

FEDERAL RESERVE BANK  
OF NEW YORK

[ Circular No. 10184 ]  
[ August 13, 1987 ]

REDUCING RISKS ON LARGE-DOLLAR WIRE TRANSFER SYSTEMS

Revised Policy Statement on Daylight Overdrafts

To the Chief Executive Officers of All Depository Institutions  
in the Second Federal Reserve District:

Following is the text of a statement on daylight overdrafts issued by the Board of Governors of the Federal Reserve System, which supersedes the policy statement adopted by the Board in May 1985:

The Federal Reserve Board has adopted an interim statement of its policy on reducing risks on large dollar transfer systems. This interim policy supersedes the policy statement adopted by the Board on May 17, 1985, and will remain in effect pending reevaluation of the Board's risk reduction program.

Large dollar funds transfer networks are an integral part of the payments and clearing mechanism. A daylight overdraft occurs when a depository institution sends funds over Fedwire in excess of the balance in its reserve or clearing account, or sends more funds over a private network than it has received.

The Board's May 1985 policy statement required privately owned large dollar payment networks using Federal Reserve net settlement services to (1) require each of its participants to establish a limit on the maximum net transfer amount that it is willing to receive from each other participant ("bilateral net credit limit") and (2) establish for each of its participants a maximum amount of net transfers ("sender net debit cap") that the participants can transfer over that network. The policy also strongly encouraged each depository institution incurring daylight overdrafts on Fedwire or participating on a private network to adopt a cross-system sender net debit cap designed to limit the amount of risk an institution presents across all systems combined.

The interim policy statement modifies the May 1985 policy as follows:

- Reduces in two stages the current sender net debit cap by 25 percent — 15 percent on January 14, 1988, and the balance on May 19, 1988, unless subsequent events suggest that the second step would disrupt the payments system and/or financial markets.
- Exempts depository institutions from self-evaluation guidelines if their boards of directors approve a *de minimis* net debit cap of the smaller of 20 percent of adjusted primary capital or \$500,000. Implementation of this provision would be no later than December 3, 1987, or earlier at the discretion of Reserve Banks.
- Imposes a \$50 million limit on book-entry securities transfers over Fedwire.
- Subjects the clearing procedures of primary dealers to review by the Federal Reserve Bank of New York.
- Permits inter-affiliate Fedwire transfers resulting in daylight overdrafts, provided certain safeguards are observed.
- Permits depository institution holding companies to centralize their wire transfer operations at one or more of their subsidiaries, provided certain safeguards are observed.

Enclosed — for depository institutions in this District — is the text of the new policy statement, as published in the *Federal Register* of August 6, 1987. Copies will be furnished to others upon request directed to the Circulars Division of this Bank (Tel. No. 212-720-5215 or 5216.)

Questions regarding this matter, and requests for copies of the staff papers presented to the Board of Governors concerning the modifications, may be directed to Ralph A. Cann, III, Vice President, who is the daylight overdraft liaison officer at this Bank (Tel. No. 212-720-7766.)

E. GERALD CORRIGAN,  
*President.*

Interim Policy Statement Regarding Risks  
on Large Dollar Wire Transfer Systems

*Reprint from*

# federal register

---

---

**Vol. 52, No. 151**

**Pp. 29255-29267**

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Revised Policy Statement on Daylight Overdrafts

29255

---

**FEDERAL RESERVE SYSTEM**

[Docket No. R-0607]

**Interim Policy Statement Regarding Risks on Large-Dollar Wire Transfer Systems**

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Interim policy statement.

**SUMMARY:** The Board has adopted a statement of an interim policy regarding risks on large-dollar wire transfer systems pending reevaluation of the Board's risk reduction program. This interim policy statement supersedes the

policy statement adopted by the Board on May 17, 1985. 50 FR 21120 (May 22, 1985). In addition to matters covered in the earlier statement, the interim policy statement:

- Reduces in two stages the current sender net debit cap by 25 per cent.
- Exempts depository institutions from self-evaluation guidelines if their boards of directors approve a *de minimis* net debit cap of the lesser of 20 per cent of adjusted primary capital or \$500,000.
- Imposes a \$50 million limit on book-entry securities transfers over Fedwire.
- Provides for review by the Federal Reserve Bank of New York of the

clearing procedures of primary dealers.

- Permits inter-affiliate Fedwire transfers resulting in daylight overdrafts, provided certain safeguards are observed, and permits depository institution holding companies to centralize their wire transfer operations at one or more of their subsidiaries, again, provided certain safeguards are observed.

**EFFECTIVE DATE:** The component parts of the interim policy will take effect as follows:

Cap Reduction: 15 per cent reduction on January 14, 1988; the remainder of the 25 per cent cap reduction on May 19, 1988.

*De Minimis* Cap: Implementation no later than December 3, 1987; earlier at the discretion of Reserve Banks. Board of director certification required by March 31, 1988.

\$50 million Book-Entry Transfer Limit: January 14, 1988.

Inter-affiliate Transfers: No later than June 30, 1988.

**FOR FURTHER INFORMATION CONTACT:** Edward C. Ettin, Deputy Director (202-452-3368), Division of Research and Statistics; Elliott C. McEntee, Associate Director (202-452-2231), Division of Federal Reserve Bank Operations; Joseph R. Alexander, Senior Attorney (202-452-2489), Legal Division; for the hearing impaired only, Telecommunications Device for the Deaf (202-452-3544), Earnestine Hill or Dorothea Thompson.

**SUPPLEMENTARY INFORMATION:** The Board of Governors of The Federal Reserve System has issued the following interim policy statement concerning risks on large-dollar electronic funds transfer systems:

#### Interim Policy Statement Regarding Risks on Large-Dollar Payment Systems<sup>1</sup>

The Board has been concerned for some time about the risks associated with large-dollar payment systems.<sup>2</sup> The Federal Reserve Banks face direct risks of loss should depository institutions<sup>3</sup> be unable to settle their intra-day overdrafts on Fedwire before the end of the day. Moreover, the inability or unwillingness of a participant to settle its net debit position on a private large-dollar network—one that permits its participants to transmit payment messages throughout the day with settlement of net positions at the end of the day—would expose the banking system to systemic risk. The Federal Reserve would bear an indirect risk if it

<sup>1</sup> This policy statement supercedes an earlier one issued by the Board on May 17, 1985. 50 FR 21120 (May 22, 1985).

<sup>2</sup> 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 payment 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.

<sup>3</sup> 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 and Edge and agreement corporations, unless the context indicates a different reading.

sought to avoid or limit this systemic risk. Systemic risk occurs when institutions unable to settle on private large-dollar payments networks cause their creditors on those networks, in turn, to be unable to settle their own commitments. Serious repercussions could, as a result, spread to other participants in the network, to other depository institutions not even participating in the private network, and to the nonfinancial economy generally. Finally, on either private wire systems or Fedwire, depository institutions create risk by permitting their customers, including other depository institutions, to transfer uncollected balances over wire systems in anticipation of their coverage before the end of the day.

The Board first began to address these risks in 1982 by permitting same-day net settlement at the Federal Reserve Bank of New York by participants in the CHIPS<sup>4</sup> network. In 1985, it adopted the next step in its effort to reduce risk on large-dollar networks by:

(1) Requiring participants in private networks using the Federal Reserve's net settlement service to establish maximum net credit limits they would establish for each other network participant (bilateral net credit limits).

(2) Requiring such networks to establish maximum limits on the net credit positions that all participants could have with any one participant (network net debit caps).

(3) Establishing guidelines by which institutions could evaluate their own ability to settle intra-day payments over Fedwire and private large-dollar wire systems combined; using these guidelines, institutions adopt voluntary limits on their maximum intra-day net debit funds positions across all large-dollar payments systems (cross-system sender net debit caps), approved annually by each institution's board of directors and subject to the primary supervisor's review as part of the examination process.

These and related steps were effective March 27, 1986.

In its 1985 policy statement, the Board indicated its intention to review its policy in late 1986, and to adopt modifications as required. In December, 1986, it published for public comment proposed modifications.<sup>5</sup> After

<sup>4</sup> CHIPS (Clearing House Inter-bank Payments System) is a large-dollar network owned and operated by the New York Clearing House.

