FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

DALLAS, TEXAS
75265-5906

December 8, 1997

Notice 97-115

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

SUBJECT

Policy Statement on Payments System Risk; Revised Policy for Risk-Focused Supervision of Small Shell Bank Holding Companies

DETAILS

The Board of Governors of the Federal Reserve System has modified the daylight overdraft measurement rules to accommodate an earlier afternoon presentment deadline for checks drawn on local Federal Reserve Banks. The modification was effective November 14, 1997.

The Board has also announced a revised policy for risk-focused supervision of small shell bank holding companies. Small shell bank holding companies are banking organizations with less than $1 billion of consolidated assets that do not have debt outstanding to the public and that do not engage in significant nonbank activities.

The new supervisory program supersedes the previous inspection frequency guidelines applicable to small shell organizations and permits a more flexible approach to supervising these entities in a risk-focused environment. Implementation of the new program began November 30, 1997.

ATTACHMENTS

A copy of the Board's notice as it appears on pages 61127-28, Vol. 62, No. 220 of the *Federal Register* dated November 14, 1997, is attached. Also attached is a copy of the Board's revised policy for risk-focused supervision.

For additional copies, bankers and others are encouraged to use one of the following toll-free numbers in contacting the Federal Reserve Bank of Dallas: Dallas Office (800) 333-4460; El Paso Branch *Intrastate* (800) 592-1631, *Interstate* (800) 351-1012; Houston Branch *Intrastate* (800) 392-4162, *Interstate* (800) 221-0363; San Antonio Branch *Intrastate* (800) 292-5810.

MORE INFORMATION

For more information regarding daylight overdrafts, please contact James Smith at (214) 922-5585. For more information regarding risk-focused supervision of small shell bank holding companies, please contact Basil Asaro at (214) 922-6066.

For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

FEDERAL RESERVE SYSTEM

Docket No. R–0989

Policy Statement on Payments System Risk; Modification to the Time Credits are Posted to Federal Reserve Accounts for Checks Drawn on Local Federal Reserve Banks for Purposes of Measuring Daylight Overdrafts

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy Statement.

SUMMARY: The Board has modified the daylight overdraft measurement rules to accommodate an earlier afternoon presentment deadline for checks drawn on local Federal Reserve Banks.

EFFECTIVE DATE: November 14, 1997.

FOR FURTHER INFORMATION CONTACT: Myriam Payne, Senior Financial Services Analyst (202/452–3219), or Stacy Panigay, Financial Services Analyst (202/452–2934), Division of Reserve Bank Operations and Payment Systems; for the hearing impaired *only*: Telecommunications Device for the Deaf, Diane Jenkins (202/452–3544).

SUPPLEMENTARY INFORMATION:

Background

When the Board modified the Payments System Risk Reduction policies in 1992 (57 FR 47093, October 14, 1992), it adopted a set of "posting rules" which comprise a schedule for the intraday timing of debits and credits to institutions' Federal Reserve accounts for different types of payments. With the implementation of these rules along with the imposition of fees for daylight overdrafts, the Board was interested in inducing behavioral changes to control risk and increase efficiency in the payments system. Under the daylight overdraft measurement rules that became effective on October 14, 1993, depository institutions that deposit in separately sorted cash letters Checks Drawn on Local Federal Reserve Banks (i.e., Federal Funds checks), U.S. Treasury Checks, Postal Money Orders, and U.S. Savings Bonds Deposited under the EZ-Clear Program by 4 p.m. ET receive credit for these items at 5 p.m. ET.

Analysis of Federal Funds Checks Presentment Deadline

The Board believes that establishing a consistent presentment deadline for Federal Funds checks in all Federal Reserve districts will help reduce the routine use of Federal Funds checks.[1] Federal Funds checks are an inappropriate means of providing regular access to an institution's Federal Reserve account and their routine use is contrary to the Federal Reserve's strategy of promoting efficient and effective methods of payment. In almost all cases where Federal Funds checks are used as the payment instrument, the transaction could have been made through a more secure and efficient method, such as a funds transfer network. To discourage the use of Federal Funds checks and encourage depository institutions' use of more efficient means of payment, a 3 p.m. local time presentment deadline for Federal Funds checks will be implemented.

