FEDERAL RESERVE BANK
OF DALLAS

TONY J. SALVAGGIO
FIRST VICE PRESIDENT

DALLAS, TEXAS 75222

October 8, 1992

Notice 92-97

TO: The Chief Executive Officer of each member bank and others concerned in the Eleventh Federal Reserve District

SUBJECT

Federal Reserve Policy Statement on Payments System Risk

DETAILS

The Board has compiled an updated, comprehensive statement of its previously-adopted policies regarding payments system risk reduction, including policies to control Federal Reserve risk, policies for private-sector networks, and other related policies. This statement incorporates all of the policy modifications adopted by the Board since the last published comprehensive statement in 1987, and supersedes all other published statements. No new policies are included in this compilation. The effective date of the policy statement was August 20, 1992.

The revised policy statement refers to a Users' Guide, which was distributed to depository institutions in March 1988 to assist them in implementing the Board's policies as they appeared in the 1987 policy statement. New Users' Guides reflecting current policies are now in the process of being prepared. They will be made available to depository institutions in this District upon publication.

ATTACHMENT

A copy of the Board's notice as it appears on pages 40455-66, Vol. 57, No. 172, of the Federal Register dated September 3, 1992, is attached.

MORE INFORMATION

For more information, please contact the DFI Monitoring Division at (214) 922-5584 or 922-5585. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely,

Tony J. Salvaggio

FEDERAL RESERVE SYSTEM

Federal Reserve Policy Statement on Payments System Risk

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy statement.

SUMMARY: The Board has compiled an updated, comprehensive statement of its previously-adopted policies regarding payments system risk reduction, including policies to control Federal Reserve risk, policies for private-sector networks, and other related policies. This statement incorporates all of the policy modifications adopted by the Board since the last published comprehensive statement in 1987, and supersedes all other published statements. No new policies are included in this compilation.

EFFECTIVE DATE: August 20, 1992.

FOR FURTHER INFORMATION CONTACT: Florence M. Young, Assistant Director (202/452-3955), Division of Reserve Bank Operations and Payment Systems; Stephanie Martin, Senior Attorney (202/452-3198), Legal Division. For the hearing impaired *only*: Telecommunications Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION: During the past seven years, the Federal Reserve System has developed a program to address payments system risk. Risk can arise from transactions on the Federal Reserve's wire transfer system (Fedwire), from other types of payments, including checks and automated clearing house (ACH) transactions, and from transactions on private large-dollar networks that permit their participants to transmit payment messages throughout the day with settlement of net positions at the end of the day. The Federal Reserve has addressed primarily large-dollar payments systems but has also developed policies regarding certain small-dollar systems, such as national ACH net settlement and ATM networks

The Federal Reserve first published a policy statement on its payments system risk reduction program in 1985 (50 FR 21120, May 22, 1985) and published an updated "interim" statement in 1987 (52 FR 29255, August 6, 1987). Since 1987, the Board has made several additions to its payments system risk reduction policy, including policies regarding private delivery-against-payment securities systems, offshore dollar-clearing and netting systems, and rollovers and continuing contracts (54 FR 26104, 26092, 26107, respectively, June 21, 1989). In 1990, the Board modified the Federal Reserve risk reduction policy with respect to book-entry securities transactions, net debit caps, capital measurements, and application of the policy to agencies and branches of foreign banks (55 FR 22087, May 31, 1990).

The Board has compiled an updated, comprehensive statement of its previously-adopted policies regarding payments system risk reduction, including policies to control Federal Reserve risk, policies for private-sector networks, and other related policies. This statement incorporates all of the policy modifications adopted by the Board since the last published comprehensive statement in 1987, and supersedes all other published statements. No new policies are included in this compilation. The policy statement is set out below:

Federal Reserve System Policy Statement On Payments System Risk

Federal Reserve System Policy Statement on Payments System Risk

Introduction

The Federal Reserve System has developed this policy statement to address payments system risk. Risk can arise from transactions on the Federal Reserve's wire transfer system (Fedwire), from other types of payments, including checks and automated clearing house (ACH) transactions, and from transactions on private large-dollar networks that permit their participants to transmit payment messages throughout the day with settlement of net positions at the end of the day. This policy statement is addressed primarily to large-dollar payments systems[1] and incorporates the Federal Reserve's policies to reduce Federal Reserve risk as well as risk on various types of private-sector networks.

The Federal Reserve Banks face direct risks of loss should depository institutions[2] be unable to settle their intraday ("daylight") overdrafts in their Federal Reserve accounts before the end of the day. Moreover, systemic risk may occur if an institution participating on a private large-dollar payments network were unable or unwilling to settle its net debit position. If this were to occur, the institution's creditors on that network might also be unable to settle their commitments. Serious repercussions could, as a result, spread to other participants in the private network, to other depository institutions not participating in the network, and to the nonfinancial economy generally. A Reserve Bank could be exposed to an indirect risk if its policies did not address this systemic risk. Finally, depository institutions create risk by permitting their customers, including other depository institutions, to transfer uncollected balances in anticipation of their coverage before the end of the day.

The Board is aware that large-dollar networks are an integral part of the clearing and settlement systems and that it is of vital importance to keep the payments mechanism operating without significant disruption. It is because of the importance of avoiding such disruptions that the Board continues to seek to reduce the risks of settlement failures that could cause these disruptions. The Board is also aware that some intraday credit may be necessary to keep the payments mechanism running smoothly and efficiently. The reduction and control of intraday credit risks, although essential, must be accomplished in a manner that will minimize disruptions to the payments mechanism. The Board anticipates that, by relying largely on the efforts of individual institutions to identify, control, and reduce their own exposures, and by establishing guidelines for use by institutions, the goal of reducing and controlling risks will not unduly disrupt the smooth operation of the payments mechanism.

The Board emphasizes that it is not condoning daylight overdrafts in Federal Reserve accounts. Although some intraday credit may be necessary, the Board anticipates that, as a result of its policies, there will continue to be a reduction in the number of institutions consistently relying on intraday credit supplied by the Federal Reserve to conduct their business. The Board also expects to continue observing, over time, a reduction in the volume of intraday credit at those institutions with a pattern of substantial reliance on such credit. The Board will continue to monitor the effect of its policies on the payments system.

The general methods used to control intraday credit exposures are explained in the policies below. These methods include caps on net debits incurred by depository institutions in their accounts at Federal Reserve Banks, collateralization, in certain situations, of overdrafts at the Federal Reserve due to book-entry securities transactions, bilateral credit limits between institutions on private large-dollar networks, and credit and liquidity safeguards for private delivery-against-payment systems. To assist depository institutions in implementing the Board's policies, the Federal Reserve has prepared a *Users' Guide* to the policy statement. The *Users' Guide* explains in detail how the policies apply to various types of depository institutions, the self-assessment procedures for establishing a net debit cap, and the role of the institutions' boards of directors in overseeing the implementation of risk reduction efforts by the institutions. Depository institutions may obtain the *Users' Guide* from their local Reserve Bank.

I. Federal Reserve Policy

A. Daylight Overdraft Definition

A daylight overdraft occurs when a depository institution's Federal Reserve account is in a negative position during the business day. The Reserve Banks use an *ex post* system to measure daylight overdrafts, calculating intraday Federal Reserve account positions as follows: At the opening of business, each institution's closing balance from the previous day is adjusted by the net of all ACH transactions. Original issues of Treasury securities[3] are posted no earlier than 9:15 a.m. Eastern Time (ET), and redemption and interest payments for Treasury and government agency securities are posted by 9:15 a.m. ET. Funds and book-entry securities transfers are posted throughout the day as they are processed. After the close of business, all other transactions, such as check and currency and coin transactions, are totalled. If the net of these transactions is a credit, it is posted as though it occurred at the opening of business; if the net is a debit, it is posted as though it occurred at the close of business.

