.e. spot, forward, and options).
- Holdovers and after-hours transactions, accounting methods, and operational procedures.
- Trading Limits- Trading limits should be evaluated in light of current strategies, liquidity/volatility of individual currencies, trader qualifications, and loss exposure related to capital. At a minimum, the bank's policy should include limits with respect to:
 - Net positions by currency and in aggregate.
 - Maturity distribution of foreign currency assets, liabilities, and contracts.
 - Individual customer and bank lines.
 - Daily settlements with customers and banks.
 - Total FX contracts outstanding.
 - Overnight net FX positions by currency and in aggregate.
 - Maximum loss by trader/desk/branch.
- The process by which limits are allocated to branches and the process through which branches may borrow limits from other branches should be reviewed. In addition, policies governing the extension of limits and the approval and reporting procedures should also be evaluated.
- Credit Limits- The allocation of credit limits and the monitoring of such limits should be reviewed. The

bank should establish the following:

- FX counterparty and settlement limits, approved by a credit review process, that are established independently of other credit lines within the bank.
- Daily reports generated by FX operations which indicate those customers or banks that have exceeded their limits (sometimes called an over-limit or exceptions report).
- Daily report of limit excesses, including written approvals for excesses prepared by an officer not in the trading area.
- Systems for allocating more risk to counterparties with long maturity positions.
- On-line systems available to traders that detail credit line status.

Examiners should review the list of approved credit limits and note any unusual concentrations or lines to banks with known market problems. A current report of all outstanding FX contracts should be compared with approval limits to verify that there are no excesses other than those reported on the exceptions report.

Management Information Systems (MIS) and Operational Support

The bank's management information systems (MIS) and Operations Department should be capable of reporting and supporting the level of current and expected trading volumes on a daily basis. Specifically, with respect to MIS, examiners should review the reports generated and evaluate the systems' ability to monitor all FX positions, compliance with limits (both trading and credit), frequency of distribution (at least daily), and periodic testing for accuracy.

The personnel in the Operations Department should report to someone other than a member of the trading staff. The Operations Department should be adequately staffed to support the volume of transactions and duties of the department should be segregated, i.e. confirmations, trader positions, counterparty positions. There should be sufficient documentation of all transactions to ensure a proper audit trail. Documentation may be in the form of taped records of phone calls and trade tickets and confirmations received via telex, facsimile, recorded telephone calls or mail. The Operations Department should also review all trader and counterparty position reports and identify and report all excesses to the Operations Manager daily. Documentation for the

approval of excesses must be obtained and reviewed each day.

The revaluation or mark-to-market of appropriate positions are calculated by operations personnel. Examiners should closely review these revaluations for accuracy and adherence to bank policy. Prices used by operations personnel should be obtained and verified from sources other than the bank's traders. Revaluations are recorded at least monthly.

Written confirmations should be sent no later than one business day after the transaction date. Incoming confirmations should be reviewed by a designated person in the back office or operations section. All confirmation discrepancies must be recorded in a log and promptly corrected.

Finally, the status of nostro and vostro accounts should be routinely reviewed to identify any outstanding items that may indicate settlement errors in those accounts.

Internal Accounting Controls

The bank's accounting systems and controls should be sufficient to provide reports on trading activities that are current and accurate and minimize the possibility of concealment of unauthorized transactions and misappropriation of funds. Documentation describing the accounting and other controls should be maintained by each trading office.

Internal control guidelines enumerate a number of specific recommendations for adequate internal controls of foreign exchange trading. In broad terms, the recommendations address the description of accounting systems and procedures, confirmation of contracts, reconciliation of trading positions, and reporting of exceptions. As a whole, the guidelines are considered minimum standards for the control of exchange activities. It is possible that the bank can control certain risks in a different manner. In such case, the bank must be able to justify its method of control.

Audit Documentation

The audit function is an important tool for management's use in determining that controls are functioning as intended and that employees are adhering to policy directives. The review of audit reports is a necessary part of an examination, particularly in specialized areas such as foreign exchange trading. The failure to extend adequate audit coverage to the bank's FX activity might be considered an important weakness in the bank's system of controls. In such case, the examiner should address the

matter in the examination report and seek corrective action from senior management.

The guidelines do not describe how the audit program is to be performed. The development of an adequate audit program is a responsibility of senior management. The guidelines contain recommended minimum standards for documenting audit procedures and findings in a manner that facilitates an appraisal of the adequacy of the audit program.

The bank should maintain audit reports, workpapers, and related documentation at its head office or another centralized location and make them available to examiners. The auditor's files should indicate the extent to which the auditor tested the control and accounting entries, as well as compliance with bank policy. The auditor should also make a determination as to whether the bank's controls are adequate for the risks involved. The files should contain any recommendations by the auditor for additional controls, or the deletion of existing controls, and the underlying rationale. Any material deficiencies disclosed by the audit should be promptly reported in writing to the board of directors or a board committee.

SUPERVISION OF U.S. OPERATIONS OF FOREIGN BANKS AND OTHER INTERNATIONAL BANKING ENTITIES

Foreign Banking Organizations

Many foreign banks have operations in the U.S. These institutions are known in the U.S. bank regulatory community as foreign banking organizations (FBOs). The banking offices of FBOs can generally be divided into bank subsidiaries, branches, agencies, Edge and Agreement Corporations, commercial lending companies, and representative offices. The FDIC insures the FBOs' U.S. bank subsidiaries and a small number of the branches. As of June 30, 2004, U.S. banking operations of FBOs, insured and uninsured totaled about \$3.4 trillion in assets. One hundred and eighty nine FBOs had 408 insured subsidiary banks, agencies, Edge and Agreement Corporations, and branches combined. FBO operations of national and state member and nonmember banks have assets totaling about \$575 billion. Interestingly, FBOs also have U.S. non-banking offices (e.g. brokerage/dealers and real-estate companies) with assets totaling approximately \$2 trillion.

U.S. Branches and Agencies of foreign banks are licensed at either the State or Federal level but have no separate legal status apart from the foreign bank. They are

extensions of the foreign bank, much like a domestic branch of a U.S. bank is merely an office of that institution. The OCC supervises the federally licensed branches, and the Federal Reserve and State banking authorities supervise the State licensed branches. The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) 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. The FDIC examines State licensed branches that are insured.

