

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. **10689**
February 8, 1994]

PAYMENTS SYSTEM RISK REDUCTION PROGRAM
Modifications to Policy Statement

*To All Depository Institutions, and Others
Concerned, in the Second Federal Reserve District:*

Last year the Board of Governors of the Federal Reserve System requested public comment on proposed modifications to its Policy Statement on Payments System Risk that would (a) modify the procedures that depository institutions must use if they choose to complete a self-assessment to establish a daylight overdraft net debit cap, and (b) eliminate the requirement that U.S. branches and agencies of foreign banks provide information on U.S. funding capability and discount-window eligible collateral for use in determining their daylight overdraft net debit cap. The proposal was sent to you in our Circular No. 10654, dated September 1, 1993.

The Board of Governors has adopted these modifications. First, effective for self-assessments performed on or after January 1, 1995, depository institutions must evaluate their operating controls and contingency procedures in addition to the three existing components of the self-assessment. Second, effective April 14, 1994, depository institutions will use a "Creditworthiness Matrix" to determine their overall creditworthiness rating, except in certain limited circumstances. Also effective April 14, the Board is eliminating the requirement that branches and agencies of foreign banks provide the information indicated above.

Printed on the following pages is the text of the Board's official notice on these modifications, as printed in the *Federal Register* of January 20. Questions on these matters may be directed to Don Anderson, Manager, Accounting Department (Tel. No. 212-720-5250), or to Anthony Fressola, Chief, Accounting Control Division (Tel. No. 212-720-5803).

WILLIAM J. McDONOUGH,
President.

[Docket No. R-0806]

Modifications to the Payments System Risk Reduction Program; Self-Assessment Procedures, Caps for U.S. Branches and Agencies of Foreign Banks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy statement.

SUMMARY: As part of its payments system risk reduction program, the Board is adopting modifications to its Policy Statement on Payments System Risk. Specifically, the Board is modifying in two ways the procedures that depository institutions must use if they choose to complete a self-assessment to establish a daylight overdraft net debit cap. First, effective for self-assessments performed on or after January 1, 1995, depository institutions must evaluate their operating controls and contingency procedures in addition to the three existing components of the self-assessment (creditworthiness, intraday funds management and control, and customer credit policies and controls). Second, depository institutions will use a "Creditworthiness Matrix" to determine their overall creditworthiness rating, except in certain limited circumstances. In addition to these two changes to the self-assessment procedures, the Board is eliminating the requirement that branches and agencies of foreign banks provide information on U.S. funding capability and discount window eligible collateral for use in determining their daylight overdraft net debit caps.

DATES: Effective April 14, 1994.

FOR FURTHER INFORMATION CONTACT: Jeffrey C. Marquardt, Assistant Director (202/452-2360), Paul Bettge, Manager (202/452-3174), Division of Reserve Bank Operations and Payment Systems; for the hearing impaired only: Telecommunications Device for the Deaf, Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

Background

The Board's Payments System Risk policy requires that institutions incurring daylight overdrafts in their Federal Reserve accounts establish a

maximum limit, or net debit cap, on overdrafts incurred in those accounts. In August 1993, the Board requested comment on three proposals to modify the procedures for establishing net debit caps. The Board received 16 public comments on the proposals.

Self-Assessment Procedures

Under the Board's policy, an institution's net debit cap (for a single day and on average over a two-week reserve maintenance period) is based on its cap category. The cap categories that permit relatively higher use of intraday credit are the Average, Above Average, and High cap categories. An institution that wishes to establish a cap in one of these categories must complete an assessment of its creditworthiness, intraday funds management and control, and customer credit policies and controls.

Operating Controls and Contingency Procedures

The Board requested comment on the addition of a fourth component to the self-assessment procedures to cover operating controls and contingency procedures, with a proposed effective date of January 1, 1995. Nine commenters viewed favorably the Board's proposal to require the assessment of operating controls and contingency procedures. These commenters did not indicate that the proposal would substantially increase regulatory burden. Two of these commenters suggested a later implementation date for the additional assessment component, however. One other commenter opposed the additional component as being duplicative of other bank regulatory requirements, while two commenters felt that the additional component would be burdensome for smaller institutions.

In the Board's view, it is important that any institution that wishes to use a relatively higher amount of Federal Reserve intraday credit perform an assessment of its operating controls and contingency procedures relating to its payments activity. Furthermore, the assessment itself consists of eight straightforward questions about the institution's operations and should pose a burden to complete. Institutions whose operating controls and contingency procedures are not currently adequate to meet the criteria in the self-assessment procedures should not incur overdrafts greater than those permitted by a de minimis cap, which permits a lower amount of overdrafts without the requirement of a

self-assessment, until they upgrade their procedures to meet such criteria.

The Board is therefore adopting the fourth component to the self-assessment procedures as proposed to cover operating controls and contingency procedures for assessments performed on or after January 1, 1995. Depository institutions may elect to include the additional component in assessments performed prior to that date, however.