[1] In a changing technological and regulatory environment, it is not possible or desirable to adopt an all-inclusive and permanent definition of a "large-dollar payments system" for the purposes of Federal Reserve risk control policy. In determining whether any particular system is a "large-dollar" system, the Board will consider any of the following four factors: (1) the employment of multilateral netting arrangements, (2) the use of same-day settlement, (3) the routine processing of a significant number of individual payments larger than $50,000, and (4) the possibility that any one participant could be exposed to a net debit position at the time of settlement in excess of its capital.

[2] In this policy statement, the terms "depository institution" or "institution" will be used to refer not only to institutions defined as "depository institutions" by 12 U.S.C. 461(b)(1)(A), but also to U.S. branches and agencies of foreign banks, Edge and agreement corporations, and bankers' banks, unless the context indicates a different reading.

[3] New issues of government agency securities are posted as the securities are delivered over Fedwire

B. [Reserved]

C. Capital

1. U.S. Chartered Institutions.

For depository institutions chartered in the United States, net debit caps are multiples of "qualifying" or similar capital measures that consist of those capital instruments that can be used to satisfy risk-based capital standards, as set forth in the capital adequacy guidelines of the federal financial regulatory agencies. All of the federal financial regulatory agencies collect, as part of their required reports, data on the amount of capital that can be used for risk-based purposes—"qualifying" capital for commercial and savings banks, "risk-based" capital for savings and loan associations, and total regulatory reserves for credit unions. Other U.S. chartered entities that incur overdrafts in Federal Reserve accounts should provide similar data to their Reserve Banks.

In some instances, further adjustments to capital are required. For example, virtually all Edge and agreement corporations are subsidiaries of depository institutions that may themselves use intraday credit. Capital would be double-counted if both the parent and the Edge or agreement corporation subsidiary used intraday credit based on their own capital bases. Accordingly, if a parent elects to permit its Edge or agreement corporation subsidiary to use daylight credit, any risk-based capital attributable to the Edge or agreement corporation subsidiary that is reflected on the parent's balance sheet must be subtracted from the parent's capital. The parent may choose, however, to use all of its capital for its own cap and to prohibit its Edge or agreement corporation subsidiary from using intraday credit.

2. U.S. Agencies and Branches of Foreign Banks.

For U.S. agencies and branches of foreign banks, net debit caps for uncollateralized overdrafts in Federal Reserve accounts are multiples of consolidated "U.S. capital equivalency."[4] All net debit caps are conditioned on the Reserve Bank's judgment that the U.S. agency or branch of the foreign bank has satisfactory U.S. funding capability and potential eligible collateral for a discount window loan, should it be unable to cover its daylight overdraft by the end of the day.

A foreign bank whose home-country supervisor adheres to the Basle Capital Accord may determine its uncollateralized daylight overdraft capacity by applying its cap multiple to a U.S. capital equivalency equal to the greater of 10 percent of worldwide capital or 5 percent of the total liabilities of each agency or branch, including acceptances, but excluding accrued expenses and amounts due and other liabilities to offices, branches, and subsidiaries of the foreign bank. In the absence of contrary information, the Reserve Banks presume that all banks chartered in G-10 countries meet the acceptable prudential capital and supervisory standards and will consider any bank chartered in any other nation that adopts the Basle Capital Accord standards (or requires capital at least as great and in the same form as called for by the Accord) eligible for the Reserve Banks' review for meeting acceptable prudential capital and supervisory standards.

To determine the net debit cap for uncollateralized overdrafts for all other foreign banks, cap multiples are applied to the U.S. capital equivalency measured as the greater of (1) the sum of the amount of capital (but not surplus) which would be required of a national bank being organized at each agency or branch location, or (2) the sum of 5 percent of the total liabilities of each agency or branch, including acceptances, but excluding accrued expenses and amounts due and other liabilities to offices, branches, and subsidiaries of the foreign bank.

All foreign banks, regardless of their cap for uncollateralized overdrafts, may incur total overdrafts up to an amount equal to their cap multiple times 10 percent of their worldwide capital, as long as the amount of the overdraft above the uncollateralized overdraft cap is collateralized. In addition, all foreign banks may elect to collateralize all or a portion of their overdrafts related to book-entry securities activity. This policy offers all foreign banks, under terms that reasonably limit Reserve Bank risk, a level of overdrafts based on the same proportion of their worldwide capital. Banks chartered in countries that follow the Basle Accord and that have demonstrated collateral and funding capacity that would result in a net debit cap based on 10 percent of worldwide capital are not permitted to incur overdrafts above their cap, except for book-entry securities overdrafts, even with collateral. All other foreign banks may incur overdrafts to the same extent as banks from Basle Accord countries, *i.e.*, up to their cap multiple times 10 percent of their worldwide capital, provided that sufficient collateral is posted for any overdrafts in excess of the cap based on their U.S. capital equivalency.

D. Net Debit Caps

To limit the aggregate amount of daylight credit extended by Reserve Banks, each institution that incurs daylight overdrafts in its Federal Reserve account must adopt a net debit cap, *i.e.*, a ceiling on the aggregate net debit position that it can incur during a given interval. Alternatively, if an institution's daylight overdrafts generally do not exceed the lesser of $10 million or 20 percent of capital, the institution may qualify for the exempt-from-filing status. Subject to the provisions for special situations described below, an institution must be financially healthy and eligible to borrow from the discount window in order to adopt a cap greater than zero or qualify for the filing exemption.

Cap categories and associated cap levels, set as multiples of capital, are listed below:

Net Debit Cap Multiples

Cap Category	Two-Week Avg.	Single Day
High	1.50	2.25
Above Avg.	1.125	1.875
Average	0.75	1.125
De Minimis	0.20	0.20
Exempt-from-filing	$10 million (0.20)	$10 million (0.20)
Zero	0.0	0.0

An institution is expected to avoid incurring net debits that, on average over a two-week period, exceed the two-week average cap, *and*, on any day, exceed the single-day cap. The two-week average cap provides flexibility, in recognition that fluctuations in payments can occur from day-to-day. The purpose of the higher single-day cap is to limit excessive daylight overdrafts on any day and to assure that institutions develop internal controls that focus on the exposures each day, as well as over time.

The two-week average cap is measured against the average, over a

[4] The term "U.S. capital equivalency" has been chosen merely as the most convenient term of art. The use of the term for purposes of this policy statement is not meant to suggest that the Board presently intends that this measure necessarily should be used to measure a foreign bank's capital position in the United States for prudential or other purposes.

two-week reserve maintenance period, of an institution's daily maximum net debit positions in its Federal Reserve account. In calculating the two-week average, individual days on which an institution is in an aggregate net credit position throughout the day are treated as if the institution was in a net position of zero. The number of days used in calculating the average is the number of business days the institution's Reserve Bank is open during the reserve maintenance period.

The Board's policy on net debit caps is based on a specific set of guidelines and some degree of examiner oversight. Under the Board's policy, a Reserve Bank may prohibit the use of Federal Reserve intraday credit if (1) an intstitution's use of daylight credit is deemed by the institution's supervisor to be unsafe or unsound, (2) an institution does not qualify for a cap exemption, does not perform a self-assessment, or does not file a board-of-directors-approved *de minimis* cap, and (3) an institution poses an excessive risk to a Reserve Bank.

The net debit cap provisions of this policy apply to foreign banks to the same extent as they apply to U.S. institutions. The Reserve Banks will advise home-country supervisors of banks with U.S. branches and agencies of the daylight overdraft capacity of banks under their jurisdiction, as well as of other pertinent conditions related to their caps. Home-country supervisors that request information on the overdrafts in the Federal Reserve accounts of their banks will be provided that information on a regular basis.