<sup>5</sup> On December 10, 1986, the Board issued the following six proposals for public comment: book-entry securities transfers (Docket No. R-0587, 51 FR 45046); cap level reductions (Docket No. R-0588, 51 FR 45050); "de minimis" caps (Docket No. 0589, 51 FR 45053); limits on inter-affiliate Fedwire transfers

reviewing the public comments and the progress of its risk reduction program to date, the Board has determined to adopt several modifications to its policy on an interim basis while the Board reconsiders the whole of its risk reduction program (see below). The interim policy changes the previous risk reduction policy in the following ways:

- The sender net debit cap multiples will be reduced by 25 per cent in two steps; a 15 per cent reduction will be effective on January 14, 1988, and the balance to 25 per cent below the original cap multiples will take place on May 19, 1988, unless subsequent events suggest the second step would be too disruptive to the payments mechanism or financial markets.

- A Fedwire transfer limit of \$50 million on secondary market book-entry securities transfer (effective January 14, 1988) has been adopted. It will be unacceptable to send multiple transfers of \$50 million or less with the express purpose of avoiding the limits or intentionally substitute book-entry for funds transfers in order to avoid quantitative limits on overdrafts.

- The Federal Reserve Bank of New York will continue to monitor clearing patterns and policies of primary dealers and will encourage these dealers to adopt practices designed to minimize book-entry overdrafts.

- With board of director approval, depository institutions may exempt themselves from self-evaluation to determine their sender net debit cap if they limit their cross-system funds overdrafts to the lesser of 20 per cent of adjusted primary capital or \$500,000. Institutions that chronically exceed this *de minimis* cap, or incur overdrafts without filing a cap, will not be permitted to incur any Fedwire overdrafts. The *de minimis* cap is intended for use by depository institutions incurring only occasional overdrafts. Institutions that incur overdrafts under the *de minimis* policy on a regular basis will be counseled to reduce their frequency of overdrafts or to file a regular cap. Institutions that have not filed any cap by March 31, 1988, will be assigned a cap of zero.

- Depository institutions may transfer funds over Fedwire to affiliates, even when the sending institution incurs an overdraft, so long as the sender's total overdrafts stay within its cap, and provided that the sending institution's

(Docket No. R-0590, 51 FR 45054); automated clearing house transactions (Docket No. 0591, 51 FR 45043); and pricing of daylight overdrafts (Docket No. R-0592, 51 FR 45052). All these proposals were published in the December 16, 1986, edition of the Federal Register.

board of directors approves and the primary supervisor finds the arrangement acceptable. (FSLIC-insured institutions are not permitted by the Federal Home Loan Bank Board to adopt such practices.)

- Depository institutions may arrange to send and receive Fedwire transfers for affiliated depository institutions with board of director approval, provided certain safeguards are met.

The Board is well aware that large-dollar networks are an integral part of the payments and clearing mechanism and that it is of vital importance to keep the payments mechanism operating without significant disruption. Indeed, it is precisely 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, however, that some intra-day credit may be necessary to keep the payments mechanism running smoothly and efficiently. While it is essential to reduce and control intra-day credit risks, this must be done in a manner that will minimize disruptions to the payments mechanism. The Board anticipates that in 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—even with the additional steps the Board has taken.

The Board reemphasizes that it is not condoning daylight overdrafts. While, as noted, some intra-day credit may be necessary, the Board anticipates that, as a result of its policy, there will continue to be a reduction in the number of institutions consistently relying on daylight overdrafts or other intra-day credit to conduct their business. The Board also expects to continue observing, over time, a reduction in the volume of intra-day credit at those institutions with a pattern of substantial reliance on such credit. The Board will continue to monitor the effect of its policy on the payments system and financial markets and anticipates that its Large-Dollar Payments System Advisory Group will advise it if significant disruptions occur from its daylight overdraft policy.

The Board believes that its policy to date has been successful in alerting senior management of depository institutions to the risks involved in extending daylight credit to their customers and in the exposure presented by other depository institutions on private networks. The

evidence suggests that most depository institutions have improved operational and credit controls and have been successful in reducing their daylight overdrafts relative to their transactions volume. The Board has taken the additional modest steps described above in order to induce a further reduction. The Board believes that these steps will not result in any disruptions to the payments mechanism.

The additional steps taken by the Board are considerably less stringent than those published for public comment in December, 1986.<sup>6</sup> In view of public comments, the Board has determined that, before it considers further steps to reduce payment system risk it will first review:

- Its long-run goals for this policy;
- The applicability to, and relationship between, caps and collateral for book-entry overdrafts;
- The role of collateral for funds and book-entry overdrafts;
- The applicability of caps to book-entry overdrafts;
- The benefits and costs of future cap reductions;
- The benefits and costs of Reserve Bank pricing of Fedwire funds and book-entry overdrafts, in lieu of, or in addition to, cap reduction;
- The benefits and costs of requiring larger clearing balances for active participants in the payment system in lieu of, or in addition to, cap reduction and/or pricing of Fedwire overdrafts; and
- Other related issues.

The Board will be requesting its Large-Dollar Payment System Advisory Group to review these issues in consultation with other interested private-sector parties and to present its views to the Federal Reserve Payment System Policy Committee<sup>7</sup> by the first quarter of 1988. At the same time, it has asked the Payment System Policy Committee to create a joint Reserve Bank-Board staff task force to review these issues as well and to present its analysis by early 1988. Subsequent to the reports of the private sector Advisory Group and the staff task force, the Payment System Policy Committee will review the analyses and present its views to the Board. The Board intends that the Committee report will highlight the Board's options and the implications

<sup>6</sup> The Board anticipates that it will consider in the fall of 1987 proposals to reduce risks on automated clearing houses (ACHs), but does not expect that it will, at that time, modify the treatment of ACH payments in its ex post monitoring system.

<sup>7</sup> The Payment System Policy Committee is chaired by Vice Chairman Johnson. Other members are Governor Angell and Presidents Corrigan and Meizer and First Vice President Monhollon.

of each of them for both risk reduction and possible market disruption.

In the interim, the Board's revised risk reduction policy is set out below:

### *I. Bilateral Net Credit Limits*

In earlier statements of its risk-reduction policy,<sup>8</sup> the Board stated that any large-dollar network obtaining net settlement services from a Federal Reserve Bank would have to require each of its participants to establish bilateral net credit limits vis-a-vis each other participant on that network. In setting bilateral net credit limits, each participant on a network determines for itself the maximum dollar amount of net transfers (i.e., the value of receives in excess of the value of sends) 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. Accordingly, the Board has decided to continue this requirement.

Under the Board's policy, no private large-dollar payment 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, and (2) establishes a system to reject or hold any payment that would exceed such a limit.<sup>9</sup>

The federal bank examiners will continue, during regular examinations, to 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.

### *II. Sender Net Debit Caps*

Bilateral net credit limits are not sufficient by themselves to reduce aggregate risk on large-dollar payment networks. The volume of daylight exposure that each institution is willing to accept from each other institution is likely to be quite large when aggregated across all receivers. Moreover, each institution is unaware of the credit made available to a given sender by other potential receivers. For this reason, the Board believes that bilateral net credit limits must be supplemented by a limit

<sup>8</sup> 49 FR 13191; 50 FR 21121.

<sup>9</sup> Bilateral net credit limits do not apply to Fedwire because the Federal Reserve provides final credit to the receiver when advice of credit is given for the transfer. 12 CFR 210.36. Reserve Banks, however, may take action to reduce their credit exposure.

on the aggregate amount of risk that an institution can present to the payments system. Accordingly, the Board strongly urges that each institution either participating on a large-dollar network or incurring daylight overdrafts on Fedwire adopt a sender net debit cap (a ceiling or "cap" on the aggregate net debit position—the value of all sends in excess of the value of all receives—that it can incur during a given interval).

Sender net debit caps—expressed as multiples of capital—should be applied across all large-dollar systems, i.e., to the aggregate position of an institution at a moment in time on all large-dollar transfer systems combined. With this "cross-system" sender net debit cap, net debit positions on one system can be offset by credit positions on other systems.<sup>10</sup> In addition to the cross-system sender net debit cap, the Board requires, as a condition for access to the Federal Reserve net settlement service, that each private network develop and impose on its participants a network sender net debit cap designed to reduce individual institution risk exposure on that network to reasonable levels. Further, each network is required to implement a mechanism for rejecting or holding those transfers that would cause an institution to exceed its cap.