Examiners should consult the Federal Reserve Board's Examination Manual for U.S. Branches and Agencies of FBOs when conducting examinations of FDIC-insured branches of foreign banks. Branches (and agencies) are assigned a ROCA rating instead of a CAMELS rating. The ROCA components are: Risk management, Operational controls, Compliance, and Asset quality. Like the CAMELS rating, the ROCA rating determines the level of supervisory concern and the frequency of the examination schedule. An electronic version of the Uniform Report of Examination for Branches and Agencies is available for examiners on the International Section's website in MS Word format. The quarterly Report of Assets and Liabilities (Schedule RAL of the FFIEC 002) for branches and agencies is publicly available from the Federal Reserve Board's National Information Center at <http://www.ffiec.gov/nic/>.

Agencies also do not have a separate legal status and may have State or Federal licenses. An agency is like a branch; however, it is not allowed to accept deposits. Agencies are permitted to have occasional credit balances under certain conditions.

Edge or Agreement Corporations are subsidiaries of financial institutions organized for the purpose of engaging solely in certain types of international financial and investment activities. Edge Corporations are chartered at the Federal level, whereas Agreement Corporations are chartered at the State level. They may be organized by member or nonmember banks, or by foreign banks, and ownership can be held by one bank or several banks. They are located in the U.S. but often not in the same state in which the parent bank operates.

Edge and Agreement Corporations are useful vehicles for banks that wish to enter the international banking business. They may be located in any part of the U.S., can establish branches in this country or overseas, and are permitted to engage in a broad range of banking activities provided the transactions are international in nature or directly related to international transactions. Operations of Edge and Agreement Corporations are governed by Part 211.6 of Federal Reserve Regulation K and supervised by the

Federal Reserve and/or the corresponding State banking authority. Deposit-taking activities of such entities are limited and uninsured.

A commercial lending office may not accept deposits but may borrow and lend on behalf of its parent company. These entities are State licensed and must receive approval from the Federal Reserve Board.

Representative offices are established under State law with the prior approval of the Federal Reserve Board. The representative office is a marketing facility and meeting place for conducting business of its parent foreign bank. The representative office cannot accept deposits or make any loan commitments for its parent company.

FBO Supervision Program

FBSEA mandated oversight of FBOs by the Federal Reserve Board. As part of its oversight responsibility, the Federal Reserve Board coordinates the examinations of FBOs with the other Federal agencies and with the various State banking authorities. In order to streamline FBO supervision, to enhance cooperation, and to reduce regulatory costs, the Federal regulatory agencies have entered into examination coordination agreements with the State banking agencies that protect the confidentiality of information shared by all participants. The information is shared through software known as the Banking Organization National Desktop (BOND). When planning an examination of an FBO, the examiner should contact the relevant case manager in the Regional Office or staff in the International Section as they may have access to more recent information that should be considered in the overall assessment of the FBO.

Part of the Federal Reserve Board's oversight requires a strength-of-support assessment (SOSA) ranking of the foreign bank, which strives to determine the ability of the parent institution to support the U.S. operations of the FBO. The purpose of this SOSA is to determine the FBO's overall risk profile and to develop an examination strategy and frequency that is commensurate with this profile. As part of the SOSA process, regulatory agencies will try to understand the FBO better by also reviewing its home-country financial system, supervisory practices, and accounting standards. A rating for the combined U.S. operations of the FBO is also assigned. For more information on FBO supervision and the SOSA process, examiners should refer to the Federal Reserve Board's SR 00-14, dated October 23, 2000, entitled, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations."

International Banking Facility

An International Banking Facility (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 Federal Reserve Regulation D and after appropriate notification to the Federal Reserve. 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 pursuant to Federal Reserve Regulations D and Q. 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, thus providing a lower cost of funds to facilitate its international banking. Such funding may also serve to diversify the bank's liability mix and prove less volatile to changes in interest rates. This may be the case as foreign depositors often seek to mitigate country risk within their home country by transferring or diversifying their wealth into the U.S. market.

Parallel-owned Banking Organizations

A Parallel-Owned Banking Organization (PBO) exists when a depository institution¹ in the U.S. and a foreign bank² are **controlled**, either directly or indirectly, by an individual, family, or group of persons³ with close business dealings or are otherwise acting in concert. PBOs do not include structures in a recognized financial group,⁴ which

¹ References to "U.S. depository institution" are intended to be synonymous with U.S. bank; and it represents all banks and savings associations insured by the FDIC.

² 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.

³ The term "persons" includes both business entities and natural persons, which may or may not be U.S. citizens.

⁴ A "recognized financial group" means 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 (BHC Act) or the Savings and Loan Holding Company Act (S&L HC Act). Such companies would be subject to the application, notice and supervisory requirements in the BHC Act or the S&L HC Act and not the procedures described here. A BHC or a S&L HC, however, may be a component of a PBO. This situation may arise when a bank

are entities that are subject to comprehensive consolidated supervision via the Foreign Bank Organization (FBO) Supervision Program established as a result of the Foreign Bank Supervision Enhancement Act⁵ (FBSEA).

PBOs are not included in the FBO Supervision Program because they do not have a foreign bank or holding company as the parent organization. PBOs, therefore, create unique supervisory concerns. A portion of the control of a PBO is located in foreign countries for which U.S. bank regulatory agencies may or may not be able to obtain sufficient, reliable information to accurately assess the risk the PBOs pose on a "top down" organization-wide basis. Therefore, this guidance addresses the lack of a "group-wide" supervisory approach by:

- Providing a supervisory definition of presumed control to identify a PBO,
- Clarifying that the entities that comprise a PBO may or may not be affiliated,
- Explaining how to determine whether intra-company transactions are subject to regulatory restrictions,
- Illustrating a complex PBO business structure,
- Describing the supervisory risks such relationships can pose to the associated bank in the U.S., and
- Discussing the methodology for conducting a risk assessment that analyzes a PBO on a "group-wide" basis.

Supervisory Control Definition

Identifying a PBO is difficult because control, based on common ownership, management, or decision-making authority, often is not clear. A review of applicable regulations and/or policies in the U.S. and abroad yielded several differing definitions of control. The lack of a globally-accepted and easily-understood definition of control complicates the identification of PBOs.