1. Cap Set Through Self-Assessment

An institution that wishes to establish a net debit cap category of high, above average, or average must perform a self-assessment of its own creditworthiness, credit policies, and operational controls, policies, and procedures.[5] The assessment of creditworthiness should address the overall financial condition of the institution, placing emphasis on conformance of the institution's capital with supervisory standards for capital adequacy. The institution should also assess its procedures for evaluating the financial condition of its customers and should establish intraday credit limits that reflect these assessments. Finally, an institution should ensure that its operational controls permit it to contain its use of Federal Reserve intraday credit and restrict its customers' use of credit to the limits it has established. The *Users' Guide* to the Board's Payments System Risk Reduction Policy, available from any Reserve Bank, includes a detailed explanation of the steps that should be taken by a depository institution in performing a self-assessment to establish a net debit cap.

Each institution's board of directors is expected to review the self-assessment and determine the appropriate cap category. The process of self-assessment, with board-of-directors review, should be conducted at least once in each 12-month period. A cap determination may be reviewed and approved by the board of directors of a holding company parent of a depository institution, or the parent of an Edge or agreement corporation, provided that (1) the self-assessment is performed by each entity incurring daylight overdrafts, (2) the entity's cap is based on the entity's own capital (adjusted to avoid double-counting), and (3) each entity maintains for its primary supervisor's review its own file with supporting documents for its self-assessment and a record of the parent's board-of-directors review.[6]

In applying these guidelines, each institution is expected to maintain a file for examiner review that includes (1) worksheets and supporting analysis developed in its self-assessment of its own risk category, (2) copies of senior management reports to the board of directors of the institution or its parent (as appropriate) regarding that self-assessment, and (3) copies of the minutes of the discussion at the appropriate board-of-directors meeting concerning the institution's adoption of a cap category.[7]

As part of its normal examination, the depository institution's examiners will review the contents of the self-assessment file.[8] The objective of this review is to assure that the institution has applied the guidelines seriously and diligently, that the underlying analysis and methodology were reasonable, and that the resultant self-assessment was generally consistent with the examination findings. Examiner comments, if any, should be forwarded to the board of directors of the institution. The examiner, however, would generally not require a modification of the self-assessment cap category unless the level of daylight credit used by the institution constitutes an unsafe or unsound banking practice.

The contents of the self-assessment cap category file will be considered confidential by the institution's examiner. Similarly, the actual cap level selected by the institution will be held confidential by the Federal Reserve and the institution's examiner. (However, cap information will be shared with the home country supervisor of agencies and branches of foreign banks.)

2. De Minimis Cap

Many depository institutions incur relatively small overdrafts and thus pose little risk to the Federal Reserve. To ease the burden on these small overdrafters of engaging in the self-assessment process and to ease the burden on the Federal Reserve of administering caps, the Board will allow institutions that meet reasonable safety standards to incur *de minimis* amounts of daylight overdrafts without performing a self-assessment. A depository institution may incur daylight overdrafts up to 20 percent of capital, if a board-of-directors resolution is submitted.

Reserve Banks will review the status of a *de minimis* cap institution that exceeds its cap on a single day or, on average, over a two-week reserve maintenance period and will decide if the *de minimis* cap should be

[5] This assessment should be done on an individual institution basis, treating as separate entities each commercial bank, each Edge corporation (and its branches), each thrift institution, etc. An exception is made in the case of U.S. agencies and branches of foreign banks. Because these entities have no existence separate from the foreign bank, all the U.S. offices of foreign banks (excluding U.S. chartered bank subsidiaries and U.S. chartered Edge subsidiaries) should be treated as a consolidated family relying on the foreign bank's capital

[6] A foreign bank should undergo the same self-assessment process as a domestic bank in determining a net debit cap for its U.S. branches and agencies. Many foreign banks, however, do not have the same management structure as U.S. depository institutions, and adjustments should be made as appropriate. Where a foreign bank's board of directors has a more limited role to play in the bank's management than a U.S. board, the self-assessment and cap category should be reviewed by senior management at the foreign bank's head office that exercises authority over the foreign bank equivalent to the authority exercised by a board of directors over a U.S. depository institution. In cases where the board of directors exercises authority equivalent to that of a U.S. board, cap determination should be made by the board of directors.

[7] In most cases, it may not be possible for the U.S. examiners to review the minutes of the meeting of a foreign bank's board of directors or other appropriate management group at which the self-assessment was discussed. In lieu of this, the file on the self-assessment that is made available for examiner review by the U.S. offices of a foreign bank should contain the report on the self-assessment made to the foreign bank's senior management by the management of U.S. operations. In addition, the file should also contain a record of the appropriate senior management's response. As in the case of U.S. institutions, this review and confirmation should be completed every year.

[8] Between examinations, examiners or Reserve Bank staff may contact an institution about its cap if statistical or supervisory reports or *ad hoc* information suggest that there may have been a change in the institution's position.

maintained or if the institution will be required to perform a self-assessment and file for a higher cap. An institution choosing to use a *de minimis* cap must submit to its Reserve Bank at least once each year a copy of the resolution of its board of directors (or its holding company's board) approving the depository institution's use of daylight credit up to the *de minimis* level.

3. Exemption From Filing

Depository institutions that only rarely incur overdrafts in their Federal Reserve accounts that exceed the lesser of $10 million or 20 percent of their capital are excused from performing self-assessments and filing board-of-directors resolutions with their Reserve Banks. This dual test is designed to limit the filing exemption to depository institutions that create only low-dollar risks to the Reserve Banks and that incur small overdrafts relative to their capital.

The Reserve Bank will review the status of an exempt depository institution that incurs overdrafts in its Federal Reserve account in excess of $10 million or 20 percent of capital on more than two days in any two rolling two-week reserve maintenance periods. The Reserve Bank will decide if the exemption should be maintained or if the institution will be required to file for a cap. Even for depository institutions meeting the size and frequency standards, the exemption would be granted at the discretion of the Reserve Bank.

4. Special Situations

Special risks are presented by the participation on Fedwire of Edge and agreement corporations, bankers' banks that do not maintain reserves, and institutions that have been assigned a cap of zero by their Reserve Bank. Some of these entities are major participants in privately-operated, large-dollar clearing and settlement systems, often making and receiving a large volume of payments on behalf of their affiliates and parent organizations. Most of these institutions lack regular discount window access. In developing its policy for these institutions, the Board has sought to balance the goal of reducing and managing risk in the payments system, including risk to the Federal Reserve, with that of minimizing the adverse effects on the payments operations of these institutions.

a. *Edge and Agreement Corporations.*[9] Edge and agreement corporations must fully collateralize all overdrafts in their Federal Reserve accounts. To protect the Reserve Banks from excessive risk in conjunction with the collateralization policy, the Board strongly urges each Edge or agreement corporation to restrain its use of intraday credit by establishing a net debit cap based on its own capital in the same manner as any other depository institution. For purposes of net debit caps, the Board suggests that all branches of an Edge or agreement corporation be consolidated. This policy reflects the lack of access of these institutions to the discount window and the possibility that the parent of an Edge or agreement corporation may be unable or unwilling to cover its subsidiary's overdraft on a timely basis.