The Board's policy calls for a voluntary cross-system sender net debit cap based on a specific set of guidelines and some degree of examiner oversight.<sup>11</sup> The Board's policy has no regulatory dimension except (1) potential responses to an actual level of aggregate daylight credit exposure at an individual institution deemed by the institution's examiner to be unsafe or unsound, (2) elimination of access to daylight overdrafts on Fedwire by institutions not engaging in the self-evaluation process or filing a board of directors approved *de minimis* cap, and (3) control of Fedwire overdrafts of individual institutions determined by a Reserve Bank to expose it to excessive risk. Events since March, 1986, have demonstrated that senior management and the boards of directors of

<sup>10</sup> As noted below, however, Reserve Banks will not permit daylight overdrafts on Fedwire to exceed the cross-system cap established by an institution; i.e., net credits on private wire systems will not be able to be used to increase the Fedwire cap. A similar arrangement will exist for private network participants where net credits on Fedwire and other private networks cannot be used to increase a participant's cap on a given private network.

<sup>11</sup> The Board acknowledges with appreciation that its policy draws heavily on the *Final Report of the Risk Control Task Force, Payments System Committee, Association of Reserve City Bankers*, prepared with the assistance of the Bank Administration Institute and Robert Morris Associates (October, 1984).

depository institutions generally have followed the proposed guidelines and procedures closely. If further events demonstrate the contrary, the Board will reconsider its options, including the adoption of regulations designed to impose explicit limits on daylight credit exposure.

#### A. Determining Cap Category

The first step for an institution in establishing its cross-system sender net debit cap is to determine its own cap category by evaluating its creditworthiness, credit policies, and operational controls and procedures.<sup>12</sup> The guidelines to be used by each institution in establishing its cap category are detailed in an Appendix to the Board's this policy statement.

Determination of cap category should be made by an institution's board of directors. 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-evaluation is performed by each entity incurring daylight overdrafts or participating on a private large-dollar network, (2) the entity's cap is based on the entity's own capital (adjusted as noted below to avoid double counting), and (3) each entity maintains for its primary supervisor's review its own file with supporting documents for its self-evaluation and a record of the parent's board of directors' review, as noted below.<sup>13</sup>

<sup>12</sup> This evaluation should be done on an individual institution basis—treating as separate entities each commercial bank, each Edge (and its branches), each thrift institution, etc. While the Board realizes that depository institution holding companies may act as integrated entities and that performing the self-evaluation on an individual institution basis may result in some increased costs, permitting holding company organizations to consolidate their funds transfer activities for daylight overdraft monitoring purposes would increase Federal Reserve Bank credit risk or systemic risk to depository institutions.

An exception is made in the case of U.S. agencies and branches of foreign banks. Since 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.

<sup>13</sup> The Board believes that in determining a sender net debit cap for its U.S. branches and agencies, a foreign bank should undergo the same self-evaluation process as domestic banks. 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-evaluation and cap level should be reviewed by senior management at the foreign bank's head office that exercises authority over the foreign bank that is

In applying these guidelines, each institution is expected to maintain a confidential file for examiner review that includes (1) worksheets and supporting analysis developed in its self-evaluation 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-evaluation, and (3) copies of the minutes of the discussion of the appropriate board of directors concerning the institution's adoption of a cap category.<sup>14</sup> The process of self-evaluation, with board of director review, should be conducted at least once in each 12-month period.

As part of its normal examination, the depository institution's examiners will review the contents of the self-evaluation file.<sup>15</sup> The objective of this review will be to assure that the institution has seriously and diligently applied the guidelines, that the underlying analysis and methodology were reasonable, and that the resultant self-evaluation was generally consistent with the examination report. Examiner comments, if any, would be expected to be forwarded to the board of directors of the institution. Consistent with the voluntary nature of the Board's policy with regard to sender net debit caps, however, it should be emphasized that the examiner cannot require a modification of the self-evaluation cap category unless the level of daylight credit used by the institution constitutes an unsafe or unsound banking practice.

#### B. Establishing Sender Net Debit Cap

The cap category resulting from the self-evaluation process should be used by each institution to establish its cross-system net debit cap. The cap levels, set as multiples of adjusted primary capital,<sup>16</sup> would be as follows:

equivalent to that exercised by a board of directors over a U.S. depository institution. In those cases where the board of directors does exercise authority equivalent to that of a U.S. board, cap determination should be done by the board.

<sup>14</sup> 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-evaluation was discussed. In lieu of this, the file on the self-evaluation that is made available for examiner review by the U.S. offices of a foreign bank should contain the report on the self-evaluation 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.

<sup>15</sup> In the interim between examinations, examiners 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.

<sup>16</sup> See Section II C on capital, *infra*.

## 1. MARCH 27, 1986 THROUGH JANUARY 13, 1988

Cap class	Net debit cap	
	2-week avg. plus	Single day
High .....	2.0	3.0
Above average .....	1.5	2.5
Average .....	1.0	1.5
Limited <sup>17</sup> .....	0.5	0.5
No Cap .....	0.0	0.0

<sup>17</sup> The "Limited Cap" is described in Section II C. infra. It will remain in effect only until January 1, 1989.

## 2. JANUARY 14, 1988 THROUGH MAY 18, 1988

Cap class	Net debit cap	
	2-week avg. plus	Single day
High .....	1.70	2.55
Above average .....	1.275	2.125
Average .....	0.85	1.275
Limited .....	0.425	0.425
No Cap .....	0.0	0.0

## 3. MAY 19, 1988 AND AFTER

Cap class	Net debit cap	
	2-week avg. plus	Single day
High .....	1.50	2.25
Above average .....	1.125	1.875
Average .....	0.75	1.125
Limited .....	0.375	0.375
No Cap .....	0.0	0.0

An institution is expected to avoid incurring cross-system 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 some flexibility for institutions and recognizes 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 overdraft volume to be measured against the cap is the average over a two-week reserve maintenance period of an institution's daily maximum net debit position across all networks. In calculating the two-week average, individual days on which an institution is in an aggregate net credit position across all systems throughout the day are treated as if the institution was in a net position of zero. The number of days to be used in calculating the average is the number of business days the institution's Reserve Bank is open during the reserve maintenance period.

## C. Capital

Sender net debit caps are multiples applied to "adjusted primary capital."

Primary capital includes common stock, perpetual-preferred stock, surplus, undivided profits, contingency and other capital reserves, qualifying mandatory convertible instruments, allowances for possible loan and lease losses (exclusive of any allocated transfer risk reserves),<sup>18</sup> and minority interests in equity accounts of consolidated subsidiaries, but excludes limited-life preferred stock. "Adjusted primary capital" is defined as the sum of these primary capital components less all intangible assets and deferred net losses on loans and other assets sold. Adjusted primary capital for thrift institutions would include any capital assistance provided by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation in the form of net worth certificates pursuant to 12 U.S.C. 1729(f) or 1823(i).

Any institution with negative adjusted primary capital may incur daylight overdrafts on Fedwire only with the permission of its Reserve Bank; all such overdrafts are to be collateralized and be subjected to "limited" sender net debit cap levels. An institution that has improved its position from negative to positive adjusted primary capital, but whose intangible assets and deferred loan and other asset losses still equal one-half or more of its adjusted primary capital, may continue to incur daylight overdrafts on Fedwire up to the limited cap for two years after it has achieved a positive adjusted primary capital position, but only with the permission of its Reserve Bank. All such overdrafts must be collateralized. Reserve Banks decide whether to allow institutions with negative capital and improving institutions to incur daylight overdrafts on a case-by-case basis and in no case permit an institution to incur daylight overdrafts on Fedwire unless the institution has undergone the self-assessment process outlined in the self-assessment guidelines and rated itself as having satisfactory credit policies and procedures and adequate creditworthiness. This limited cap policy will remain in effect until January 1, 1989, after which time all institutions must adopt another appropriate sender net debit cap.

In some instances, further adjustments to capital will be required. For example, virtually all Edge and agreement corporations are subsidiaries of

<sup>18</sup> Allocated transfer risk reserves ("ATTR") are reserves against certain assets whose value has been found by the federal bank regulatory agencies to have been significantly impaired by protracted transfer risk problems. Such reserves are not considered capital by the agencies.

depository institutions that may themselves use intra-day credit. The same capital would be double-counted if both the parent and the Edge or agreement corporation subsidiary used such 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 adjusted primary capital attributable to its Edge or agreement corporation subsidiary that is reflected on the parent's balance sheet must be subtracted from the parent's capital. The parent could choose, however, not to permit its Edge or agreement corporation subsidiary to use intra-day credit, and use all of its (the parent's) capital for its own cap.