Creditworthiness Matrix

In an attempt to reduce the burden on institutions electing to undertake an assessment, the Board proposed a simplified approach to assessing creditworthiness. Under the new methodology, an institution's prompt corrective action capital category and its supervisory rating are combined into a single rating for the creditworthiness component of the self-assessment using a Creditworthiness Matrix, which is shown below.

The Board believes that it is appropriate, in nearly all circumstances, for depository institutions to use the Matrix to determine their creditworthiness rating. In certain limited circumstances, however, institutions will be permitted to perform a full assessment of creditworthiness. (Procedures for completing the full assessment of creditworthiness are included in the Guide to the Federal Reserve's Payments System Risk Policy, which is available from any Reserve Bank.) For example, an institution whose condition has changed significantly since its last examination, or that possesses additional substantive information regarding its financial condition, may be permitted to justify a different rating based on a full creditworthiness assessment. In all cases, the Reserve Banks retain the responsibility for reviewing caps and determining appropriate cap levels.

CREDITWORTHINESS MATRIX

Capital level	Supervisory composite rating		
	Strong	Satisfactory	Fair
Well Capitalized.	Excellent	Very Good.	Adequate
Adequately Capitalized.	Very Good	Very Good.	Adequate
Undercapitalized.	(**)	(**)	Below Standard.

***Institutions that fall into this category should perform a full assessment of creditworthiness.

Note: Institutions that fall into categories not shown in the Matrix would receive a Below Standard rating.

U.S. branches and agencies of foreign banks located in countries that adhere to the Basle Capital Accord are treated in the same manner as U.S.-based banks, with supervisory ratings of the U.S. branches or agencies used in conjunction with the capital category of the parent bank. The resulting creditworthiness rating for the U.S. branch or agency is conditioned on the overall creditworthiness of the entire foreign banking organization, however. In addition, foreign banks from countries that have not subscribed to the Basle Capital Accord must perform a full assessment of creditworthiness in order to determine their net debit cap.

In August 1993, the Board requested public comment on the use of the Creditworthiness Matrix. Eleven commenters specifically addressed the changes in the methodology for the assessment of creditworthiness. Nine commenters expressed support for the Board's proposal to streamline the self-assessment process through the use of the new Creditworthiness Matrix and indicated that the new procedures would reduce regulatory burden. Of these, however, five commenters felt that depository institutions should be permitted the option of completing the full assessment of creditworthiness.

Two commenters did not support the Creditworthiness Matrix method, but suggested that its use be optional. The Institute of International Bankers, an association representing foreign banks, opposed any mandatory use of the Matrix as it would result in lower caps for many branches and agencies of foreign banks.

In the Board's view, the benefits of the Creditworthiness Matrix approach, namely a streamlined self-assessment process and increased objectivity of the creditworthiness ratings across institutions, mitigates objections to standardized usage of the Matrix. As institutions adopting caps in the Average, Above Average, and High categories may be permitted to incur overdrafts greater than their capital, it is particularly important that these caps be appropriate given institutions' financial strength as measured by objective regulatory criteria. While some institutions, including a number of foreign banks, will likely adopt lower caps as a result of using the Creditworthiness Matrix, analysis of these institutions' recent daylight overdraft activity indicates that these caps should not be unduly constraining.

The Board is, therefore, adopting the modifications as proposed to the creditworthiness component of the self-assessment procedures, effective April 14, 1994. For self-assessments performed on or after that date, including those performed as part of the annual cap renewal process, depository institutions will be required to use the Creditworthiness Matrix in all but certain limited circumstances. If appropriate, depository institutions may, at their option, use the Creditworthiness Matrix in completing self-assessments prior to that date.

Net Debit Caps for Branches and Agencies of Foreign Banks

The determination of net debit caps for foreign banks is based on essentially the same procedures as those for U.S. institutions. However, for foreign banks, the Federal Reserve has also required evidence of an institution's U.S. funding capability and discount window eligible collateral. The dollar amount of an institution's net debit cap could be reduced (below its cap multiple times its capital) based on these amounts.

Experience with U.S. funding capability and collateral data has shown that, in order to collect these data with sufficient precision and frequency, a significant regulatory burden is imposed. In addition, it is unlikely that these data accurately measure a foreign bank's ability to raise funds at times when rapid access to money markets may be necessary. As a result, the Board proposed to discontinue reporting of information on U.S. funding capability and discount window eligible collateral by branches and agencies of foreign banks for use in determining daylight overdraft net debit caps.

Only two commenters mentioned the proposal to discontinue reporting of this information by foreign banks. The Institute of International Bankers supported the proposal. One U.S. commercial bank opposed the proposal, based on the rationale that supervisory ratings used in determining net debit caps for foreign banks are not comparable to those for U.S. institutions. In the Board's view, the proposed requirement that creditworthiness ratings of branches and agencies of foreign banks be conditioned on the overall creditworthiness of the entire foreign banking organization should help alleviate such concerns. The Board is therefore adopting the proposed modification to the method for establishing caps for branches and agencies of foreign banks, effective April 14, 1994.