At the same time, the Board believes it is preferable for Edge and agreement corporation subsidiaries of U.S. banks, together with their parents, to arrange their affairs in a way that would allow them to continue to service their customers and at the same time reduce risk exposures. Specifically, the Board notes that the parent of an Edge or agreement corporation could fund its subsidiary during the day over Fedwire and/or the parent could substitute itself for its subsidiary on private networks. Such an approach by the parent could both reduce systemic risk exposure and permit the Edge or agreement corporation to continue to service its customers. Edge and agreement subsidiaries of foreign banks are treated in the same manner as their domestically-owned counterparts.

b. *Bankers' Banks.*[10] Bankers' banks are exempt from reserve requirements and do not have regular access to the discount window. They do, however, have access to Federal Reserve payment services. To protect Reserve Banks from potential losses resulting from bankers' banks' daylight overdrafts, bankers' banks should refrain from incurring overdrafts and should post collateral to cover any funds or book-entry securities overdrafts they do incur. Bankers' banks may voluntarily waive their exemption from reserve requirements, thus gaining access to the discount window and avoiding the requirement to post collateral for all overdrafts. Such bankers' banks would be subject to the same policy as other depository institutions.

c. *Zero-Cap Depository Institutions.* Some depository institutions have caps of zero that are imposed by Reserve Banks because of the institutions' financially troubled status, because of Board policy (such as limited-purpose trust companies), or because the institution itself requested a zero cap. Regardless of whether it has access to the discount window, if a depository institution on which a Reserve Bank has imposed, or that has adopted, a zero cap incurred a funds-related overdraft, the Reserve Bank would counsel the institution and may monitor the institution's activity in real-time and reject or pend any Fedwire funds tranfer instruction that would cause an overdraft. Because the timing of book-entry securities transfers are not fully within the control of the receiving depository institution, the Board will allow depository institutions with caps of zero that have access to the discount window to continue to incur book-entry overdrafts, but will require that such overdrafts be collateralized even if they are infrequent and modest.

E. Book-entry Securities Transactions

1. Collateralization

A depository institution's funds and book-entry securities overdrafts are combined for purposes of determining an institution's compliance with its cap. Financially healthy depository institutions with positive caps that frequently exceed their caps by material amounts solely due to book-entry securities transactions are required to collateralize all of their book-entry securities overdrafts. To determine whether an institution exceeds its net debit cap due solely to book-entry securities activity, the Reserve Bank determines what activity in an institution's Federal Reserve account is attributable to funds transfers and other payment transactions and what activity is attributable to book-entry securities transactions. Book-entry securities balances are calculated by posting charges for original issues of Treasury securities and credits for interest and redemption payments for Treasury and government agency book-entry securities at 9:15 a.m. ET and posting credits and debits from transfers of book-entry securities as they occur. A book-entry securities overdraft occurs when an institution's book-entry securities balance, less any credit in its funds balance, is a net debit.

[9] These institutions are organized under section 25(a) of the Federal Reserve Act (12 U.S.C. 611-631) or have an agreement or undertaking with the Board under section 25 of the Federal Reserve Act (12 U.S.C. 601-604a).

[10] For the purposes of this policy, a bankers' bank is a financial institution that is not required to maintain reserves under the Board's Regulation D (12 CFR part 204) because it is organized solely to do business with other financial institutions, is owned primarily by the financial institutions with which it does business, and does not do business with the general public and is not a depository institution as defined in the Board's Regulation A (12 CFR 201.2(a)).

For the purposes of this policy, "frequently" means more than three occasions in two rolling two-week reserve maintenance periods, and "material amounts" means in excess of 10 percent of cap. For example, a depository institution with a $50 million cap that meets the "frequent" and "material" tests and has a $70 million overdraft— $30 million due to funds transfers and $40 million due to book-entry securities transactions—will be required to collateralize the entire $40 million book-entry securities overdraft.

In addition, all financially healthy depository institutions with positive caps may *choose* to collateralize all or part of their book-entry securities overdrafts, even if they have not exceeded their caps. Such secured overdrafts shall not be included with those overdrafts measured against their caps. For example, a financially healthy depository institution with a $50 million cap and a $30 million overdraft—$15 million due to funds transfers and $15 million due to book-entry securities transfers—would ordinarily have excess capacity of $20 million. Such an institution may increase its excess capacity by $15 million by collateralizing all of its book-entry securities overdrafts (or may increase its excess capacity by less than $15 million by collateralizing some portion of its book-entry securities overdrafts). Such an institution may not increase its cap of $50 million by over-collateralizing its book-entry securities overdrafts or by collateralizing any part of its funds overdrafts. At the same time, if an institution that voluntarily collateralizes its book-entry securities overdrafts and those overdrafts become frequent and material, the institution will be required to collateralize 100 percent of its book-entry securities overdrafts.

Depository institutions have some flexibility as to the specific type of collateral they may pledge to secure book-entry securities overdrafts. The Reserve Banks will not give preference to a particular type of collateral, such as securities in transit, discount window collateral, or stable pools of collateral, unless a preference is desired by the depository institution. All collateral must be acceptable to the Reserve Bank.

2. Transfer Size Limit

Secondary market book-entry securities transfers on Fedwire are limited to a transfer size of $50 million par value. This limit is intended to induce multiple deliveries to reduce position-building by dealers, a major cause of book-entry securities overdrafts; participants may choose to limit their trade size as well. This limitation does not apply to:

(a) original issue deliveries of book-entry securities from a Reserve Bank to a depository institution or,

(b) transactions sent to or by a Reserve Bank in its capacity as fiscal agent of the United States, government agencies, or international organizations. Thus, requests to strip or reconstitute Treasury securities, or to convert bearer or registered securities to or from book-entry form, are exempt from this limitation. Also exempt are pledges of securities to a Reserve Bank as principal (*e.g.*, discount window collateral) or as agent (*e.g.*, Treasury Tax and Loan collateral).

F. Inter-Affilliate Transfers

Although the institutions affiliated through common holding company ownership are not permitted to consolidate their wire transfer activity and capital for the purpose of monitoring compliance with this policy, such institutions may engage in funds transfers over Fedwire that are intended to simulate consolidation among affiliated depository institutions and that create a pattern of daylight overdrafts up to the sending institution's net debit cap, provided the following conditions are met:

1. Each of the individual sending depository institutions' boards of directors approve, at least once each year, the intraday extension of credit to the specified affiliate(s),[11] and sends a copy of the directors' resolution to its Reserve Bank.

2. During the regular examination, the individual institution's primary federal supervisor reviews the timeliness of board-of-directors resolutions, the establishment by the institution of limits on credit extensions to each affiliate, the establishment by the institution of controls to assure that credit extensions stay within such limits, and notes whether credit extensions have in fact stayed within those limits.

The Board notes that the adoption of this policy regarding transfers among depository institution affiliates does not in any way change the treatment of depository institutions and their Edge and agreement corporation subsidiaries. The ability of a parent institution to fund its Edge or agreement subsidiaries on an intraday basis remains unchanged, so long as the parent remains within its own cap.

[11] The provision of this policy statement that allows a holding company to establish caps for its depository institution subsidiaries does not apply to this requirement.

G. Third-Party Access Arrangements

The Board will allow, under certain conditions, arrangements whereby a depository institution or other entity ("the service provider") could initiate Fedwire transfers from the Federal Reserve account of another depository institution. Such arrangements will be permitted provided:

1. The institution whose account is being charged (the "institution") retains control of the credit-granting process by individually approving each transfer or establishing credit limits within which the service provider can act.

2. The service provider must be an affiliate of the institution, or, if the institution approves each individual transaction, an unaffiliated company. All service providers must be subject to examination.

3. The service provider must not permit or initiate transfers that would exceed individual customer credit limits without first obtaining the institution's permission.

4. The service provider must have the operational ability to ensure that the aggregate funds transfer activity of the institution does not result in daylight overdrafts in excess of the institution's cap.

5. All Fedwire transfer activity must be posted to the institution's account, and the institution will remain responsible for its account.

6. The institution's board of directors must approve the specifics of the arrangement, including: (a) the operational transfer of its Fedwire transfer activity to the service provider; (b) the net debit cap for the activity to be processed by the service provider; and (c) the credit limits for any inter-affiliate funds transfers.