In determining cross-system sender net debit cap levels, U.S. branches and agencies of a foreign bank should use the world-wide consolidated capital of that foreign bank<sup>19</sup> not that bank's parent. Furthermore, the adjusted primary capital of any U.S. bank subsidiary of the foreign bank should be subtracted from the foreign bank's adjusted primary capital to avoid double counting.

## D. "De Minimis" Caps

Many depository institutions incur insignificant amounts of overdrafts and thus impose little risk to the payments system. In order to ease for these small overdrafters the burden of engaging in the self-evaluation process, and to ease the burden on the Federal Reserve of administering caps and monitoring these institutions, the Board has adopted its proposal to allow those institutions that meet reasonable safety standards to incur "de minimis" amounts of daylight overdrafts. The *de minimis* cap policy will take effect on December 3, 1987, or earlier at the option of each Reserve Bank.

Under this policy, any institution, including an Edge or agreement corporation or a "family" of U.S. offices of a foreign bank, may incur daylight overdrafts up to the lesser of 20 per cent of its adjusted primary capital (or U.S. "capital equivalency" for foreign banks' overdrafts on Fedwire) or \$500,000.

This *de minimis* cap will be available to any institution, even though the institution has not conducted the self-evaluation normally required under Board guidelines. Nevertheless, an institution choosing to use a *de minimis* cap must submit to its Reserve Bank at least once each year a copy of the

<sup>19</sup> As reported on Form FR 2225, the daylight overdraft capital report for U.S. branches and agencies of foreign banks.

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. Of course, if an institution's primary supervisor or Reserve Bank believes that the institution is not creditworthy, it will not be permitted to incur daylight overdrafts on Fedwire.

Depository institutions using a *de minimis* cap will not be permitted to have daylight overdrafts on a regular basis. Each Reserve Bank will counsel institutions that have a *de minimis* cap but continue to use daylight overdrafts habitually; those institutions that continue to incur overdrafts on a regular basis within the *de minimis* cap will be asked to file a regular cap or reduce their frequency of overdrafts. Institutions that exceed their *de minimis* caps on a chronic basis will be counseled vigorously to file a regular cap or to eliminate overdrafts. Institutions that fail to respond to counseling will be prohibited from incurring overdrafts on Fedwire by being assigned a zero cap and by either having their transfers monitored on a real-time basis or handled manually.

#### E. Additional Considerations

The contents of the self-evaluation 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. Finally, the Board notes that exceptional circumstances may require an institution to incur overdrafts in excess of its cap. Such a pattern of overdrafts should be discussed with its Reserve Bank, with specific plans developed to reduce the intra-day credit positions as soon as possible to a level within the institution's cap.

### III. Other Components of the Board's Policy

#### A. Daylight Overdrafts on Fedwire

The Fedwire cap for depository institutions is equal to the voluntary cross-system cap adopted by the institution, reduced by the institution's actual net debits on other networks as determined in an after-the-fact measurement process. This cap is thus to be monitored on an ex post basis.<sup>20</sup>

<sup>20</sup> Reserve Banks, however, monitor an institution's Fedwire positions on a real-time basis when they believe that the institution is exposing the Federal Reserve to excessive risk. Real-time monitors permit a Reserve Bank to take action when a transaction exposes the Reserve Bank to excessive risk.

The Fedwire cap is not increased by the institution's net credits on other networks. Each Reserve Bank, of course, retains the right to protect its risk exposure from individual institutions by reducing unilaterally 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 problem institution off-line or prohibiting it from using Fedwire.

Institutions that incur Fedwire overdrafts for the first time will be subjected to the *de minimis* cap of the lesser of 20 per cent of adjusted primary capital or \$500,000. After 90 days, this provisional cap will be reduced to zero unless the institution either submits the appropriate board of directors approval of the *de minimis* cap or files a self-assessment rating and regular cap.<sup>21</sup>

#### B. Inter—Affiliate Transfers

The Board's prior policy statement provided for sender net debit caps to be established for each individual depository institution regardless of whether an institution was part of a holding company. Recognizing that depository institution subsidiaries of holding companies often seek to operate their funds transfers as if they were a single consolidated entity, the Board requested the private sector Large-Dollar Payments System Advisory Group to study whether institutions affiliated through common holding company ownership should be allowed to consolidate their wire transfer activity and capital for the purpose of monitoring compliance with the Board's payments system risk policy. The matter was also studied by a Federal Reserve task force.

After considering the recommendation of the Advisory Group and the Federal Reserve task force, the Board determined to continue its prior policy and not permit the consolidation of affiliates' capital and funds transfer activity for daylight overdraft monitoring purposes. The Board did, however, in December, 1986, request the public's comments on whether to permit or forbid holding companies to simulate consolidation through inter-affiliate transfers. After considering the public comments and the staff's

<sup>21</sup> Under the self-policing policy adopted by the Board, an institution that does not adopt a cap for itself would be able to use without limit all credit available to it over any private network, unless use of such credit is found to constitute an unsafe or unsound banking practice by the institution's examiner. Such behavior, however, would not be consistent with the spirit of the Board's policy.

recommendations, the Board has determined to permit transfers of funds over Fedwire among affiliated depository institutions that are intended to simulate consolidation and which create a pattern of daylight overdrafts up to the sending institution's sender 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 intra-day extension of credit to the specified affiliate(s),<sup>22</sup> and sends a copy of the directors' resolution to its Reserve Bank.

2. During the regular examination, the individual'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 Federal Home Loan Bank Board has advised that federal law prohibits any extension of credit between affiliated institutions insured by the Federal Savings and Loan Insurance Corporation. Accordingly, FSLIC-insured institutions may not enter into such "consolidation" arrangements. The federal bank regulatory agencies have indicated that they will scrutinize inter-affiliate transfers carefully, with particular emphasis on any indications of concentrations of credit beyond the sending bank's usual 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 intra-day basis remains unchanged, so long as the parent remains within its own cap.

The Board has also adopted a proposal to allow 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

<sup>22</sup> 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.



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 funds 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 funds transfer activity to the service provider; (b) the net debit cap for the activity to be processed by the service provider; (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 backup 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 funds 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.

Any existing third-party access arrangements that do not conform to

these requirements should be phased out as soon as possible, but in no event later than June 30, 1990. In order to assure consistency with the Board's policy, each new arrangement should be reviewed by the Director of the Division of Federal Reserve Bank Operations prior to approval by the Reserve Bank.

### C. Book-entry Securities Transfers

In formulating its daylight overdraft policies, the Board has been concerned about the effect that overdraft restrictions could have on the U.S. government securities market and on the Federal Reserve's ability to conduct monetary policy through open market operations. Accordingly, the Board, pending adoption of procedures for reducing the Reserve Banks' risk exposure, had provisionally exempted from quantitative overdraft controls those Fedwire daylight overdrafts resulting from the transfer of book-entry securities against payment.<sup>23</sup>

In May, 1985, and again in December, 1986, the Board requested public comment on options that would collateralize part or all of book-entry securities overdrafts and subject the uncollateralized portion to the sender net debit cap. The Board has determined that, in light of the adverse public comments and the changes and potential changes in Treasury regulations governing the government securities market and the transfer and pledge of Treasury securities,<sup>24</sup> the collateralization of book-entry overdrafts and the inclusion of some or all of these overdrafts under the sender net debit cap warrants further review. The Board has thus determined to continue to exempt book-entry overdrafts from explicit quantitative limitations and delay its consideration of the collateralization of such overdrafts in normal circumstances pending the outcome of this review process, which will be part of the general review of longer-run goals, collateral, caps, pricing, etc., discussed above. Of course, as is now the case,

<sup>23</sup> Such overdrafts occur when the institution receiving book-entry securities has received book-entry securities against payment at a point in time of a greater value than the securities it has sent. Because receipt of a book-entry security and Fedwire payment to the sender of the security are simultaneous, the sender of the security receives Fedwire payment regardless of the securities overdraft position of the receiver. The definition used for a book-entry securities overdraft means that such an overdraft could occur even while the receiver's funds account was in credit balance.