Policy Statement on Payments System Risk

The Federal Reserve Board has adopted the following changes to the "Federal Reserve System Policy Statement on Payments System Risk," under the heading "I. Federal Reserve Policy":

Modified Procedures for Measuring Daylight Overdrafts

Post at 5:00 p.m. Eastern Time:

• Treasury checks, postal money orders, and EZ-Clear Savings Bond redemptions in separately sorted deposits. These items must be deposited by 4:00 p.m. Eastern Time.

• Local Federal Reserve Bank checks. These items must be presented before 3:00 p.m. Eastern Time.

• Processed manual letters of credit.

+/- Same-day ACH transactions. These transactions include ACH return items, check truncation items, and flexible settlement items.

Post after the close of Fedwire funds transfer system:

+/- All other non-Fedwire transactions. These transactions include the following: local Federal Reserve Bank checks presented after 3:00 p.m. Eastern Time but before 3:00 p.m. local time; noncash collection; credits for U.S. Treasury and government agency definitive security interest and redemption payments if the coupons or securities are received on or after the maturity date; Treasury Tax and Loan (TT&L) calls; subscriptions for SLGS; currency and coin shipments; small-dollar credit adjustments; all debit adjustments; and small-dollar check collections. Discount window loans and repayments are normally posted after the close of Fedwire as well; however, in unusual circumstances a discount window loan may be posted earlier in the day with repayment 24 hours later, or a loan may be repaid before it would otherwise become due.

By order of the Board of Governors of the Federal Reserve System, November 7, 1997.

Jennifer J. Johnson,

Deputy Secretary of the Board.

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[1] Federal Funds checks are drafts drawn by a depository institution against its account at a Federal Reserve Bank. These funds represent immediately available funds when presented for payment, and thus, when used, the checks are most often used to settle same-day securities transactions, interbank transfers, international transactions, real estate transactions, payments to state and local governments, Federal Reserve Bank transactions and for other situations where a bank check is required for legal reasons.

Attachment A

RISK-FOCUSED SUPERVISION POLICY FOR SMALL SHELL BANK HOLDING COMPANIES

This policy sets forth a framework for applying risk-focused supervision concepts to small shell bank holding companies (SSBHCs).[1] It was developed in the interest of increasing the effectiveness of Federal Reserve supervisory activities, while enhancing interagency coordination and reducing regulatory burden on banking organizations. In recent years, changes to statutory frequency requirements for bank examinations, enhancements to off-site monitoring procedures, and the implementation of risk-focused examination practices have made it possible to focus supervisory activities more effectively on SSBHCs exhibiting the greatest degree of risk. Accordingly, the Federal Reserve is adopting a risk-focused supervision program for SSBHCs that tailors supervisory activities for these companies based on an assessment of their reported condition and activities and the condition of their bank subsidiaries. Based on these assessments, Reserve Banks will be required to develop a strategy for addressing the supervisory issues related to each organization. For companies where significant risk factors are present, Reserve Banks must consider a range of supervisory responses, including informational requests and management interviews, visitations or advisory visits, as well as on-site target and full-scope inspection activities. The program is to be implemented as soon as practical, but should be fully operational by November 30, 1997. With the implementation of this program, the Board is rescinding for SSBHCs the bank holding company inspection scope and frequency requirements of SR 85-28, "Examination Frequency and Communicating with Directors."