7. The institution and the service provider must execute an agreement with the relevant Reserve Banks delineating the terms of the agreement.

8. The institution must have adequate back-up procedures and facilities to cover equipment failure or other developments affecting the adequacy of the service being provided. This back-up must provide the Reserve Bank with the ability to terminate a service provider arrangement.

9. The institution must have the ability to monitor transfers being made on its behalf.

10. The institution must provide an opinion of counsel that the arrangement is consistent with corporate separateness and does not violate branching restrictions.

11. The primary supervisor must not object to the arrangement.

12. No individual with decision-making responsibilities relating to the Fedwire transfer area may hold such a position in more than one affiliated institution participating in an approved arrangement.

13. The institution must have in place an adequate audit program to review the arrangements at least annually to confirm that these requirements are being met.

In order to assure consistency with the Board's policy, each new arrangement should be reviewed by the Director of the Division of Reserve Bank Operations and Payment Systems prior to approval by the Reserve Bank.

H. Monitoring

1. Ex Post

Under the *ex post* monitoring procedure, an institution with a net debit position in excess of its cap will be contacted by its Reserve Bank.[12] The Reserve Bank will counsel the institution, discussing ways to reduce its excessive use of intraday credit. Each Reserve Bank retains the right to protect its risk exposure from individual institutions by unilaterally reducing Fedwire caps, imposing collateralization or clearing balance requirements, holding or rejecting Fedwire transfers during the day until the institution has collected balances in its Federal Reserve account, or, in extreme cases, taking the institution off-line or prohibiting it from using Fedwire.

2. Real Time

A Reserve Bank will apply real-time monitoring to an individual institution's position when the Reserve Bank believes that it faces excessive risk exposure, *e.g.*, from problem banks or institutions with chronic overdrafts in excess of what the Reserve Bank determines is prudent. In such a case, the Reserve Bank will control its risk exposure by monitoring the institution's position on a real-time basis, rejecting or delaying transfers if the account balance would otherwise be exceeded, and taking other prudential actions.

3. Multi-District Institutions

A depository institution that chooses to access Fedwire through accounts in more than one Federal Reserve district is expected to manage its accounts so that its aggregate net debit position across all accounts does not exceed its net debit cap. One Reserve Bank will act as administrative Reserve Bank and will have overall risk-management responsibilities for institutions maintaining accounts in more than one Federal Reserve district. In the case of families of branches and agencies of the same foreign bank, net debit cap compliance will be monitored by the Reserve Bank that exercises the Federal Reserve's oversight responsibilities under the International Banking Act.[13] The administrative Reserve Bank may determine, in consultation with Reserve Banks in whose territory other U.S. agencies or branches of the same foreign bank are located and with the management of the foreign bank's U.S. operations, that branches and agencies outside its district either will not be permitted to incur overdrafts in Federal Reserve accounts or must allocate part or all of the foreign family's net debit cap (and the responsibility for administering part or all of the collateral requirement) to a Reserve Bank in whose district one or more of the foreign offices operate.[14] For domestic depository institutions that have branches in multiple Federal Reserve districts, the administrative Reserve Bank generally will be the Reserve Bank where the head office of the bank is located.

4. ACH Controls

To reduce risk in the ACH mechanism associated with the origination of ACH credit transactions by institutions that are experiencing financial difficulties, the Reserve Banks:

(a) will monitor ACH credit payments originated by such depository institutions;

(b) may require advanced funding or other assurance of payment or may reject payments if it appears the originating depository institution will not have sufficient funds on the settlement day; and

(c) will review origination patterns for all ACH originators of debit and credit payments.

In addition, a Reserve Bank may defer the availability of some or all of the credit from debit payments originated by an institution that the Reserve Bank believes will not have sufficient balances to pay return items when they are presented.

Further details on Federal Reserve ACH controls are set out in the Uniform ACH Operating Circular, available from each Reserve Bank.

II. Policies For Private-Sector Networks

A. Private Large-Dollar Funds Transfer Networks

Any large-dollar payments system obtaining net settlement services from a Federal Reserve Bank must establish liquidity and credit controls that provide a reasonable degree of assurance that settlement can be achieved on the settlement day. Under the Board's policy, no private large-dollar payments network is eligible for Reserve Bank net settlement services unless it:

(1) Requires each participant to establish bilateral net credit limits vis-a-vis each other participant on that network,[15]

(2) Establishes a system to reject or hold any payment that would exceed such limits, and

(3) Establishes and monitors in real time network-specific net debit limits. In order that Reserve Banks may properly monitor the use of intraday credit, no future or existing large-dollar network will be permitted to settle on the books of a Reserve Bank unless its members authorize the network to provide position data to the Reserve Bank on request.

In setting bilateral net credit limits, each participant on a network must determine for itself the maximum dollar amount of net transfers (*i.e.*, the excess of the value received over the value sent) that it is willing to accept from each other participant on that network. The Board believes that bilateral net credit limits reduce risk by enabling an institution to identify and control the exposure it could face in the event of a settlement failure. The volume of daylight exposure that each participant is willing to accept from each other participant is likely to be quite large when aggregated across the network. Moreover, participants may be unaware of the credit made available to a given sender by other potential receivers. For this reason, bilateral net credit limits

[12] Even if the institution is not a state member bank, the Reserve Bank can make this contact when an overdraft occurs in a reserve or clearing account or when the institution is in a net debit position on a wire system that settles on the books of the Federal Reserve.

[13] 12 U.S.C. 3101-3108.

[14] As in the case of Edge and agreement corporations and their branches, with the approval of the designated administrative Reserve Bank, a second Reserve Bank may assume the responsibility of managing and monitoring the net debit cap of particular foreign branch and agency families. This would often be the case when the payments activity and national administrative office of the foreign branch and agency family is located in one district, while the oversight responsibility under the International Banking Act is in another district. If a second Reserve Bank assumes management responsibility, monitoring data will be forwarded to the designated administrator for use in the supervisory process.

[15] Bilateral net credit limits do not apply to Fedwire transfers because the Federal Reserve provides final credit to the receiver when the amount of the payment order is credited to the receiver's account or when the payment order is sent to the receiver, whichever is earlier (12 CFR 210.31(a)). Reserve Banks, however, may take action to reduce their credit exposure.

should be supplemented by network-specific net debit caps, which will limit the aggregate amount of risk a participant may present to the network.

The federal bank examiners will, during regular examinations, review and comment on the procedures used by each institution in establishing, monitoring, reviewing, and modifying bilateral net credit limits, and ensure that institutions understand their potential exposures with each other participant over more than one network and in more than one market.

Avoidance of Risk Reduction Measures

The Board believes that the use of Fedwire for the avoidance of Federal Reserve or private-sector risk reduction measures is not appropriate. The Board seeks to prevent institutions from participating in bilateral netting arrangements that provide only payments netting under which gross payment messages are exchanged during the day and settled at the end of the day by using Fedwire to adjust net positions bilaterally. Such arrangements would be difficult for Reserve Banks to detect and would be outside of Federal Reserve and private-sector risk control measures. They still, however, present the same risks to the payments mechanism that other net settlement arrangements present because settlement failures are possible, and such failures could have deleterious consequences to the payments system.

The Board realizes, however, that certain netting arrangements are not intended to avoid risk reduction measures and can, in fact, reduce risk. For example, institutions may, by means of novation, net transactions prior to settlement, with each participant legally obligated only for the resultant net position. This arrangement reduces risk because it replaces gross transactions with the smaller net obligation, and failures to settle would almost always involve smaller exposures (and less systemic risk) than with simple bilateral net settlement. The Board's policy on limiting avoidance techniques is not intended to restrict this kind of netting arrangement.