In April 2002, the U.S. banking agencies adopted the Joint Agency Statement on PBOs addressing inconsistencies in the definition of control specifically for PBOs and to facilitate their detection. It states, in part, that the U.S.

holding company or savings and loan holding company controls the U.S. depository institution, and the holding company, in turn, is controlled by a person or group of persons who also controls a foreign bank.

⁵ The FBSEA was enacted in 1991 to improve the degree of supervision of foreign banks operating in the U.S. As a result of FBSEA, an Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations (the FBO Supervision Program) was established and applied to all FBOs with a presence in the U.S.

banking agencies consider whether an individual, family, or group of persons acting in concert “control⁶” 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.

A supervisory definition of presumed control is derived from applying the criteria in the April 2002 Joint Agency Statement on PBOs to the ownership structure of a foreign bank. Thus, if the individual, family, or group of persons acting in concert controls 10 percent or more of any class of the voting shares of both the U.S. bank and the foreign bank, then the individual, family, or group of persons is presumed to control both organizations. This approach provides an objective standard for ascertaining if a PBO relationship exists, which bank officials can rebut.

If the 10 percent or more stock ownership threshold is not met, the presence of certain other characteristics may nonetheless 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;
- 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 any one of the subjective characteristics, by itself, is unlikely to indicate that an individual, family, or group of persons exert sufficient influence to control the U.S. depository institution and the foreign bank, the presence of a combination of them may indicate that a PBO relationship does exist. For example, Mr. Jones owns 10 percent of a U.S. bank holding company, which, in turn, wholly-owns a U.S. depository institution. Separately, Mr. Jones owns/controls 4 percent of a foreign bank. Mr. Jones also either serves as a director or executive officer at both institutions and/or serves on a committee that establishes policy for both banks. This scenario strongly suggests that Mr. Jones exerts a controlling influence over both organizations even though he does not meet the 10 percent stock ownership threshold.

However, the 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.

PBO versus Affiliate Relationships

A key issue with PBOs is that affiliation, either through common ownership or management, often is not clear. The preceding supervisory definition of presumed control is provided for identifying a PBO for supervisory monitoring purposes only. An individual, family, or group of persons 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 criteria to be considered affiliates, as specified in the Federal Reserve Act (FRA).

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 would not be subject to the FRA. However, non-affiliated PBOs can not be disregarded because such relationships can pose the same or greater risks than those from affiliated PBOs.

The FRA⁷ 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(1)(C) defines an affiliate of a U.S. bank to include any company that is **controlled directly or indirectly** by

⁶ A variety of presumptions and technical rules apply to determinations of control.

⁷ See 12 U.S.C. §§ 371c, 371c-1.

shareholders who also directly or indirectly control the bank. Section 23A(b)(3) defines control as:

1. having the power to vote 25 percent or more of any class of voting securities of the U.S. bank;
2. controlling the election of a majority of the directors of the U.S. bank; **or**
3. receiving a determination that the shareholder or company exercises a controlling influence over management or policies of a U.S. bank from the Federal Reserve Board.

This definition differs from the supervisory definition of presumed control used to identify a PBO primarily in the percentage of stock the beneficial owner(s) controls. 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-bank⁸ exemption as it requires ownership by a holding company.

For example, Mr. Jones 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 subject to the restrictions in the FRA. If Mr. Jones owned/controlled 12 percent of each institution's outstanding stock, then the two entities would not be affiliated per the FRA, but a PBO would exist.

If the beneficial owner(s)'s stock ownership or voting rights are less than 25 percent, then the next criteria must be reviewed. Item (2) considers whether the beneficial owner(s) controlled the election of a majority of the directors. Section 23A(b)(1)(C) further defines an affiliate as any company in which a majority of its directors constitute a majority of the persons holding any such office with the U.S. bank. If an individual, family, or group of persons acting in concert control the election of a majority of both institutions' boards; or, constitute a majority of both a U.S. bank's and a foreign bank's directorate, then a PBO and an affiliate relationship exist and the FRA is applicable.

For example, Mr. Jones, his son, and his brother 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.

If neither the beneficial owner(s)'s stock ownership/voting rights percentage nor the board's election thresholds are met, then item (3) must be considered. If the Federal Reserve Board determined that the shareholder/company exercises a controlling influence over the management or policies of the bank, then a PBO and an affiliate relationship exist and the FRA applies. In addition, the FRA states a person is presumed to have control if the company or shareholder, directly or indirectly, or acting through one or more persons, owns or controls 15 percent or more of the equity capital of the company unless the company or shareholder provide information acceptable to the Board to rebut this presumption of control.

It is important to note, however, that any transaction by the U.S. bank with any person, where the proceeds of the transaction are used for the benefit, or are transferred to, an affiliated entity, it is considered a covered transaction for purposes of Section 23A(a)(2). Furthermore, despite the absence of regulations governing transactions between the U.S. bank and the foreign bank, transactions must nonetheless conform to reasonable business terms and practices. Any abuses or questionable practices are subject to criticism.

PBO versus Related Interests of Insiders

An individual, family, or group of persons acting in concert may exercise sufficient control to meet the preceding supervisory definition of presumed control for establishing that a PBO exists; but, not meet the criteria to be considered affiliates, as contemplated by the Federal Reserve Board's Regulation O.⁹ Regulation O restricts extensions of credit to the related interests of executive officers, directors, and principal shareholders, collectively known as bank insiders. The FDIC made virtually all of these restrictions applicable to state nonmember banks in the FDI Act.¹⁰ 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.

The definition of control is of great importance. Regulation O provides a similar but not identical definition of control as does the FRA as follows:

⁹ 12 CFR Part 215.

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

⁸ See 12 U.S.C. §§ 371c, 371c-1, Section 23A(d).

1. 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. exercising a controlling influence over the management or policies of the company or bank.

Please note that the first two items are very similar to those on the previous page from the FRA. Item three 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 bank in the foreign country, then the same situation exists as under item (1) of the FRA and all transactions with related interests would be subject to the restrictions established in Regulation O.