Risk Assessment Process

Under this program, Reserve Banks should perform a risk assessment for

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[1] Small shell bank holding companies are defined for the purpose of this program as those companies with less than $1 billion in consolidated assets that do not have debt outstanding to the public, and that do not engage in significant nonbank activities. A nonbank activity could be considered significant based on the scope or type of activity. For example, credit extending activities as well as investment and trading activities where the holding company acts as a principal would generally be considered significant. The provision of services on a fee basis such as the provision of data processing services to affiliated and/or unaffiliated banks or the sale of instruments on an agency basis may also, in certain instances, be considered significant, depending on the scale of the activity or other factors that may pose direct or indirect risk to the holding company or any insured depository institution subsidiary.

each SSBHC at least once during each "supervisory cycle." For each company, its supervisory cycle will be determined by the examination frequency mandated for the lead subsidiary bank. The purpose of this risk assessment is to determine whether the risk profile of the SSBHC has weakened, the company is having an adverse effect on the subsidiary bank(s), or there are violations of law or regulation warranting further review. As described more fully below, where the risk assessment does not raise significant supervisory concerns, the assessment would serve as the basis for assigning a final BOPEC rating for the company. The risk assessment should be completed within 45 days of receipt of the lead bank's full-scope examination report. While risk assessments will be driven in most cases by the conclusions expressed in the current examination reports for subsidiary banks, they should also incorporate information from other sources available at the Reserve Bank, such as regulatory financial reports, previous inspection reports, and surveillance reports. The preparation of risk assessments should not routinely require requests for additional information from the company. Risk assessments should include reviews of the following areas:

- Financial condition of the parent company, including an evaluation of debt levels and cash flow;
- Financial condition of bank subsidiaries;
- Consolidated analysis (if applicable);
- Management, including any changes to senior management or ownership;
- Compliance with laws and regulations by the bank holding company and bank subsidiaries, as well as compliance with regulatory orders and other requirements imposed in connection with the granting of any application or other request;
- Intercompany and insider transactions as addressed by examinations and financial reports; and
- New activities and recent or planned acquisitions.

In the process of conducting the risk assessment Reserve Banks should pay special attention to bank examination report findings pertaining to possible violations of law or inappropriate transactions. In addition, changes in the organizational structure, management, or ownership of the company should be assessed to determine whether these may be cause for concern. The use of automated analytical tools and screens to perform the required financial analysis will normally suffice. When this review discloses no material supervisory concerns, the risk assessment should be used to assign a final rating to the company.

Development of Supervisory Strategies

If no unusual supervisory issues or concerns are identified by the risk assessment, no special follow-up with the company is necessary. However, all companies should continue to be monitored under existing surveillance and monitoring programs aimed at identifying significant changes in a company's condition, performance, or compliance profile that may prompt further review. Such changes may include 1) a material decline in the earnings performance or capital position of a bank subsidiary; 2) significant changes in management or ownership; 3) a large increase in outstanding debt; 4) new or expanded activities that may pose additional risk; 5) rapid growth; 6) questionable insider or intercompany transactions; 7) less than satisfactory SEER or other performance factors for the subsidiary bank(s); or 8) information suggesting less than satisfactory compliance with regulatory orders and other requirements imposed in connection with the granting of any application or other request. When these or other changes raise supervisory concerns, the risk assessment should be updated using the methods discussed below.

When a risk assessment is prepared in conjunction with the review of an examination report for a bank rated satisfactory or better, but supervisory concerns such as those listed above preclude the immediate assignment of a satisfactory BOPEC rating, a strategy for addressing those concerns must be developed and documented as part of the risk assessment. The strategy would typically require gathering additional information from the bank regulator or the company, either written or verbal. Where supervisory concerns are not satisfactorily addressed through off-site measures, a number of remedies should be considered, including visitations, targeted reviews of internal processes and specific transactions, or broader inspections encompassing a review of more significant financial and managerial issues, processes, or reporting systems. The specific timing of these activities is not prescribed by this policy; however, the on-site activity should be conducted as soon as possible following the off-site review, given that it is required only in situations when supervisory concerns have surfaced.