B. Private Delivery-Against-Payment Securities Systems

Private delivery-against-payment securities systems that settle on a net, same-day basis entail credit and liquidity risks for their participants and for the payments system in general. The Board believes that these systems should include risk-control features if they are to rely on Fedwire for ultimate settlement. The need for such risk controls is becoming increasingly important in view of these systems' potential for growth, their high volumes, and the possible future course of the Federal Reserve's payments system risk reduction program, e.g., pricing intraday Fedwire funds and book-entry overdrafts.

Delivery-against-payment securities systems, as described below, are expected to adopt appropriate liquidity and credit safeguards in order to ensure that settlement occurs in a timely fashion and that the participants do not face excessive intraday risks. In view of the continuing evolution of these systems, the Board has established general guidelines rather than specifying the exact form such safeguards should take. Reversals or "unwinds" of funds and securities transfers, however, are not considered appropriate liquidity control measures.

The policy addresses four issues:

(1) Liquidity safeguards for ensuring settlement;

(2) Provisions for reversals;

(3) Credit safeguards, such as collateral and netting features; and

(4) Open settlement accounting. These components, and the scope and regulatory implications of this policy, are described below.

Scope of the Policy

This policy is specifically targeted at large-scale private delivery-against-payment securities systems that settle their obligations on a net, same-day basis over Fedwire, either directly or indirectly. These systems settle securities transactions for their participants by transferring securities and the accompanying payment obligations on the books of a clearing corporation or a depository institution operating the system and arrange for final settlement of the funds positions on a net basis at the end of the processing day. Settlement on a "net basis" means that the funds obligations are netted among all participants, so that a participant can settle obligations to or from many counterparties by making a single transfer to or from the system. "Same-day" settlement means that the appropriate funds and securities transfers are settled on the day that a delivery-against-payment request is entered into the system. "Large-scale" systems are those systems that routinely process a significant number of individual transfers larger than $50,000 or that would permit any one participant to be exposed to a net debit position at the time of settlement in excess of its capital.

This policy applies to systems that function primarily as a means of transferring securities and funds between participants. If a firm or bank is providing clearing services to a customer, and these services focus primarily on the bilateral relation between the clearer and the customer, the firm or bank would not be viewed as a system under this policy. Moreover, at least initially, a system that is an integral component of a full service bank, such that obligations that settle on an item-by-item basis are the direct obligations of the bank, will not be subject to this policy because of the existing supervisory oversight of a bank's liquidity and credit resources.

This policy applies to systems in the United States that transfer debt and equity securities, including those not eligible for Fedwire. The policy does not apply to systems dealing with other financial instruments, such as futures and options.

This policy is directed at limiting the risks arising out of the intraday credit generated in private delivery-against-payment systems. The policy does not address other potential sources of risk in these systems, such as inadequate management or facilities. The Board expects that these systems will be subject to regulatory oversight because they are typically clearing agencies subject to supervision by the Securities and Exchange Commission, or because they are limited purpose trust companies subject to state or federal banking supervision, or both. These supervisors have broad responsibility for ensuring the safety and integrity of these systems.

Liquidity Safeguards

Because they give rise to the extension of intraday credit, private delivery-against-payment systems rely on payments by participants with net obligations to the system ("net debtor" participants) in order to make settlement payments to participants with net obligations due from the system ("net creditor" participants). In the absence of appropriate safeguards, the failure by a single participant with a net debit position may delay settlement of the system. The result of a system's failure to settle in a timely manner will be that participants do not receive the transfers of funds and securities that they expected and that they, therefore, may not be able to conclude other transactions outside the system. Because settlement typically occurs at the end of the day, the system and net creditor participants will have relatively little time to react to any failure that may occur.

This policy seeks to ensure that private systems settle in a timely manner, so that participants can rely on the funds or securities obtained as a result of transfers through the system. The importance of ensuring reliable transfers is due in part to the fact that these systems generally allow participants to re-transfer funds credits or securities acquired during the day. If, for example, a participant sold securities early in the day and later used his funds credits to purchase other securities, then a failure in the settlement of the earlier transaction could result in a failure of the settlement of the later transaction.

The Board believes that private systems should protect timely settlement by adopting safeguards that are commensurate with the risk of settlement failure. The Board recognizes that a private system relying on intraday credit will not be able to guarantee timely settlement of funds and securities transfers under all conceivable circumstances and, therefore, that such a system cannot make an absolute guarantee of settlement finality. At a minimum, however, a system must have sufficient safeguards so that it will be able to settle on time if any one of its major participants defaults. In addition, the Board strongly encourages systems to adopt settlement safeguards beyond this required minimum.

Liquidity arrangements that will enable a system to make end-of-day settlement payments are crucial settlement safeguards. Liquidity safeguards adopted by private delivery-against-payment systems should include provisions that give the system access to sources of readily available funding that will support timely settlement in case a participant is unable to settle its obligation. Funding sources could, for example, include prearranged lines of credit or a pool of funds contributed by the participants. The system should limit, on an intraday basis, the size of potential net debit positions to ensure that these liquidity sources will be adequate.

Because settlement risks and structure may vary in different systems, the Board does not consider it appropriate to specify the exact structure of acceptable safeguards. One example of an appropriate liquidity safeguard may be a cap on the net debit funds position that may be incurred by an individual participant, which is tied to the liquidity resources available to the system and/or to the participant. If such a cap is used, it may be appropriate for it to be administered in a flexible manner, with due regard for liquidity and credit risks and for the efficient operation of the system.

Reversals

Currently, certain systems permit reversals of transfers of funds and securities to facilitate settlement if a participant defaults. By reversing transactions, the systems try to reduce the obligations of the defaulting participant. However, settlement with reversals will not ease the liquidity problems caused by a default; reversals will simply transfer a liquidity shortfall from the defaulter to another participant and will do so at the end of the day, when it may be difficult to arrange for alternate sources of liquidity. The return of securities, with the resulting reversal of a funds credit, may cause the participant receiving the returned securities to default on its obligations. Thus, settlement using reversals will not achieve this policy's objective, because participants will not be able to rely on transfers of funds and securities if transfers may be reversed.

Because the Board does not view reversals as a satisfactory liquidity safeguard, the systems covered by this policy should not use reversals as a substitute for liquidity arrangements, such as those discussed above, in order to ensure timely settlement.

Credit Safeguards

As stated above, these systems effectively allow participants to use intraday credit when receiving securities. All participants may be affected by one participant's failure to repay this credit. The Board, therefore, believes that these systems should adopt clear loss-allocation rules and should minimize credit risks incurred through the system. Methods of reducing credit risk may vary in different systems. Appropriate methods include requiring contributions by all participants to a fund that may be used in the event of a default or requiring the pledging of a sufficient volume of marked-to-market collateral. The loss allocation schedule should not increase risks to the system. In particular, the system should calculate the loss resulting from a default on the basis of the net obligations of the defaulter rather than on the basis of the underlying gross obligations between the defaulter and its counterparties. Thus, the Board would find a loss allocation scheme to be unacceptable if it reversed all transactions between the defaulter and other participants.

This policy, including the restriction on reversals, is not intended to prevent a system from allocating credit losses to the counterparty of a defaulter based on the business dealings between the counterparty and the defaulter. It may be appropriate and prudent for a system to have rules that would require participants who have dealt with the defaulter to be responsible, after settlement, for the related loss. These arrangements could well include returning securities to the counterparty to help absorb the loss.