If the beneficial owner(s)'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 shareholders 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

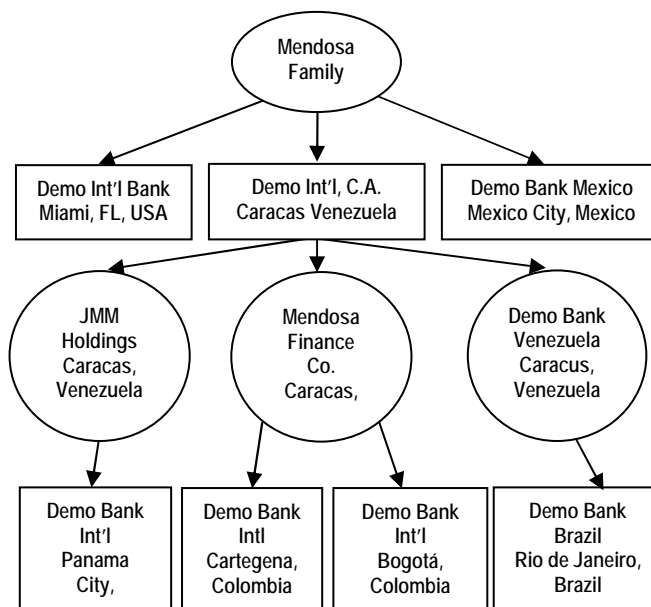
a greater percentage of that class of voting securities.

Ascertaining whether an individual, family, or group of persons acting in concert exercises a controlling influence over the management or policies of the bank is difficult to determine. If the criteria in either item (a) or item (b) above are met, then a PBO exists and all transactions with related interests would be subject to the restrictions of Regulation O.

An individual, family, or group of persons 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. Despite the absence of regulations governing these transactions, these dealings must nonetheless conform to reasonable business terms and practices. Any abuses or questionable practices are subject to criticism.

Business Structures

A PBO can have a simple or a complex business structure or organization chart. A simple PBO business structure consists of an individual who directly controls both a U.S. depository institution and a foreign bank. However, PBOs often exhibit a complex organizational structure that 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 who collectively exercise a controlling influence throughout the PBO. The following is an illustration of a complex PBO structure.



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

Complex PBOs also could be part of privately held multinational 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 scarce. Conversely, PBOs can be part of large multi-national conglomerates that are publicly traded and where financial services are typically not a main activity of the enterprise. In these structures, information on ownership, operations, and affiliations is more readily obtainable.

Supervisory Risks

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. From a regulatory perspective, the risks presented by PBOs may be greater than those 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 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. The Core Principles¹¹ of the Basel Committee on Banking Supervision requires banks to be supervised on a consolidated basis to minimize the leveraging of capital, ensure that risks are managed on a group-wide basis, and mitigate the risk of contagion within a banking group.

However, the beneficial owner(s) of a PBO may be an individual, family, group of persons acting in concert, or a holding company¹² that is seeking entry into the U.S. market, but is not subject to comprehensive consolidated supervision by their home country supervisors before establishing a banking presence in the U.S.

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; and, 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 harder to understand and monitor.

PBOs may foster other management and supervisory risks:

- Concentrations of risk on a group level may be inadequately monitored or managed, exposing the entire organization to excessive risk in the event of an external shock affecting a specific market or sector.
- Officers and directors of the U.S. depository institution may be unable or unwilling to exercise independent control to ensure that transactions with the foreign bank or affiliates are legitimate and comply with applicable laws and regulations. As a result, the U.S. depository institution may be the conduit or participant in a transaction that violates U.S. law or the laws of a foreign country; or, that is designed to prefer a foreign bank or non-bank entity in the group to the detriment of the U.S. depository institution.
- The home country of the foreign bank may have insufficient mechanisms or authority to monitor changes in ownership or to ensure arm's-length inter-company transactions between the foreign bank and other members of the group, including the U.S. depository institution, or monitor concentrations of loans or transactions with third parties that may present safety and soundness concerns to the group.
- Money-laundering concerns may be heightened due to the potential lack of arm's-length transactions between the U.S. depository institution and the foreign bank. Specifically, the flow of funds through wires, pouch activity, and correspondent accounts may be subject to less internal scrutiny by the U.S. depository institution than usually is warranted. This risk is greatly increased when the foreign bank is located in an offshore jurisdiction or other jurisdiction that limits exchange of information through bank secrecy laws, especially if the jurisdiction has been designated as a "non-cooperating country or territory" or the jurisdiction or the foreign bank has been found to be a money-laundering concern under the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001.
- Securities, custodial, and trust transactions may be preferential to the extent that assets, earnings, and losses are artificially allocated among the parallel banks. Similarly, low-quality assets and problem loans can be shifted among parallel banks to manipulate earnings or losses and avoid regulatory scrutiny. In addition, the common owners or the foreign bank might pressure the U.S. depository institution to provide liquidity or credit support in excess of legal limits to the foreign bank if it were experiencing financial difficulties.

¹¹ Basel Committee on Banking Supervision Core Principles, Cross-Sectoral Comparison. November 2001.

¹² A "holding company" excludes any entity that is part of a "recognized financial group."

- Political, legal, or economic events in a foreign country may affect the U.S. depository institution. For example, the intervention and assumption of control of the foreign bank by its supervisor may trigger a rapid inflow or outflow of deposits at the U.S. depository institution, thereby affecting liquidity. Foreign events could increase the U.S. depository institution's reputation risk. These events also may adversely affect the foreign bank owner's financial resources and decrease the ability of the foreign bank owner to provide financial support to the U.S. bank. In addition, foreign law(s) may change without the U.S. depository institution or banking agencies becoming aware of the effect of these legal changes on the U.S. bank.
- PBOs may seek to avoid legal lending limits or limitations imposed by securities or commodities exchanges or clearinghouses on transactions by one counterparty, thereby unduly increasing concentration and credit risk to the banking entities within the organization and others.
- Capital may be generated artificially through the use of international stock-purchase loans. Such loans can be funded by the U.S. depository institution directly to the foreign bank; or, to a non-bank affiliate with the purpose of shifting the funds back to the foreign bank, leveraging the U.S. depository institution or vice versa. As a result, capital for one of the parallel banks is increased even though there is no external capital injection into either bank. This concern is elevated if the foreign bank is not subject to comprehensive supervision.