Guide to the Federal Reserve's Payments System Risk Policy

In order to facilitate public comment on the August 1993 proposals, the Board provided depository institutions with a draft version of the Guide to the Federal Reserve's Payments System Risk Policy. This document is intended to provide a thorough description of the procedures to be used in conducting a self-assessment. Once issued in final form, the Guide to the Federal Reserve's Payments System Risk Policy will supersede previously issued versions of the Users' Guide to the Payments System Risk Policy. The Federal Reserve has also issued a new summary document, entitled Overview of the Federal Reserve's Payments System Risk Policy, which describes the requirements of the policy for institutions that incur minimal daylight overdrafts. The Board is also modifying the text of the Policy Statement on Payment System Risk to include appropriate references to these two new documents.

Federal Reserve System Policy Statement on Payments System Risk

The Board is amending its "Federal Reserve System Policy Statement on Payments System Risk" under the heading "I. Federal Reserve Policy" by replacing the last three sentences of the Introduction, part (C)(2) under the headings "C. Capital" and "2. U.S. Agencies and Branches of Foreign Banks," and the first paragraph of part (D)(1) under the headings "D. Net Debit Caps" and "1. Cap Set Through Self-Assessment" as set forth below:

Introduction

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To assist depository institutions in implementing the Board's policies, the Federal Reserve has prepared two documents, the Overview of the Federal Reserve's Payments System Risk Policy and the Guide to the Federal Reserve's Payments System Risk Policy, which are available from any Reserve Bank. The Overview of the Federal Reserve's Payments System Risk Policy provides a summary of the Board's policy on payments system risk, including daylight overdraft net debit caps and fees. The Overview is intended for use by institutions that incur only small and infrequent daylight overdrafts. The Guide to the Federal Reserve's Payments System Risk Policy explains in detail how the policies apply to various types of institutions and includes procedures for completing a self-assessment and filing a cap resolution, as well as

information on other aspects of the payments system risk policy.

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I.C. Capital

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

For U.S. agencies and branches of foreign banks, net debit caps on daylight overdrafts in Federal Reserve accounts are calculated by applying the cap multiples for each cap category to consolidated "U.S. capital equivalency."⁴

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

For all other foreign banks, U.S. capital equivalency is measured as the greater of (1) the sum of the amount of capital (but not surplus) that would be required of a national bank being organized at each agency or branch location, or (2) the sum of 5 percent of the total liabilities of each agency or branch, including acceptances, but excluding accrued expenses and amounts due and other liabilities to offices, branches, and subsidiaries of the foreign bank.

In addition, any foreign bank may incur daylight overdrafts above its net debit cap up to a maximum amount equal to its cap multiple times 10 percent of its worldwide capital, provided that any overdrafts above its net debit cap are collateralized. This policy offers all foreign banks, under terms that reasonably limit Reserve Bank risk, a level of overdrafts based on the same proportion of worldwide capital. Consequently, banks chartered

in countries that follow the Basle Accord and whose net debit cap is based on 10 percent of worldwide capital are not permitted to incur overdrafts above their net debit cap. All other foreign banks may incur overdrafts to the same extent as banks from Basle Accord countries, that is, up to their cap multiple times 10 percent of their worldwide capital, provided that sufficient collateral is posted for any overdrafts in excess of their net debit cap. In addition, foreign banks may elect to collateralize all or a portion of their overdrafts related to book-entry securities activity.

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I.D. Net Debit Caps

1. Cap Set Through Self-Assessment

In order to establish a net debit cap category of Average, Above Average, or High, an institution must perform a self-assessment of its own creditworthiness, intraday funds management and control, customer credit policies and controls, and, effective January 1, 1995, operating controls and contingency procedures.⁵ The assessment of creditworthiness should be based on the institution's supervisory rating and Prompt Corrective Action capital category. An institution may be permitted to perform a full assessment of its creditworthiness in certain limited circumstances, for example, if its condition has changed significantly since its last examination, or if it possesses additional substantive information regarding its financial condition. Additionally, U.S. branches and agencies of foreign banks based in countries that do not adhere to the Basle Capital Accord are required to perform a full assessment of creditworthiness to determine their ratings for the creditworthiness component. An institution performing a self-assessment must also evaluate its intraday funds management procedures and its procedures for evaluating the financial condition of and establishing intraday credit limits for its customers. Finally, the institution must evaluate its operating controls and contingency procedures to determine if they are sufficient to prevent losses due to fraud or system failures. The Guide to the

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

Federal Reserve's Payments System Risk Policy, available from any Reserve Bank, includes a detailed explanation of the steps that should be taken by a depository institution in performing a self-assessment to establish a net debit cap.

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By order of the Board of Governors of the Federal Reserve System, January 13, 1994.

William W. Wiles,

Secretary of the Board.

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⁴ The term "U.S. capital equivalency" is used in this context to refer to the particular capital measure used to calculate daylight overdraft net debit caps, and does not necessarily represent an appropriate capital measure for supervisory or other purposes.