<sup>24</sup> See, Treasury regulations implementing the Government Securities Act of 1986, 17 CFR Ch. IV, 52 FR 19,642 (May 26, 1987), and proposed regulations governing the Treasury-Reserve Automated Debt Entry System, 31 CFR Part 357, 51 FR 43027 (Nov. 23, 1986).

Reserve Banks will continue to take steps to protect themselves against the risks posed by weak organizations or other special cases. For these high-risk situations, a Reserve Bank will take whatever steps it deems necessary, including requiring additional or specific collateral to be posted for funds and book-entry overdrafts, or, in extreme cases, even denying direct access to the funds and book-entry Fedwire system.

Nevertheless, the Board has adopted the following measures:

1. The operating circulars of the Reserve Banks will be revised to impose, effective January 14, 1988, a \$50 million par value transfer size limit on secondary market book-entry Fedwire transfers. This limit is intended to induce multiple deliveries to reduce position building by dealers, a major cause of book-entry overdrafts; participants may choose to limit their trade size as well. New issue allocations to dealers and transfers of Treasury STRIPS would be exempt from the transfer limit. The Federal Reserve will work with the Public Securities Association and others to establish market practices and policies consistent with the intent of this policy modification, and the Board will monitor the effects of this policy on overdraft levels.

2. It will not be acceptable for institutions to use Fedwire to avoid the Board's risk reduction policy. Among other things, institutions should not:

(a) Send multiple deliveries of \$50 million or less in succession for the account of the same customer for the purpose of avoiding the \$50 million transfer limit;

(b) Intentionally substitute book-entry transfers for funds transfers in order to avoid quantitative limits; or

(c) Establish multilateral netting arrangements which settle net differences at the end of the day on Fedwire in order to reduce measured daylight overdrafts without reducing the gross obligations among participants. (This policy applies both to funds and book-entry Fedwire transfers.)

3. Staff in the surveillance and open market units of the Federal Reserve Bank of New York will continue to monitor primary dealers' clearing patterns and policies and review their findings with senior officials of those dealers. The Reserve Bank will seek to persuade dealers to adopt practices designed to minimize book-entry overdrafts.

4. After review by the Federal Reserve's Payments System Policy Committee of the work of a System task force, Reserve Banks are to develop and

implement book-entry real-time monitoring capabilities as soon as possible, but not later than the first quarter of 1989.

5. Reserve Banks will review the book-entry clearing and settlement activities of institutions incurring sizable book-entry daylight overdrafts or conducting large-scale book-entry securities operations to assure themselves that such institutions have developed acceptable procedures to control the associated risk. In the event that an institution's controls are found to be inadequate, the Reserve Bank will take whatever steps it deems necessary to cover its risk exposure.

#### D. Automated Clearing Houses Transactions

In the past, automated clearing houses (ACHs) have generally been regarded as small-dollar systems. Recently, however, the ACHs have been evolving in such a way that they appear to be taking on many of the characteristics of large-dollar transfer systems, and they therefore present many of the same risks.

Accordingly, the Board directed its staff to undertake a study of ACH risk and sought comment on ACH risk issues.<sup>25</sup> Based upon the comments received and further study of the issues, the Board proposed certain changes in the Federal Reserve's treatment of ACH transactions.<sup>26</sup>

The Board has now determined to postpone any changes to the treatment of ACH transactions pending the review of the Federal Reserve's payments system risk policy. Pending completion of this review, the present treatment of ACH transactions on the ex post monitoring system will remain in place. Specifically, for purposes of ex post monitoring, net debits and credits resulting from ACH transactions will continue to be posted at the Reserve Bank's opening of business on the settlement date.<sup>27</sup> In addition, pending completion of the payment system risk study, the Board has suspended consideration of providing same-day ACH settlement service by Reserve Banks.

E. Edge and Agreement Corporations, U.S. Branches and Agencies of Foreign Banks, and New York Article XII Investment Companies<sup>28</sup>

Special risks are presented by the participation on large-dollar transfer systems of these institutions. Some of them are major participants in those networks, often making and receiving a large volume of payments on behalf of affiliates and their parent organizations. The size of their payment activities is generally quite large relative to their U.S. capital (or for branches and agencies of foreign banks, measures derived from their U.S. financial statements), and thus sender net debit caps would tend to constrain severely the ability of many of these institutions to participate directly in the U.S. dollar payments mechanism, forcing them to deal either through their U.S. parent (in the case of Edges) or through U.S. correspondents or affiliates (in the case of U.S. agencies and branches and Edge subsidiaries of foreign banks, and some New York investment companies).

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. In addition, the principle of fair and equitable treatment embodied in the U.S. policy of national treatment for foreign banks was given explicit consideration.

1. *Edge and Agreement Corporations.* Under current Board policy, all Fedwire overdrafts of Edge and agreement corporations must be fully collateralized. 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.

The Board believes that Edge and agreement corporation subsidiaries of U.S. banks can, together with their parents, arrange their affairs in a way that would allow them to continue to service their customers at the same time that risk exposures are reduced. 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. Indeed, data suggest that, in virtually all cases, the consolidated Edge and parent overdraft position would be within the cap limits of the parent if it were evaluated as an above average cap institution, even though the Edge's overdrafts are very large in relation to the Edge's own capital. This suggests that such an approach by the parent could both reduce systemic risk exposure and permit the Edge corporation to continue to service its customers.<sup>29</sup>

With respect to Edge and agreement subsidiaries of foreign banks, the Board believes that because they lack access to the discount window and ready access to a U.S. affiliate that can provide support, these institutions should be treated in the same manner as their domestically owned counterparts.

Accordingly, the Board has determined that all Edge and agreement corporations will continue to be required to collateralize Fedwire daylight overdrafts, and strongly urges that each such corporation restrain its use of intra-day credit by establishing sender net debit caps based on its own capital in the same manner as any other domestic depository institution. In addition, the Board urges parents of Edge and agreement corporations to substitute themselves for their Edge or agreement subsidiaries on private large-dollar networks.

For purposes of sender net debit caps, the Board suggests that all branches of these same Edge or agreement corporations be consolidated. The consolidated entity's overdraft position will be monitored by the Reserve Bank of the Edge or agreement corporation's head office.<sup>30</sup> The monitoring Reserve Bank, in consultation with those Reserve Banks in which the Edge or agreement branches operate and the management of the consolidated entity, can either (1) determine that Edge or agreement branches outside its District will not be permitted to run Fedwire overdrafts, or (2) allocate part or all of the Edge or agreement corporation's Fedwire cap (and the responsibility of administering part or all of the collateral requirement) to a Reserve Bank in which one or more of the branches operate.

<sup>25</sup> 50 FR 21130 (May 22, 1985).

<sup>26</sup> 51 FR 45043 (Dec. 16, 1986).

<sup>27</sup> This posting procedure is for ex post monitoring purposes and will in no way change when actual settlement entries are made or when ACH transactions become final.

<sup>28</sup> This section excludes discussion of foreign-owned U.S. depository institutions, including U.S. depository institutions that are either subsidiaries of foreign banks or of foreign bank holding companies. These entities have U.S. depository institution charters and capital in the U.S., and are treated the same as any other U.S. depository institution.

<sup>29</sup> The Board's action to place certain restrictions on inter-affiliate transactions has not changed the existing policy with respect to the treatment of depository institutions and their Edge or agreement subsidiaries.

<sup>30</sup> With the consent of the parties, a Reserve Bank other than that of an Edge head office can assume the management of these responsibilities.

2. *U.S. Branches and Agencies of Foreign Banks.* As noted previously, the Board believes that U.S. branches and agencies of foreign banks should undergo the same self-evaluation process as domestic depository institutions, but that it be done on the basis of all U.S. branch and agency operations, rather than on an office-by-office basis. In setting a cross-system sender net debit cap, the Board believes that it is appropriate the cap be based on the world-wide consolidated capital of the foreign bank (less any adjusted primary capital attributable to subsidiary U.S. banks and Edge or agreement corporations reflected in the foreign bank's world-wide capital). The Board has reached this conclusion because public comments and other data indicate that private market participants view the intra-day credit risk associated with U.S. offices of foreign banks in terms of the world-wide creditworthiness of the entire foreign bank.