To minimize these risks, the U.S. bank regulatory agencies collectively developed best practices for identifying these entities and supervising the risks that PBOs present, which were incorporated into industry guidance and examination programs. In addition, the U.S. regulatory agencies will coordinate their supervision of a PBO's U.S. operations by:

- Working with appropriate U.S. and non-U.S. supervisors to better understand and monitor the activities of the foreign banks and the owners;
- Sharing information regarding material developments with foreign and domestic supervisory agencies that have supervisory responsibility over relevant parts of the PBO, as appropriate, feasible, and in accordance with applicable law; and
- Imposing special conditions or obtaining special commitments or representations related to an application or other supervisory action, when warranted.

Examination Guidance

Gaining a comprehensive understanding of a PBO's structure and any supervisory risk that it presents will be an examiner's main priority and greatest challenge inasmuch as these organizations are complex, and their ownership can be vested in cross-border, multi-tiered companies that can be difficult to analyze. To complicate matters, financial reporting in foreign countries often can be opaque and may not adhere to generally accepted accounting principles.

In developing the examination strategy for a U.S. bank that is part of a PBO, the examiner should consider any risks arising from the lack of consolidated supervision, especially if the U.S. bank actively engages in business activities with its foreign bank. The U.S. bank's board of directors and senior management are expected to be cognizant of the risks associated with being part of a parallel-owned banking structure, especially with respect to diversion of a depository institution's resources, conflicts of interest, and affiliate transactions. The depository institution's internal policies and procedures should provide guidance on how personnel should treat transactions between PBOs. The U.S. banking agencies will expect to have access to such policies, as well as to the results of any audits of compliance with the policies. The examiner may want to contact the International Section to obtain current information on the condition of the foreign bank and any supervisory concerns or developments in the home country that may adversely affect the U.S. bank.

It is important to recall that the companies that comprise the PBO may or may not be affiliates of the U.S. bank. Where an affiliate relationship exists, the Federal Reserve Act is applicable. If an affiliate relationship is absent, transactions should adhere to customary business and banking principles. Likewise, Regulation O may or may not be applicable to transactions between U.S. bank's insiders and the foreign bank. Examiners should scrutinize transactions between the entities in a PBO for adherence with applicable laws and prudent banking practices.

Examiners should evaluate the U.S. bank's relationship with the other companies within the PBO and determine whether the relationship has had, or is likely to have, a negative impact on the U.S. bank. Appropriate supervisory action should be taken to address any conditions or abusive practices that can adversely affect the U.S. bank. Regulatory authorities can also develop a strategy to work with home country supervisors to stay informed of developments associated with the organization and to share information.

If the examiners' review represents the initial identification of a PBO, the examiner should contact the International Section to discuss the facts and circumstances surrounding the bank. The examiner should contact the DSC Associate Director of the International and Large Bank Branch if the analysis determines that a modification to an existing parallel bank structure has occurred, i.e. the beneficial owner(s) sold its interest in the U.S. or foreign bank.

In all instances where a PBO relationship is possible, the examiner should complete the Parallel-owned Banking Organizations page. Examiners should consider all of the issues detailed in the Parallel-owned Banking Organizations page to ascertain whether a PBO exists. If the examiner determines that a PBO does not exist, the Parallel-Owned Banking Organizations page should be maintained in the examination workpapers to document the basis of the examiners' conclusion. If the examiner determines that a PBO does exist, the Parallel-Owned Banking Organizations page should be maintained in the examination workpapers unless an adverse trend is noted. The page should be included in the Report of Examination if any adverse trends are noted within the PBO relationship.

Upon the examination's completion, the region should forward the Parallel-Owned Banking Organizations page, whether it is included in the Report of Examination or not, with a cover letter to the DSC Associate Director of the International and Large Bank Branch. Refer to the Report of Examination Instructions and the International Section in ED Module for additional guidance.

LAWS AND REGULATIONS

Several laws and regulations govern certain international activities of banks and some are discussed briefly in this section. Examiners should be familiar with these laws and will find it useful to refer directly to them. They have been made available to the field staff either in the Prentice-Hall volumes or in memorandum form, both of which are accessible on the Examiner Reference CD.

Part 347 of the FDIC's Rules and Regulations covers international banking. Briefly, Subpart A of Part 347 (and corresponding sections of Part 303) implements Sections 18(d) and 18(l) Federal Deposit Insurance 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. The FDIC's external website identifies foreign countries where state nonmember banks have subsidiaries and branches. This site will specifically inform the applicant whether expedited processing is available or not.

Subpart B of Part 347 implements Section 6 of the International Banking Act of 1978 and governs FDIC insured branch operations of FBOs. This section establishes asset pledge and asset 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). The section deals with the establishment of an Allocated Transfer Risk Reserve (ATRR) and accounting for and reporting of international loans and assets.

The provisions of Part 347 are similar to those contained in Regulation K of the Board of Governors of the Federal Reserve System which is applicable to member banks. State nonmember banks which operate foreign branches or subsidiaries are regulated by Part 347. Regulation K applies primarily to member banks but it does govern Edge or Agreement Corporations operated by nonmember banks.

FinCEN Advisories and OFAC

The Financial Crimes Enforcement Network (FinCEN) occasionally issues advisories on countries that the Financial Action Task Force on Money Laundering (FATF) has determined to be noncooperative in the fight against money laundering. Upon receiving an advisory, banks are expected to closely scrutinize any transactions of their customers with these countries. A listing of FATF's Noncooperative Countries and Territories (NCCTs) can be found FATF's website. FinCEN advisories can be found on FinCEN's website.

The Department of Treasury's Office of Foreign Asset Control (OFAC) enforces embargoes and sanctions by the U.S. against foreign countries. Typically, the President initiates these actions through an executive order based upon authority granted to the Executive Branch by acts of Congress. In addition, a number of individuals and entities have been specifically designated as narcotics traffickers, terrorists, or engaged in the proliferation of weapons of mass destruction. Banks that identify a transaction dealing

with one of these countries or specially designated nationals (SDNs) are to block the transaction or freeze the account and notify OFAC of their actions. Violations of OFAC regulations carry substantial civil and criminal penalties. Examiners typically review OFAC compliance as part of Bank Secrecy Act examinations. Current listings of OFAC regulations and SDNs can be obtained at OFAC's website. Additional information on OFAC is available in the various Financial Institution Letters to Chief Executive Officers, in the Bank Secrecy Act section of this Manual, or in the Examination Documentation (ED) module for Anti-Money Laundering/Bank Secrecy Act.