Open Settlement Accounting

As delivery-versus-payment systems grow in size and volume, the timely and orderly completion of end-of-day settlements takes on an increased importance for the settlement of other large-dollar payments systems. As a general matter, the Board believes that it will be easier for market participants and supervisors to monitor and protect against settlement risks if current information is readily available. Participants in a delivery-against-payment system should therefore have up-to-date information on their net position and on the settlement progress of the system, and appropriate market supervisors should have ready access to current intraday information on both the system's settlement and participants' positions. For those systems wishing to use Fedwire payments as a means of settlement, the Board encourages the use of Federal Reserve Bank net settlement services rather than individual wire payments that cannot be distinguished from all other Fedwire payments. This policy is in no way intended to broaden access to Federal Reserve services; neither Fedwire nor net settlement services will be available, as a general matter, to non-member, non-depository institutions.

C. Offshore Dollar-Clearing and Netting Systems[16]

For some time, the Board has been sensitive to the risks associated with the actual and potential development of netting and clearing arrangements for U.S. dollar payments located outside the United States. In particular, the Board has been concerned that the steps being taken to reduce systemic risk in U.S. large-dollar payments systems may themselves induce the further development of "offshore" dollar payments systems. These offshore systems can settle through payments on the Federal Reserve's wire transfer system (Fedwire) or the New York Clearing House's Clearing House Interbank Payments System (CHIPS), but may operate without adequate

[16] The Board adopted this policy statement in June 1989 as an interim measure to address offshore clearing and netting systems until an international consensus is reached among central banks and bank supervisory authorities.

procedures for the management of risks and without any form of official oversight. The Board also recognizes that the development of offshore clearing and netting arrangements raises issues of concern which go beyond the immediate question of payment risks in the U.S. banking system.

Banks in all countries have been experiencing strong incentives to reduce payment flows and credit exposures. As an apparent consequence, there is an increasing number of proposed or actual interbank netting arrangements which affect an offset or netting of amounts due between banks, arising not only from payment instructions but also from the settlement of foreign exchange and other financial contracts, on either a bilateral or multilateral basis. When located outside the country of issue of the currency subject to the netting, these arrangements have the potential to alter significantly the structure of the international interbank clearing and settlement process.

In response to these developments, the Group of Experts on Payments Systems from the G-10 central banks, meeting at the Bank for International Settlements (BIS) in Basle, Switzerland, studied a variety of payment and currency netting arrangements. The BIS Payments Experts' "Report on Netting Schemes" primarily addresses the allocation of credit and liquidity risk in various netting structures and draws general conclusions as to whether these risks are increased or decreased by the different "institutional forms" of netting. The Board believes that, in so doing, the Report of the Payments Experts provides a valuable starting point for the consideration of risk in the international payment process.

In addition, the Report notes that a number of broader monetary, financial, and supervisory policy implications are associated with the further development of netting arrangements for interbank markets. Netting systems for foreign currency payments and contracts have the potential to create changes in the financial character of affected interbank markets, as well as in the cross-border relationships between national banking systems. These changes, in turn, raise questions about the extent and quality of central banks' oversight and supervision of settlements in their respective currencies, including the allocation of supervisory responsibility among various central banks and national supervisory authorities.

On the basis of this preliminary work, the Governors of the G-10 central banks have determined that a further study of these broader issues be undertaken with a view toward establishing an international understanding of the monetary, financial, and supervisory issues raised by the development of offshore or cross-border netting arrangements.[17]

At the same time, the Board recognizes that the technological, market, and regulatory incentives that are giving rise to the growth of these arrangements will continue to operate. The Board believes that it is important, therefore, to begin to address the potential policy concerns raised by the further development of offshore netting and clearing systems for U.S. dollar payments and the risks that these systems may create. This is particularly the case in light of the significant steps that have been and are being taken by the Federal Reserve and the U.S. banking industry to address payment risk issues. These include both the Board's ongoing payments system risk reduction program and the efforts of the New York Clearing House Association to improve CHIPS participants' awareness of payment risks, to control the level of daylight exposures within CHIPS, and now to adopt settlement finality procedures.[18]

Offshore clearing of U.S. dollar payments, for subsequent net settlement in the United States, may create transaction and other efficiencies for participants in such offshore systems. If, however, the allocation of credit and liquidity risks associated with the netting and settlement is not clearly understood or defined, offshore dollar clearing arrangements may well obscure, or even increase, the level of systemic risk in U.S. large-dollar payments systems as well as in the international dollar settlement process generally. The BIS Report notes that this shifting of risk "can be particularly troubling where the transaction cost efficiencies are enjoyed by banks located in one country, but the credit and liquidity risks associated with the settlement of payments resulting from that netting system may be experienced in the banking system of another country." This is precisely what can happen when U.S. dollar payments are netted in systems outside of the United States and subsequently settled through CHIPS or Fedwire.

Because of the potential for offshore dollar clearing systems both to shift risk to U.S. large-dollar payments systems and to be used to avoid the Board's domestic risk reduction policies, the Board believes that it is appropriate for it to provide preliminary guidance on the framework within which offshore dollar systems should operate. The Board recognizes that the question of the degree of oversight and supervision of offshore clearing and netting systems can only be fully addressed on a cooperative basis among central banks and national bank supervisory authorities. In the interim, the Board's approach to offshore dollar clearing and netting systems will be guided by the following general principles:

1. An offshore dollar clearing or netting system, which settles directly or indirectly through CHIPS or Fedwire, should at a minimum be subject to oversight or supervision, as a system, by a relevant central bank or supervisory authority.

2. The participants should be responsible for clearly identifying the operational, liquidity, and credit risks created within the system and for assuring the prudent management of these risks.

3. The system should have arrangements in place that provide for the finality of settlement obligations and the practical means to assure the timely satisfaction of these obligations.

4. The direct or indirect settlement of the system's obligations through CHIPS or Fedwire should be conducted by an identified settlement agent, in the United States, so that satisfaction of the settlement obligations can be readily ascertained by the participants, the Federal Reserve, and other relevant central banks and supervisory authorities.

Consistent with the foregoing interim principles, the Federal Reserve is prepared to work with the central bank and/or supervisory authorities of the country in which an offshore dollar clearing or netting system is located, on a cooperative basis, to assure the continuing adequacy of the system's procedures for controlling risk.

The Board believes that these interim principles are consistent with the concerns identified by the BIS Payments Experts Group. The minimal conditions that they would impose on offshore clearing and netting systems are similar to the risk-reduction procedures that have been established for CHIPS. These principles should not be regarded as establishing a policy of either encouraging or discouraging the operation of offshore dollar payments systems. Rather, they represent an initial attempt by the Board to indicate the minimum structural features that the

[17] In November 1990, the "Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries" was published by the BIS. Federal Reserve staff is reviewing the Board's policies on offshore dollar-clearing and netting systems.

[18] CHIPS adopted settlement finality procedures in October 1990.

Board believes are appropriate for offshore dollar clearing arrangements. These principles also presume a cooperative international approach to the supervision of offshore clearing and netting arrangements.

D. Private Small-Dollar Clearing and Settlement Systems

1. National ACH Net Settlement

In October 1990, the Board approved a proposal under which the Federal Reserve would provide net settlement services to depository institutions participating in a national, multilateral automated clearing house (ACH) clearing arrangement. The factors considered by the Board in 1990, discussed below, would also apply to any future proposals for national ACH net settlement services.

Assurance of settlement. The ACH is generally considered a small-dollar payment mechanism, and the settlement positions of ACH participants tend to be small relative to capital. Additionally, unlike large-dollar funds transfer systems, such as CHIPS, ACH payments typically are exchanged in batches before the settlement day. Payments received by ACH participants, therefore, generally are not used to fund subsequent payments to participants within the system. These two factors—the relatively low value of payments and the single flow of payments—result in less systemic credit and liquidity risk for participants in ACH clearing arrangements than for participants in large-dollar payments systems.