In assessing the Federal Reserve's own risk, however, the Board is still concerned about the lack of timely information filed with Reserve Banks, and the Federal Reserve's inability to monitor developments concerning each foreign bank's non-U.S. operations. Accordingly, the Board has determined that, only for purposes of determining the volume of a foreign bank family's uncollateralized Fedwire overdrafts, the multiples developed from the self-evaluation process (Section II-B, above) will be multiplied by the consolidated "U.S. Capital equivalency" of its U.S. agencies and branches.<sup>31</sup> (The term "U.S. capital equivalency" has been chosen merely as the most convenient term of art. While "U.S. capital equivalency" is to continue to be used in connection with "sender net debit cap multiples," developed from the foreign bank's self-evaluation, to determine foreign banks' maximum uncollateralized daylight overdrafts on Fedwire, the Board's use of the term 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.) Any Fedwire overdrafts in excess of that amount will have to be collateralized. Any use of intra-day

<sup>31</sup> "Capital equivalency" is defined 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 branch or agency location, or (2) the sum of 5 per cent of the total liabilities of each branch or agency, including acceptances, but excluding (A) accrued expenses and (B) amounts due and other liabilities to offices, branches, and subsidiaries of the foreign bank.

credit on private large-dollar networks will be treated as any other use of intra-day credit, and, as noted above, the total cross-system cap of a foreign bank's U.S. agencies and branches will be based on the world-wide capital of the foreign bank (less the noted adjustments).

The cross-system sender net debit cap for families of branches and agencies of the same foreign bank will be monitored by the Reserve Bank which exercises the Federal Reserve's oversight responsibilities under the International Banking Act. The administering Reserve Bank can, in consultation with Reserve Banks in which other U.S. agencies and/or branches of the same foreign bank are located and the management of the foreign bank's U.S. operations, determine that branches and agencies outside its District either will not be permitted to incur Fedwire overdrafts or will allocate part or all of the foreign family's Fedwire cap (and the responsibility for administering part or all of the collateral requirement) to a Reserve Bank in which one or more of the foreign offices operate.<sup>32</sup>

The Board believes that this approach will limit the Federal Reserve's risk while giving foreign banks with U.S. branches and agencies open access to the U.S. payments mechanism in keeping with the policy of national treatment.

3. *New York Investment Companies.* Investment companies chartered under Article XII of the New York Banking Law are not subject to reserve requirements and do not have access to the discount window. Because they do not maintain accounts with the Federal Reserve, they cannot use Fedwire. Some are, however, active participants on private networks, and therefore introduce risk in the payments system much like other participants. Accordingly, the Board urges that investment companies that participate on private large-dollar networks establish for themselves a cross-system sender net debit cap using the procedures and guidelines the Board has established for depository institutions.

<sup>32</sup> As in the case of Edge and agreement corporations and their branches, with the approval of the designated administering Reserve Bank, a second Reserve Bank may assume the responsibility of managing and monitoring the cross-system sender 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.

## F. Bankers' Banks

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 loss resulting from daylight overdrafts incurred by bankers' banks, the Board adopted, in 1982, a policy that bankers' banks should refrain from incurring overdrafts and post collateral to cover any overdrafts they do incur. Bankers' banks may voluntarily give up their exemption from reserve requirements, thus gaining access to the discount window and avoid having to post collateral.

The Board has determined to continue the present policy.

## G. Monitoring

The Board believes that ex-post monitoring is consistent with the voluntary, flexible approach it has adopted. Under ex-post monitoring, an institution with a cross-system net debit position in excess of its cap will be contacted by its Reserve Bank.<sup>33</sup> The Reserve Bank will counsel the institution, discussing ways to reduce its excessive use of intra-day credit. No regulatory action will be taken, but the Reserve Bank may

- Advise the appropriate examiner, who may recommend supervisory action if the volume of cross-system overdrafts are deemed unsafe or unsound, and/or
- Take appropriate action to limit its own risk exposure on Fedwire.

A Federal Reserve Bank will apply real-time monitoring to an individual institution's Fedwire position when the Reserve Bank believes that it faces excessive risk exposure, e.g., for problem banks or from institutions with chronic overdrafts in excess of what the Reserve Bank thinks is prudent. In such a case, the Reserve Bank will control its risk exposures by monitoring the institution's position on a real-time basis, and taking other prudential actions.

In order that Reserve Banks may properly monitor the use of intra-day 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.

<sup>33</sup> Even if the institution is not a state member bank, the Reserve Bank can make this contact because an overdraft is occurring on Fedwire or because the institution is in a net debit position on a wire system settling on the books of the Federal Reserve.

#### H. Avoidance of Risk Reduction Measures

In its March 29, 1984, policy statement, the Board stated that "use of Fedwire for the avoidance of Federal Reserve or private sector risk reduction measures is not appropriate." The Board adopted this policy to prevent institutions from participating in bilateral netting arrangements whereby they would exchange gross payment messages during that day and settle 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 still possible, and such failures would have the same deleterious consequences as any other settlement failures.

The Board, therefore, reaffirms its policy that institutions may not use Fedwire or other payments networks as a method of avoiding risk reduction measures.

The Board realizes, however, that certain netting arrangements are not intended to avoid risk reduction measures. Indeed, they can themselves 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 bilateral net settlement. The Board's policy on limiting avoidance techniques is not intended to restrict this kind of netting arrangement.

#### I. Large-Dollar Payment Systems Advisory Group

In July, 1985, the Board appointed a Large-Dollar Payment Systems Advisory Group composed of knowledgeable representatives of institutions active in the large-dollar payments market. Although the Board has not adopted all of the recommendations that the Advisory Group has made, it has found the Group an invaluable source of information on industry practices and industry views. Indeed it has asked the Advisory Group to aid in the Board's continued evaluation of its daylight overdraft policy. The Advisory Group will report directly to the Board through the Payment System Policy Committee and will be free to study any and all

matters associated with the Board's policy of reducing risks on large-dollar payment systems.

By order of the Board of Governors of the Federal Reserve System, July 30, 1987.

James McAfee,

*Associate Secretary of the Board.*

#### Appendix—Guidelines for Establishing Risk Categories

This appendix presents the Board's guidelines to be used by institutions in determining their own classifications for purposes of setting their own sender net debit caps. The Board policy recognizes that individual institutions may perceive that special or unusual circumstances not adequately captured in these guidelines may, in the view of the institution's management and board of directors, be consistent with a higher grade classification and higher sender net debit cap. Such a position should be fully supported by analysis and evidence included in the file for examiner review. Examiners will be critical if such special factors are not fully documented, and will be especially sensitive to evidence that special positive factors are being emphasized and adverse factors ignored or downplayed.

The guidelines address creditworthiness; operational controls, policies, and procedures; and credit policies and procedures. The last section suggests how the self-evaluation in each of these three areas is to be combined into an overall assessment, which is then to be the basis for determining a sender net debit cap.

##### I. Creditworthiness

Self-assessment of creditworthiness should begin by reference to an institution's most recent examination report and, where applicable, to peer group statistics contained in the most recent Uniform Bank Performance Report (UBPR) and to the most recent Bank Holding Company Performance Report (BHCP). Additional data from other reports and analyses should, of course, be used.

Major emphasis should be placed on asset quality, capital, and earnings where an institution's relative standing can be determined based upon quantifiable measures. Liquidity and holding company strength should be added in as modifying factors which, if strongly positive or negative, could influence the overall assessment of creditworthiness. For each of the characteristics that become the primary determinants of the initial benchmark assessment of creditworthiness, each institution should rank itself using a four

part scale from "Excellent" to "Below Standard."<sup>1</sup> The institution's files maintained for examiner review of cap determination should provide supporting analysis for the self-ranking assigned for each of the characteristics.

a. *Asset quality.* Asset quality should be graded "Excellent" through "Below Standard" in relation to

(a) The level, distribution, and severity of classified assets; (b) the level and composition of non-accrual and reduced rate assets; (c) the adequacy of valuation reserves; and (d) demonstrated ability to administer and correct problem credits. The self-analysis should take peer group statistics into consideration.<sup>2</sup> Obviously, adequate valuation reserves and a proven capacity to police and collect problem credits mitigate to some degree the weaknesses inherent in a given level of classified assets. In evaluating asset quality, consideration should also be given to any undue degree of concentration of credits or investments, the nature and volume of credits specially mentioned or classified, lending policies, and the adequacy of credit administration procedures. Evaluations of asset quality significantly different from the last examination report should be highlighted and supported in the cap determination file.

b. *Capital.* In the self-evaluation of capital, institutions should, as a starting point, note that the federal guidelines call for a minimum primary capital-to-asset ratio of 5.5 per cent for commercial banks. In assigning a specific rating for its capital position, adjustments should be made for the volume of risk assets; the level of off-balance sheet risk; the volume of classified assets; and bank growth experience, plans, prospects, and peer group capital levels. Asset quality should receive particular weight. Any institution that ranks its capital more than one grade above its asset quality has a significant burden of proof to justify such a grade, and its cap file should contain specific documentation.

c. *Earnings.* Earnings should also be graded "Excellent" to "Below Standard" with respect to (a) the ability to cover losses and provide for adequate capital, (b) earnings trends, (c) peer group comparisons, and (d) quality and composition of earnings. Consideration must also be given to the inter-relationships that exist between the dividend payout ratio, the rate of growth

<sup>1</sup> The full scale is as follows: "Excellent," "Very Good," "Adequate," and "Below Standard."