USA PATRIOT Act

On October 26, 2001, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT Act) was signed. A number of implementing regulations deal with foreign shell banks and foreign correspondent banking relationships became effective on December 26, 2001.

The Department of the Treasury's Financial Recordkeeping rules prohibit *covered financial institutions* from maintaining correspondent accounts in the U.S. with a foreign shell bank that is not a regulated affiliate. A *covered financial institution* includes an agency or branch of a foreign bank operating in the U.S. and Edge and Agreement Corporations. A foreign bank is one that is organized under foreign law, or an agency, branch or office of a bank located outside the U.S. A *foreign shell bank* is defined as a foreign bank that does not have a *physical presence* in a country. A *physical presence* is defined as a place of business that is maintained by a foreign bank located at a physical address (not solely an electronic address or a post office box). The address must be in a country in which the foreign bank is authorized to conduct banking business, employs one or more individuals on a full-time basis, maintains operating records related to its banking activities, and is subject to inspection by the banking authority that licensed it to conduct banking business.

The Financial Recordkeeping rules also require covered financial institutions to take reasonable steps to obtain ownership information and a certification from foreign banks with which correspondent accounts are maintained that the account is not being used indirectly by a foreign shell bank. If the ownership information and certification by the foreign bank are not provided, covered financial institutions are required to close these correspondent accounts. Once every three years, the covered financial institution must obtain a recertification from the foreign

bank providing ownership information and attesting the account is not being used indirectly by a foreign shell bank. Foreign banks are required to appoint an agent in the U.S. to accept service of legal process for foreign bank records concerning the correspondent account. Additional information on the USA Patriot Act is available in the Department of the Treasury's Financial Recordkeeping rules and regulations in the Prentice-Hall volumes or in various memorandum form (both on the Examiner Reference CD), in the Bank Secrecy Act section of this Manual, or in the ED module for Anti-Money Laundering/Bank Secrecy Act.

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 contains a number of provisions. First, companies subject to the jurisdiction of the Securities and Exchange Act of 1934 are required to maintain strict accounting standards and management control over their assets. The falsification of accounting records to conceal corrupt payments is prohibited. Second, the Act makes it a crime for a U.S. company, or individuals acting on behalf of a company, to bribe foreign officials or foreign political candidates or parties for the purpose of acquiring or retaining business. However, facilitating or so-called "grease" payments are not prohibited. Grease payments generally are those payments for expediting shipments through customs, securing required permits, or obtaining adequate police protection even though such payments may involve the payment of money for the proper performance of duties. The legislative history of the Act recognizes that, in some countries, payments to expedite or implement bureaucratic processing are customary practices.

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 which 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.

GLOSSARY OF INTERNATIONAL BANKING TERMINOLOGY

The following glossary of international banking terminology will assist examiners during examinations of banks' international operations and in completing required reports.

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 his or her 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-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 – A drawing or payout of funds representing the disbursement of a loan, including disbursement in stages. In international banking, an extension of credit usually recurring, when no instrument (other than a copy of the advice of an advance) is used as evidence of a specific indebtedness, except in special cases. A signed agreement must be on file in the department, stating the conditions applicable to payments made to the borrower. This loan category does not include commercial account overdrafts, but may be created to finance payments affected under a

commercial letter of credit, to finance payments of collections or to refinance a maturing loan.

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

Advised Letter of Credit – See Letter of Credit Advised.

Advised Line – A credit authorization that will be made known to the customer. See also guidance line.

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.

Agreement Corporation – A company chartered or incorporated under State law that, like an Edge Act corporation, is principally engaged in international banking. See also Edge Act.

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 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 (SDRs), gold, or some other denominator. Second, the member can by cooperative arrangement 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.

At the Money – A term used to refer to a call or put option whose strike price is equal (or virtually equal) to the current price of the asset on which the option is written.

Authority to Pay – An advice from a buyer, sent by his or her 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 (defined below).

Bankers' Acceptance – A time draft that has been drawn on and accepted by a bank. The bank accepting the time bill becomes primarily liable for payment. See also acceptance.

Bankers' Acceptance Liability – The moment the draft is accepted by the bank, a direct liability is recorded in its "Acceptances Executed" account. The contra account on the asset side of the balance sheet is "Customer's Liability on Acceptances." On the date of maturity of the bankers' acceptance, the bank charges the customer's account and retires the acceptance by paying the beneficiary or drawee of the draft. The bank's liability records are liquidated at this point, and the transaction is completed.

Barter – The exchange of commodities using merchandise as consideration instead of money. This scheme has been employed in recent years by countries that have blocked currencies.

Base Rate – A rate used as the basis or foundation for determining the current interest rate to be charged to a borrower, such as the prime rate or London Interbank Offered Rate.

Basel Capital Accord – 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 to take into account bank risk exposure.

Basel Committee on Bank Supervision – The Committee was established by the central bank Governors of the G-10 countries in 1975. It consists of 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, and the U.S. The Committee usually meets at the Bank for International Settlements (BIS) in Basel, where its permanent Secretariat is located.

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-asked Spread – The difference between a bid and the asked 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 his or her 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.

- **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.
- **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.
- **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. However, the mention of the consignee's name does not confer title to the merchandise.
- **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.
- **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.
- **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.

Black Market – A private market that operates in contravention of government restrictions.

Blocked Account – An account from which payments, transfers, withdrawals, or other dealings may not be made without Office of Foreign Asset Control (OFAC) or U.S. Treasury Department approval. Although the bank is prohibited from releasing funds from these accounts, deposits may be accepted. Banks are subject to significant fines for releasing funds from blocked accounts.

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

Blocked Exchange – Exchange which 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.

Bulldog Bonds – British pound sterling denominated foreign bonds issued in London.

Boycott – An organized ban on the purchase of goods or services of a particular country or company for political or economic reasons. Bankers need to remain cognizant of the Export Administration regulations addressing restrictive trade and boycotts.

Buyer's Option Contract – When the buyer has the right to settle a forward contract at his or her 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.

Cable – A message sent and delivered by an international record carrier via satellite or cable connections to a foreign country. "Cable" also includes messages transmitted by bank telex. The terms "cable" and "telex" are generally used interchangeably.

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.