Strategies for Problem and Deteriorating Companies and Those with Identified Management Weaknesses

A full-scope, on-site inspection should be conducted the first time that the risk assessment preliminarily supports the assignment of a BOPEC rating of 3 or worse, or a management rating of less than satisfactory. Typically, this would occur when a significant subsidiary bank's CAMELS composite or management component is assigned a rating of 3, 4, or 5. In such a case, an inspection is deemed necessary to ensure that sufficient information is available to develop an effective supervisory strategy. The purpose of the inspection is: 1) to confirm the Reserve Bank's understanding of the SSBHC's financial condition, activities, and management oversight of the bank, as well as whether violations of law or regulation or inappropriate intercompany transactions have occurred; 2) to determine the extent to which any of these factors is having an adverse effect on the bank(s); 3) to identify steps the holding company should take to strengthen its subsidiary bank(s); and 4) to assign a BOPEC rating to the company. Based on these inspection results and information available prior to the inspection, and in consultation with the bank's federal and state supervisory authority(ies), the Reserve Bank should develop a supervisory strategy for dealing with the company.

In situations where the company and management are adversely affecting the bank, the strategy should contemplate enforcement activities that are coordinated with those of the bank's federal or state regulator(s), a clear delineation of the actions and reports expected of holding company management, and plans for additional supervisory activities, either on-site or off-site. The Reserve Bank should designate a primary contact responsible for monitoring the company's condition and updating the risk assessment and supervisory strategy.

In situations where the bank holding company is neither contributing to the bank's problems nor in a position to serve as a source of strength, a typical supervisory strategy would be to maintain an open dialogue with the bank's primary regulator(s) and to review relevant regulatory reports.

Communicating Supervisory Findings

When a risk assessment discloses no supervisory concerns, or when an existing 3, 4, or 5 BOPEC rating is reaffirmed through the risk assessment, a brief letter detailing this overall conclusion and the SSBHC's BOPEC rating should be forwarded to the company. A prototype of such a letter is attached.

When more detailed off-site reviews are performed or on-site targets or visitations are conducted, Reserve Banks may also communicate the scope of these activities, relevant findings, and supervisory recommendations to the company in a letter. Alternatively, the findings can be conveyed to the company in a more structured report similar to the existing bank holding company inspection report. When full-scope inspections are conducted, use of existing bank holding company report pages is mandatory; however, the only pages required to be completed are the Examiner's Comments, Scope, Analysis of Financial Factors, and the confidential pages. The use of any other page (including financial data pages) should be limited to situations where its presentation is useful for supporting conclusions or recommendations.

With regard to correspondence and reports to satisfactorily rated SSBHCs, it is generally appropriate for commissioned, non-officer personnel who are designated as the primary contact or portfolio manager for such companies to have signing authority. Reports and other official communications to problem and deteriorating companies require an officer's signature.

Discontinuation of Risk Management Ratings for SSBHCs

Effective January 1, 1997, the Uniform Financial Institutions Rating System (CAMELS) was amended specifically to require the evaluation of risk management systems both in the overall management rating and in the individual financial components. By definition, financial and management activities at SSBHCs are conducted in the subsidiary banks and the risk management process of the company is essentially the same as that of the bank(s). Accordingly, no separate risk management rating will be required of SSBHCs.

Newly Formed SSBHCs

Consistent with long-standing Federal Reserve policy, an initial full-scope, on-site inspection of a newly formed SSBHC should be conducted within the first 12 to 18 months of operations. Thereafter, risk assessments should be performed in accordance with this policy.

Attachment B

Prototype Letter to Communicate
Findings of a Risk Assessment

Board of Directors
[name and address of SSBHC]

Dear Members of the Board:

This Reserve Bank has conducted a review of [SSBHC] based primarily on financial and other information regularly provided by your organization to the Federal Reserve and other supervisory agencies, as well as the recent examination report for [Bank], SSBHC's subsidiary bank. The review was conducted by Examiner [EIC] and disclosed no supervisory concerns [or, no concerns in addition to those previously communicated to the institution].

[SSBHC] is assigned a composite BOPEC rating of [numerical rating], based on a bank component rating of [numerical rating] and a parent company component rating of [numerical rating]. Management is regarded as [rating]. The ratings assigned to the bank holding company are part of the overall findings of this review and are confidential. They should not be disclosed or made public.

If you have any questions or comments regarding the risk assessment, or any regulatory matter concerning your organization, please contact [Reserve Bank contact] of this Reserve Bank at [telephone number].

Sincerely yours,