<sup>2</sup> In the case of classified assets, reference should be made to nonperforming assets of peer group institutions.

of retained earnings, and the adequacy of bank capital. A dividend payout rate that is excessive in this context, would warrant a lower grade despite a level of earnings that might otherwise result in a more favorable appraisal. Quality is also an important factor in evaluating this dimension of an institution's performance. Consideration should be given to the adequacy of transfers to the valuation reserve and the extent to which extraordinary or nonrecurring items, securities transactions, and tax effects contribute to net income.

The self-grading for asset quality, capital, and earnings should be combined into a single preliminary grade of creditworthiness based on an average of the three components. This preliminary grade would be affected by two final considerations, which are graded positive (+), neutral (o), or negative (-).

d. *Liquidity.* In most instances, an analysis of liquidity will indicate a stable funding base with a reasonable cushion of assets or untapped funding sources available to meet contingencies. In such instances, liquidity should be regarded as a neutral (o) factor in assessing creditworthiness. Evidence of frequent, unplanned borrowing from the Federal Reserve's discount window or deterioration in the normal funding base would be regarded as negative (-), and, depending upon the severity of the situation, the preliminary grade might be downgraded. Extremely liquid findings (+) could cause an upgrading of the preliminary rating, but such findings would usually need to demonstrate asset liquidity as well as sound liability management practices.

e. *Holding company and affiliates.* The relative strength of other depository institutions within the holding company, the parent company itself, and nondepository institution subsidiaries within the company can also marginally affect the preliminary grade. In general, if the regulators have characterized the consolidated holding company as in satisfactory condition in its most recent inspection, the influence should be regarded as neutral (o). If it was regarded as less than satisfactory, the influence should be regarded as negative (-). Downgrading of the preliminary grade would be expected if significant losses were being incurred or anticipated at the parent or nondepository institution subsidiary level, if consolidated capital was materially less than that of the subsidiary institution(s), or if holding company debt service necessitated excessive dividends from the depository institution subsidiaries. If the parent had

a demonstrated record of capital contributions and other support for the depository institution subsidiary, its influence would be regarded as positive (+) and could raise the preliminary grade upward.

These five factors become the initial and minimum benchmark for the self-assessment. Other considerations, such as major changes in management or pending litigation that is material, may be significant when evaluating an institution. Further, in using any ratio in the analysis of the first three factors, the limitations of using a single ratio or even a few ratios must be recognized. To the extent that other factors or mitigating circumstances are factored into the final grade on creditworthiness, the reasoning for special consideration should be clearly laid out for the examiner's review. Also, in a voluntary self-assessment program, management should recognize its own natural predisposition to identify and emphasize positive factors while downplaying adverse ones. To the extent that files do not document balanced analyses, examiners should be critical.

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

U.S. branches and agencies of foreign banks pose special problems for assessing creditworthiness because they do not have a corporate identity in the United States separate from that of the world-wide institution. Conceptually, however, the same analytical approach is appropriate, although special considerations are necessary to address data limitations.

In many cases, branches and/or agencies belonging to a single family will be found in several different geographic regions and subject to different supervisory authorities. Because the strength of the foreign bank, including all of its parts, will largely determine the strength of each branch or agency in the United States, a single overall assessment is necessary. Thus, branches and agencies of foreign banks should assess creditworthiness on the basis of the entire family—excluding any subsidiary U.S. chartered banks or Edge corporations of the foreign bank—rather than on an individual branch or agency basis.

For capital and earnings, the same approach and standards used for domestic depository institutions are appropriate. In general, the analysis should be done using available data on the foreign parent. Branches and agencies may restate their data to identify undisclosed reserves that are functionally equivalent to capital and to adjust earnings to reflect additions to

such reserves. To the extent that the self-assessment relies on these factors, the file available to the examiner should provide supporting documentation.

For assessment of asset quality, additional difficulties are encountered. While information on the overall organization is clearly the data that should be used, asset quality information on the foreign bank or on the consolidated organization is generally not available to either the manager of U.S. operations or U.S. supervisory authorities. Instead, only U.S. asset quality information is available. Even then, organizations with multiple branches or agencies will typically have examinations of individual entities conducted on different dates and by different supervisors. Combining these results into a single meaningful composite of U.S. operations is therefore not easily accomplished. Recognizing these imperfections, the only practical approach available in most cases is to extrapolate for the overall family from whatever information is available in the U.S. operations.

Recognition should be given to the distortions that can arise when a single international credit becomes problematic and is booked entirely in or outside the U.S. for control purposes. In instances where it is booked in the U.S., the credit may unduly overstate the severity of asset problems in the U.S. by attributing it entirely to the U.S. when it should more properly be attributed to the overall family. Judgment is therefore clearly appropriate in assessing asset quality.

As in the case for domestic depository institutions, asset quality, capital, and earnings provide a benchmark for the assessment of creditworthiness of the branch or agency. Other factors, like liquidity or the effect of affiliates, should be factored in as appropriate. Nevertheless, because the assessment has already included the strength of the foreign bank in measuring capital and earnings, extra care should be taken to avoid double counting the foreign bank in the assessment of its U.S. branches and agencies.

#### II. Operational Controls, Policies and Procedures

Two distinct components require analysis in the operational area if an institution is to be able to monitor its payments system risk effectively. These components are:

- Monitoring of the position of the institution on *each* payments system on which it operates and *across* all systems as an overall net position; and

• Monitoring of individual customers and the extent to which the institution extends credit by making funds available before they are collected, both when the institution is a sender and a receiver of funds.

Both components are important to any institution in its efforts to manage its payments system risk. The significance of monitoring the debit and credit flows to determine one's overall position and the position of individual customers does not decrease for smaller institutions. For both components, the business activity is first defined, areas of significant risk identified, and the adequacy of controls reviewed.

Factors such as automation or the size of the institution are not relevant except as they affect the ability to monitor risks. References to "real-time," therefore, address the timeliness of information, and not the degree of automation. Indeed, a manual system in a small institution that records every transaction may be far more effective as a real-time monitor than a fully automated and integrated system in a major operation that has yet to bring one area with substantial risk exposure in the institution into the monitored environment.

Based upon the analysis of the business activities and the identification of existing monitoring capabilities, each component is graded "strong," "satisfactory," or "unsatisfactory," using specific standards. These two separate ratings of overall activity and individual customers should then be combined into an overall rating of operational controls, policies, and procedures.

**a. Monitoring Institution Positions Relative to Net Debit Caps**

Before evaluating its wire transfer operation, each institution needs to define the magnitude and relative importance of each payment system in which it participates.