Cedel – One of two main clearing systems in the Eurobond market, Cedel, based in Luxemburg, began operations in 1971 and established Cedel Bank, a clearing bank chartered in Luxemburg.

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 (i.e. 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 to products of certain countries.

Chain – A method of calculating cross rates. For example, if a foreign-exchange trader knows the exchange rate for German marks against U.S. dollars and for French francs against U.S. dollars, the "chain" makes possible the calculation of the cross rates for German marks against French francs.

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 contemplated.

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 insurances 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. They 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.

Clearing Corporation – A clearinghouse that exists as an independent corporation rather than as a subdivision of an exchange.

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.

Clearing House Interbank Payments System (CHIPS) – A computerized telecommunications network provided by the New York Clearing House Association, which serves as an automated clearinghouse for interbank funds transfers.

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

Closing a Position – Covering open long or short positions by means of a spot operation and/or outright forward 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.

Confirmation – Written communication to the counterparty in a foreign exchange transaction which recites all the relevant details agreed upon by phone or telex.

Consular Documents – Bills of lading, certificates of origin, or special forms of invoice which 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 a 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 Limit – The amount of money that a bank has established as the maximum it is willing to lend borrowers in a given country regardless of the type of borrower or the currencies involved.

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 his or her 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 value 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-term and long-term capital flows are excluded as they are included in the capital account balance.

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 (SDRs), or a currency. After devaluation, there are more devalued currency units relative to the dollar, gold, SDRs, 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. The government, however, 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 .0030 and .0275, the forward quotes would be adjusted to \$2.3700 and \$2.4225. This discount usually represents differences in interest rates in the U.S. and Britain. However, in periods of crisis for a currency, the discount can represent the market anticipation of a lower price.

Divergence Indicator System – One aspect of the European Monetary System that measures the departure of a country's economic policies from the European Union's "average." The measure of divergence is based exclusively on the movement of a country's exchange rate with respect to the European Currency Unit (ECU).

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 his or her acceptance of the draft.

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

Dragon Bond – A bond issue by a foreign borrower in an Asian or Pacific country excluding Japan.

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

Drawer – The issuer or signer of a draft.

Edge Act – An act passed December 24, 1919, as Section 25A of the Federal Reserve Act, with the title "Banking Corporations Authorized to do Foreign Banking Business." Edge Act Corporations are chartered by the Board of Governors of the Federal Reserve System for 20 years with a minimum capital of \$2,000,000. Edge Act Corporations finance international commerce, may operate interstate branches, accept deposits outside the U.S., and invest in non-U.S. firms. A nonbanking Edge Act Corporation makes equity investments under Federal Reserve Regulation K in foreign corporations, such as merchant banks or finance companies. A banking Edge buys and sells notes, drafts, and bills of exchange, and basically complements the international banking activities of its parent bank.

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 – The nonresident ownership of one of the major western European currencies. Eurocurrencies, similar to Eurodollars, are frequently available for borrowing in the London Interbank Market.

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 of the 25-member European Union (EU). The Eurosystem consists of each member's national central banks (NCBs) headed by the ECB. The 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 for the Euro area (not all members of the EU have opted for monetary integration), to conduct foreign exchange operations, and to maintain the EU payment systems. The ECB is headed by the Governing Council (composed of the Executive Board and the governors of each of the NCBs).

European Currency Unit (ECU) – A portfolio currency used in the European Monetary System as a community "average" exchange rate. It is also used in the private market as a means of payment and as a currency of denomination for lending, borrowing, and trade.

European Union (EU) – A free trade area consisting of 25 European nations with the ultimate goal of achieving political and economic integration. The ECB is the central bank of the EU. Effective January 2002, the euro is the currency of the EU for those member nations that have opted for the monetary union. The principal aspects of the EU are to establish a European citizenship; to ensure a common system of justice and security; to create a single European market and currency and increase jobs; to promote regional development; and to promote European interests in the world. Member nations give up certain aspects of their national sovereignty to institutions that represent the entire EU. In return, EU members achieve common law, freedom of movement, reduced barriers to trade, and strengthened external security. The original member countries are Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden, and the United Kingdom. In May 1, 2004, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia joined the EU.

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 convertible foreign 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 noncommercial risks can be insured.

Export-Import Bank of the United States (Ex-Im Bank) – Established in 1934 as an independent Federal agency, Ex-Im Bank provides intermediate and long-term non-recourse 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 a number of other useful programs such as export credit insurance. Further details about the Ex-Im Bank and their programs can be found at <http://www.exim.gov>.

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. Subpart C of Regulation K of the Federal Reserve provides guidance and restrictions for these companies.

Financial Action Task Force (FATF) – Task Force on Money Laundering created by the leaders of the G-7 countries and the President of the European Communities in 1989. The FATF is overseeing international efforts to combat money laundering and terrorist financing. The FATF presently has 28 member countries. The FATF also supports the activities of other international organizations that share the same goals (i.e., the Asia/Pacific Group, Caribbean Financial Action Task Force, the Egmont Group of Financial Intelligence Units, and the Wolfsberg Group

of Banks). As an international policy-making body, the FATF reviews country compliance with its Forty Recommendations: A Global Framework for Combating Money Laundering. Those countries determined to be noncooperative in the fight against money laundering are blacklisted. In the U.S., FinCEN advises banks to closely scrutinize any transaction with these noncooperative countries by their customers.

Financial Intelligence Unit (FIU) – FIUs are central repositories and clearing houses for reports of financial crimes to be used for disseminating information to law enforcement and regulatory agencies. FIUs also provide a country gateway for information sharing and international cooperation with the law enforcement and regulatory agencies in other countries. The FATF in its Forty Recommendations: A Global Approach for Combating Money Laundering encourages every country to establish a FIU. The Financial Crimes Enforcement Network (FinCEN) is the FIU for the U.S.

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 (SDRs). 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, SDR's 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 ceiling vis-a-vis the dollar, gold, SDR's 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 Bank Supervision Enhancement Act (FBSEA) – Part of the FDIC Improvement Act of 1991, FBSEA mandated oversight of FBOs by the Federal Reserve. The Federal Reserve Board coordinates the examinations of

FBOs with the other Federal agencies and with the various State banking authorities.

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 Market – Communications between dealers and brokers to transact wholesale business in foreign exchange and Eurocurrencies.

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 which usually include gold and easily traded currencies of major industrial nations.