Nevertheless, a national ACH network that receives settlement services from the Federal Reserve should take steps to minimize the risk exposure of its participants should one of the participants be unable to fund its net debit position at the designated settlement time. The Board does not mandate specific risk control provisions but will consider the effectiveness of provisions suggested by the participants in a clearing and settlement arrangement. Among the types of credit and liquidity controls that should be considered by such clearing and settlement arrangements are (a) objective admission criteria and ongoing monitoring of participants' adherence to those criteria, (b) bilateral credit limits, (c) net debit caps, and (d) gross origination caps.

For example, an ACH network might control credit risk by evaluating the creditworthiness of participants and setting specific credit criteria for admission or by requiring each participant to establish bilateral credit limits with each other participant in a multilateral clearing arrangement. If a relatively large number of institutions use a national ACH clearing arrangement, however, setting and maintaining bilateral limits may be difficult operationally. On the other hand, setting net debit settlement caps provides a means to limit the risk that any one participant can impose upon the group. Gross origination caps serve a similar purpose.

Recasts and unwinds. Because of the potential systemic risks, the Board will examine closely any ACH clearing arrangements that provide for recasting or unwinding the settlement in the event of a participant default. Generally, the Board does not view recasts or unwinds as satisfactory liquidity controls. It is important to determine the degree of systemic risk associated with a multilateral ACH clearing arrangement in order to assess whether a settlement guarantee should be required or whether a settlement recast would be an acceptable alternative. For example, if simulations of a participant's failure to settle indicate that the degree of systemic risk associated with the recast is relatively low and that participants should be able to cover the changes in their settlement positions caused by a recast, the Board may conclude that a settlement guarantee is not necessary to avoid potential systemic problems. Moreover, a relatively wide distribution of ACH payments would tend to limit the exposure of any one participant to the inability of another participant to settle.

Although the degree of systemic risk associated with ACH clearing arrangements is relatively low, a network's reliance upon a complete unwind, if a settlement cannot be achieved in an orderly fashion, raises concerns. If such an event were to occur, it would cause disruption because a potentially large number of payments would not be made as planned. A national ACH network seeking Federal Reserve settlement services should incorporate appropriate risk controls and should be able to demonstrate that the possibility of an unwind would be remote.

Finality of payment. The Board will consider the extent to which settlement entries under the national ACH network are final. For example, use of Fedwire by participants to make settlement payments would provide finality for net settlement entries by the designated settlement time, which could be relatively early in the day, assuming that all participants in net debit positions are able to fund their positions. The use of Fedwire for settlement may also reduce temporal risk, again assuming all net debtors are able to fund their positions. Additionally, the Reserve Banks' risk is minimized because of the controls used to monitor Fedwire.

Operational concerns. The national ACH network should be able to assure the Board that settlement through a Reserve Bank would not cause serious operational problems for the network or any service provider to the network. In addition to operating capabilities, the Board will consider a service provider's financial viability and its ability to demonstrate that it can provide efficient ACH processing services.

2. Small-Dollar ATM Networks

A small-dollar electronic funds transfer or automated teller machine (ATM) network may request settlement services from a Federal Reserve Bank. The Board has delegated to the Director of the Division of Reserve Bank Operations and Payment Systems, with the concurrence of the General Counsel, authority to approve such arrangements under the following conditions: The standard net settlement service agreement must stipulate that net settlement entries are to be considered provisional until the business day following the presentment of a statement to the Federal Reserve in order to ensure the settling depository institutions' ability to cover their net debit positions. The network must agree that large-dollar payments will not be processed under any circumstances and that the Federal Reserve may terminate net settlement services immediately if there is any indication that the network is being used for large-dollar transfers. The network must agree to provide information to the Federal Reserve regarding its operations and transactions when requested. The Federal Reserve has the right to modify or terminate the agreement at any time.

III. Other Policies

A. Rollovers and Continuing Contracts

The Board believes that the use of market innovations, such as federal funds or Eurodollar rollovers or continuing contracts, to reduce daylight overdrafts in Federal Reserve accounts and on the New York Clearing House's Clearing House Interbank Payments System (CHIPS) is consistent with the Board's policy concerning daylight overdrafts. The Board urges market participants to consider using such innovations for these and other financial instruments where feasible. In doing so, participants should be mindful that implementing changes of this type may involve incremental costs, at least transitionally, and modified risk positions. Accordingly, participants should evaluate these factors and take them into account when selecting and negotiating with counterparties.

Many overnight interbank federal funds and other similar purchases and sales are negotiated in the morning with the funds being sent over Fedwire in the afternoon. Typically, the previous day's overnight borrowings are returned to the seller in the early morning, thus leaving a midday time gap of three or more hours between the morning repayment and the receipt of that same day's new borrowing. Often these transactions are between the same two banks for the same amount. This funding time gap can contribute to daylight overdrafts for the borrowing institution and create risk to Reserve Banks.

Rollovers are interbank overnight transactions where the principal does not change and is not returned the next day to the seller but, instead, is rolled over for the next overnight period. The overnight interest rate is negotiated daily between buyer and seller. The maturity is one business day, or no maturity is specified, and the arrangement may be cancelled at any time by either party. The Board understands that national bank lending limits would not apply to federal funds transactions that have a maturity of one business day or no stated maturity and require no advance notice for termination. Because the rollover procedure eliminates the daily movement of principal on Fedwire and the corresponding time gap that could otherwise exist between repayment of the previous day's borrowings and receipt of new reborrowing, daylight overdrafts are reduced.

Continuing contracts are similar to rollovers. With a rollover, the size of each day's sale is the same. With a continuing contract, the size of each day's sale can vary, and only the difference in principal from the previous day's borrowing is moved over Fedwire or CHIPS. Such arrangements reduce the size of the daily movement of principal on Fedwire and CHIPS and also eliminate the time gap that could otherwise exist between repayment of the previous day's borrowings and receipt of new reborrowing, thereby reducing daylight overdrafts in Federal Reserve accounts or net debits on CHIPS. When the same maturity conditions apply to a continuing contract as apply to a rollover (one business day or unspecified maturity and cancellation at any time by either party) national bank lending limits do not apply.

Each participant should satisfy itself that it has the flexibility to negotiate amounts, rates, and maturity options before using these practices for federal funds, Eurodollars, or other financial instruments. Either of these practices, rollovers or continuing contracts, can reduce daylight overdrafts or intraday net debits, and their prudential use by the banking industry is consistent with the Federal Reserve's policy of reducing intraday exposures on Fedwire and CHIPS. When borrowing banks reduce their daylight overdrafts by use of these practices, some extra operational costs and risks may be incurred by either party compared to current arrangements in the overnight market. For example, sellers of federal funds and other instruments may have to develop alternative audit trail procedures and may accept some additional risk of repayment since funds would not be returned each day before they would be relent. In addition, buyers of federal funds and other instruments may experience some extra initial operating costs to set up rollover arrangements between themselves and lending banks and may have to pay a higher rate to induce lenders to commit their funds for a longer time. However, these costs and risks, if any, should be reflected in the rate or rate spread received and paid. Although it is unclear whether rates on daily interbank funds transactions will fall relative to rates paid for rollovers, continuing contracts, or term funds, or whether the reverse will occur, the Board believes that the negotiation of terms relative to the use of these arrangements should be left to the free operation of the private market.

The Board also supports efforts to encourage timely return of overnight federal funds and other borrowings and encourages operational improvements that would consistently allow timely receipt of funds purchased soon after a seller negotiates a sale. Similar arrangements and industry standards were suggested for federal funds by the American Bankers Association in July 1986.

By order of the Board of Governors of the Federal Reserve System, August 25, 1992.

Jennifer J. Johnson,

Associate Secretary of the Board.

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