The table below seeks to define the institution's funds transfer environment.<sup>3</sup>

**AVERAGE DAILY VOLUME**

System	Dollars sent	Percent of total	Dollars received	Percent of total
1. CHIPS.....				
2. Fedwire.....				
3. Other.....				
Total.....		100		100

For each system in which the institution participates, an acceptable

<sup>3</sup> To the extent that an institution uses other payments systems with same-day settlement, the list should be expanded to include them.

level of risk exposure needs to be identified against which its position will be monitored. The monitoring of each system should then be identified as being: (1) On a real-time basis; (2) on a periodic basis and at what periodicity; or (3) not currently monitored or monitored only at the end of the day. Completing the following table summarizes the type of monitoring activity for each system:

**INDIVIDUAL SYSTEM MONITORING CAPABILITY**

System	Real time	Periodic	(Frequency)	No interim monitoring
1. CHIPS.....			( )	
2. Fedwire.....			( )	
3. Other.....			( )	

For systems that are monitored, the extent of cross-system monitoring can then be determined. For example, a real-time, cross-system monitor on Fedwire might be combined with a periodic monitor on CHIPS (or other networks that might develop in the future) to give a periodic cross-system on all systems. By identifying which systems used by the institution are monitored on a cross-system basis to determine a net exposure, an overall risk exposure can be obtained. As with the individual system, a summary table of cross-system monitoring capability can be completed like the one below.<sup>4</sup>

**CROSS-SYSTEM MONITORING CAPABILITY**

Systems monitored together	Real time	Periodic	(Frequency)	No interim monitoring
.....			( )	
.....			( )	
.....			( )	

Based on the cross-system monitoring capability and the volume of business handled by each system, a rating for the institution's controls for its cross-system exposure can be obtained as follows:

**Rating for Monitoring Institution Positions**

**Strong**

a. 95% of total dollars sent and received are monitored on a real-time basis or at 15 minute intervals or less and

b. a cross-system calculation of the institution's net debit/credit positions is computed and compared to established

<sup>4</sup> Systems may often be listed on more than one line. For example, a real-time cross-system monitor on Fedwire and CHIPS might be combined with a periodic monitor on other systems to give a periodic cross-system monitor on all four systems.

limits on a real-time basis or at 15 minute intervals or less.

**Satisfactory**

a. 80% of the total average daily dollar volume sent is monitored on a real-time basis or at 30 minute intervals or less; and

b. a cross-system calculation of the institution's net debit/credit position, utilizing these data, is computed and compared to established limits on a real-time basis or at 30 minute intervals or less.

*Unsatisfactory*—Any other condition.

**b. Monitoring Customer Positions**

Each institution should have the capability of monitoring the effect of all significant transactions on the funds positions of customers as the transactions occur during the business day. At a minimum, the institution should be aware of the positions of customers that have a high-dollar volume of funds transfer activity in relation to each customer's funds position or to the institution's capital. Customer position should reflect the collected status of funds sent and received over payments systems, as well as the effect of other activities, such as loan advances, loan payments, and book transfers (transfers between customers on the institution's own books) which may result from instructions developed internally or received over message systems, such as S.W.I.F.T. Some customers require frequent monitoring because the volume of their daily transactions is large. Others need to be monitored only as a result of particularly large and unusual transactions.

For customers that are significant users of the payments system, three questions are important:

	Yes	No
1. Has the institution isolated its customers which participate to a significant degree in funds transfer systems as either senders or receivers of funds?.....		
2. Can the institution monitor the positions of these customers taking into account the source of significant transactions?.....		
3. Does the monitoring system include the opening collected balances?.....		

In monitoring customers for compliance with intra-day overdraft position limits established by credit policy and/or in approving over-limit payments, transactions other than those being transmitted and received over payments systems need to be considered as they directly affect the intra-day position. Among the transaction sources that should be

considered are message systems such as S.W.I.F.T. and Telex; internal book transfers; and the institution's own lending, investment, and check processing operations. While it may not be feasible or reasonable to monitor all transactions from all areas, material thresholds should be established by the institution as criteria for monitoring individual transactions or aggregate transactions for a single customer that could put the institution at risk. The files should clearly document the reasons for including or excluding other areas and justify threshold limits sets.

Once customers have been identified and individual transaction limits set, the institution's ability to monitor and control the funds positions of its customers can be determined. The following checklist identifies the adequacy of controls:

	Yes	No
1. Does the system for monitoring positions of customers cover:		
a. All significant sources generating customer account entries? .....		
b. Total dollar volume of transactions over an established dollar limit? .....		
c. Overdraft limits? .....		
d. Single transfer limits? .....		
2. Does the system halt any transaction in excess of established limits from further processing until appropriate action is taken? .....		
3. If documentation of action taken with regard to over-limit transactions reflects consistent exceptions attributed to a customer, is analysis of those accounts intensified? .....		
4. Are reviews of the funds transactions environment conducted by internal or external auditors at least annually? (These reviews should conform to the standards established by the Bank Administration Institute and the Federal Financial Institutions Examination Council.) .....		

Institutions must be able to respond positively to all questions in this section on monitoring customer positions if they are to evaluate their control as satisfactory or strong. These ratings should be obtained as follows:

**Rating for Customer Monitoring System and Controls**

1. *Strong*—Responses to all of the above are positive and comprehensive customer monitoring is in force for both debits and credits on a real-time basis or at intervals of 15 minutes or less.<sup>5</sup>

2. *Satisfactory*—Responses to all of the above are positive and comprehensive customer monitoring is in force for all debit transactions greater than or equal to the monitoring

<sup>5</sup> If an institution monitors on a worst case basis, that is, debits only, a strong rating may still be justified if the limits established are no higher than those appropriate for monitoring a net position.

threshold on a real-time basis or at intervals of 30 minutes or less.

3. *Unsatisfactory*—Any other condition.

**Overall Rating for Operational Controls, Policies, and Procedures**

The two separate ratings for monitoring capability are combined into a single rating by taking the lower of the two ratings as follows:

Monitoring institution positions	Monitoring customer and controls	Overall rating
Strong .....	Strong .....	Strong.
Strong .....	Satisfactory .....	Satisfactory.
Satisfactory .....	Strong .....	Satisfactory.
Satisfactory .....	Satisfactory .....	Satisfactory.
—Either Rated Unsatisfactory—		Unsatisfactory.

**III. Credit Policies and Procedures**

A simple two-way classification system for credit policies and procedures should be used. All institutions should have explicit, written credit policies and the necessary internal procedures in place to implement these policies. Failure to have such policies and procedures puts all participants in the payments system at risk, and should preclude a satisfactory overall rating and its associated debit cap limit regardless of the ratings for creditworthiness or monitoring capabilities.

The following checklist identifies the adequacy of credit policies and procedures:

	Yes	No
1. Does the institution have a written credit policy detailing normal and exception approval and reporting procedures for all loans and credit commitments, including daylight overdraft and bilateral limits and other special facilities? .....		
2. Are all facilities and exposures approved as part of acknowledged aggregate exposure to individual bank and commercial customers? .....		
3. Does the institution use monitoring systems which identify usage in excess of approved facilities and provide adequate information for review and evaluation of such usage on a timely basis? .....		
4. Does the institution have exception identification and approval systems which are tailored to the speed, volume, and size of credit approvals required by its payment system generated exposures? .....		
5. Are the institution's review systems geared to single out and take action on deteriorating risk situations? .....		
6. Does senior management periodically review and take action on aggregate exposures over a finite limit? .....		
7. Are all controls and procedures reviewed and tested by the institution's internal auditors? .....		
8. Is adequate training available and required for operations, credit, and account officer staff responsible for monitoring the intra-day overdraft exposure system of the institution? .....		

In completing the checklist, negative responses should not be explained away in order to obtain a satisfactory self-assessment except under extremely unusual circumstances. Institutions that attempt to explain shortcomings will be scrutinized very closely by the examiners.

**IV. Overall Assessment**

The three component evaluations can be combined into a single overall assessment using the following table:

Credit policies and procedures	Operational controls policies and procedures	Credit worthiness	Overall assessment
Satisfactory .....	Strong .....	Excellent .....	High cap
		Very good .....	Above average cap
		Adequate .....	Average cap
		Below standard .....	No cap
Satisfactory .....	Satisfactory .....	Excellent or very good .....	Above average cap
		Adequate .....	Average cap
		Below standard .....	No cap
Satisfactory .....	Unsatisfactory .....	Any .....	No cap
Unsatisfactory .....	Any .....	Any .....	No cap

In completing the assignment for U.S. branches and agencies of foreign banks that are part of a single family operating in more than one state, a single assessment for the family should be conducted. If more than one branch or agency has access to a large-dollar system, the adequacy of operational controls for each access point should be assessed separately and combined into a single assessment. A single cap should then be determined and divided among the entities having access. The file

documenting the assessment and its division among the separate entities should be available to examiners in a designated office in the District of the Administrative Federal Reserve Bank.

[FR Doc. 87-17694 Filed 8-5-87; 8:45 am]

BILLING CODE 8210-01-M