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 aggregated 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 whose forward price is more expensive than its spot price. Also referred 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 his or her 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 his or her 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 reexport 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.”

Free Trade Area of the Americas (FTAA) – A movement by 34 member countries initiated in 1994 to integrate the Western Hemisphere into a single free trade area. The goal of the FTAA is to reduce trade and investment barriers between member countries.

Negotiations to form the FTAA are still in process but are supposed to be finalized by January 2005. Implementation of the FTAA is to begin as soon possible thereafter with the ultimate goal of achieving the FTAA by December 2005.

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 which he or she may need or may be due in the future.

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, Luxembourg, the Netherlands, Sweden, the United Kingdom, and the U.S.. Switzerland joined in 1984, but the name remains as is.

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 (HIPC) – 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 HIPC's. 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 August 2002, the IMF identified 41 countries as HIPC's, with most of the nations being in Africa.

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 policy of national treatment of foreign banks with regard to their operations in the U.S.

International Banking Facility (IBF) – 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 Lending Supervision Act (ILSA) – Enacted in 1983, the act requires U.S. banking agencies to consult with bank supervisory authorities in other countries to achieve consistent policies and practices in international lending.

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.

Intracountry 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.

Issuing Bank – Also known as the opening bank. The buyer's bank which issues a letter of credit.

Latin American Integration Association (LAIA) – Replaced LAFTA in 1981 and its purpose 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 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.

- **Confirmed Irrevocable Letter of Credit** – A letter of credit in which a bank in addition to the issuing bank is responsible for payment.
- **Irrevocable Letter of Credit** – A letter of credit in which the issuing bank waives all right to cancel or in any way amend without consent of the beneficiary or seller.
- **Revocable Letter of Credit** – A letter of credit in which the issuing bank reserves the right to cancel or amend that portion of the amount that has not been demanded before the actual payment or negotiation of drafts drawn.
- **Revolving Letter of Credit** – A letter of credit in which the issuing bank notifies a seller of merchandise that the amount of credit when used will again become available, usually under the same terms and without the issuance of another letter.
- **Special Clauses** –
 - **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.
 - **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.
 - **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 that the required

documents have been received and are being forwarded.

Letter of Credit - Confirmed – A letter of credit issued by the local bank of the imported 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 - 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 recorded 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 in part to any party.

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, however named or described, that represents an obligation to the beneficiary on the part of the issuer to:

- repay money borrowed by or advance 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 - 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.

Limits – Maximum line amounts by bank name with other banks for forward exchange transactions; Eurocurrency and Eurodollar transactions, and payments arising from foreign exchange transactions on the same day.

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 – Current accounts banks hold with foreign banks in a foreign currency on behalf of their 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 not

merely for losses arising from fire, but also from piracy, wreck, and most 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. However, 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.

Maturity Gap (Gap) – Mismatched asset and liability maturities creating periods of uneven cash inflows and outflows. A substantial inflow of a particular currency over a prolonged period may result in excess idle funds for which no investment or sale has been arranged. This could mean a loss of income on the idle funds for that period and/or of be amount by which the value of that currency is expected to appreciate or depreciate. Conversely, substantial outflows prior to the maturities of offsetting assets may necessitate purchasing or borrowing the required currency for that period (gap) at substantially higher rates. Thus, the bank is exposed to the risk of rate changes between the time the gap was created and the date it is actually closed.

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 on the basis of 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 on the basis of a "4 + 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 French francs made in London or a contract for U.S. dollars against German marks made in New York. 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 which 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 which 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.

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.

Office of Foreign Asset Control (OFAC) – An office within the U.S. Treasury Department that administers U.S. laws imposing economic sanctions against targeted hostile foreign countries. While OFAC is responsible for administration of these statutes, all of the bank regulatory agencies cooperate in ensuring compliance.

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.

Opening Bank – The bank that draws up and opens the letter of credit and that makes payment according to the conditions stipulated.

Option Contracts – A contract giving the purchaser the right, but not the obligation, to buy (call option) or sell (put option) an asset at a stated price (strike or exercise price) on a stated date (European option) or at any time before a stated date (American option).

Organization for Economic Cooperation and Development (OECD) – An organization of 30 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.

Other Transfer Risk Problems (OTRP) – A category assigned by ICERC for countries near default or in noncompliance with their debt requirements.

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.

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.

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 which 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. However, 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 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.

Reserve Requirements – Obligations imposed on commercial banks to maintain a certain percentage of deposits with the central bank or in the form of central bank liabilities.

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.

Samurai Bonds – Yen-denominated bonds issued by a foreign borrower in Japan.

Sanctions – A coercive governmental action that restricts trade with a specific country (i.e. 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 his or her option anytime within a specified period.

Shell Branch – See offshore branch.

Shogun Bonds – Foreign bonds issued in Tokyo and denominated in currencies other than the Japanese yen. The usual denomination is the U.S. dollar.

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 the selling of it for a profit in another market.

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

Specially Designated Nationals – Persons or entities listed by OFAC. These persons or entities are typically front organizations and are subject to OFAC prohibitions.

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 the 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.

Subsidiary – In the context of banking, an entity in which a bank has a degree of control. Used to facilitate entry into foreign markets in which other operations are proscribed.

Sushi Bonds – Dollar-denominated Eurobonds issued by Japanese companies and purchased primarily by Japanese investors. These bond issues are typically managed by Japanese banks.

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 funds into another currency and back again in a “swap” transaction. 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 enables 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.

Tariff – A duty or tax on imports of goods or services that can be either a percentage of cost or a specific amount per unit of import.

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. Foreign currency time (usance) drafts are also bought at the TT rate, but interest to maturity is deducted for the time which must elapse until maturity.

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

Tenor – Designation of payment of a draft as being due at sight, a given number of days after sight, or a given number of days after the date of the draft.

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. A test key generally consists 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 – Banker's acceptances issued by banks in one country that finance the transport or storage of goods traded between two other countries.

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.

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. See also tenor.

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 lists and is a receipt for goods or commodities deposited in the warehouse which 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 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.

Withholding Tax – A tax imposed by a country on the gross amount of payments to a foreign lender from an in-country borrower.

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 outstandings 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.

Zero Coupon – A bond that pays no interest but that is redeemed at its face value at maturity.