FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **10724**
July 27, 1994]

PRIVATELY OPERATED LARGE-DOLLAR MULTILATERAL NETTING SYSTEMS

Comment Requested on Proposed Policy Statement by October 17, 1994

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

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has requested public comment on a proposal to update its policies on "Privately Operated Large-Dollar Funds Transfer Networks" and "Offshore Dollar-Clearing and Netting Systems" and integrate those policies into a single policy statement on "Privately Operated Large-Dollar Multilateral Netting Systems."

Comment is requested by October 17, 1994.

In general, the policy statement would apply to such arrangements as domestic, privately operated, large-dollar multilateral payment netting systems; offshore large-dollar multilateral payment netting systems; multilateral foreign exchange clearinghouses involving settlements in U.S. dollars; and multicurrency payment netting systems involving settlements in U.S. dollars.

The Board is proposing to incorporate into the new policy statement minimum standards for the design and operation of privately operated large-dollar multilateral netting systems. These minimum standards are based on those set out in the *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* ("Lamfalussy Report"), which was published in November 1990 by the Bank for International Settlements.

The Board is also requesting comment on the need for, and possible specifications of, a higher standard with respect to assuring settlement that might be applied to large-dollar multilateral netting systems that present a high degree of systemic risk.

Printed on the following pages is the Board's official notice on the proposed statement; it also appears in the July 18 edition of the *Federal Register.* Comments should be submitted by October 17, 1994 and may be sent to the Board, as indicated in the notice, or to our Payments System Studies Staff.

Questions on this matter may be directed, at this Bank, to MarySue Fisher, Counsel and Vice President (Tel. No. 212-720-5930) or Christopher J. McCurdy, Senior Vice President (Tel. No. 212-720-5446).

William J. McDonough,
President.

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FEDERAL RESERVE SYSTEM

[Docket No. R-0842]

Proposed Policy Statement on Privately Operated Large-Dollar Multilateral Netting Systems

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board of Governors is requesting comment on a proposal to update its policies on "Privately Operated Large-Dollar Funds Transfer Networks" and "Offshore Dollar-Clearing and Netting Systems" and integrate those policies into a single policy statement on "Privately Operated Large-Dollar Multilateral Netting Systems." In general, the policy statement would apply to such arrangements as domestic, privately operated, large-dollar multilateral payment netting systems; offshore large-dollar multilateral payment netting systems; multilateral foreign exchange clearinghouses involving settlements in U.S. dollars; and multicurrency payment netting systems involving settlements in U.S. dollars. The Board is proposing to incorporate into the new policy statement minimum standards for the design and operation of privately operated large-dollar multilateral netting systems. These minimum standards are based on those set out in the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries ("Lamfalussy Report"), which was published in November 1990 by the Bank for International Settlements. The Board is also requesting comment on the need for, and possible specifications of, a higher standard with respect to assuring settlement that might be applied to large-dollar multilateral netting systems that present a high degree of systemic risk.

DATES: Comments must be received on or before October 17, 1994.

ADDRESSES: Comments should refer to Docket No. R-0842, and may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. Comments may be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays or to the security control room anytime. Both Room B-2222 and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, N.W. Comments may be inspected in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's rules regarding availability of information.

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FOR FURTHER INFORMATION CONTACT: Jeffrey C. Marquardt, Assistant Director (202/452-2360), Paul Bettge, Manager (202/452-3174), Kelly Shaw, Project Leader (202/452-3054), Division of Reserve Bank Operations and Payment Systems; or Oliver Ireland, Associate General Counsel (202/452-3625), Stephanie Martin, Senior Attorney (202/452-3198), Legal Division, Board of Governors of the Federal Reserve System; for the hearing impaired only, Telecommunications Device for the Deaf, Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

The Board's current Policy Statement on Payments System Risk incorporates two policies directed specifically at large-dollar funds transfer systems: "Private Large-Dollar Funds Transfer Networks" and "Offshore Dollar-Clearing and Netting Systems." Neither of these policies addresses multicurrency clearing and settlement arrangements involving settlements in U.S. dollars, such as the multilateral foreign exchange clearinghouses that are under development in North America and Europe. Further, the Board intended its existing policy statement on "Offshore Dollar-Clearing and Netting Systems" to be an interim measure until an international consensus was reached among central banks on the minimum standards for the development and operation of multilateral cross-border netting systems.

That consensus was reached with the 1990 publication of the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries ("Lamfalussy Report"). The Lamfalussy Report recognized that multilateral netting arrangements for interbank payment orders and forward-value contractual commitments, such as foreign exchange contracts, have the potential to improve the efficiency and the stability of interbank settlements through the reduction of settlement costs, along with credit and liquidity risks, provided that certain conditions are met. In this regard, the report developed and discussed, in some detail, "Minimum Standards for Netting Schemes" ("Lamfalussy Minimum Standards") and "Principles for Co-operative Central Bank Oversight" of such arrangements.

Central banks have now had a period of time to analyze the practical implications of the Lamfalussy Minimum Standards, and the Board believes that it would be appropriate to revise its "Policy Statement on Payments System Risk" to incorporate the Lamfalussy Minimum Standards and to address explicitly privately operated, large-dollar multicurrency netting arrangements involving settlements in U.S. dollars.[1] The Board is proposing to integrate its policies on "Private Large-Dollar Funds Transfer

[1] The Lamfalussy Minimum Standards have been endorsed by the European Union central banks as minimum standards for domestic large-value netting systems within the European Union.

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Networks" and "Offshore Dollar-Clearing and Netting Systems" into a single comprehensive policy on "Privately Operated Large-Dollar Multilateral Netting Systems" that would include the Lamfalussy Minimum Standards. Large-dollar multilateral, multicurrency netting systems would be covered by the same policy.

Scope and Application of the Policy. Specifically, the Board's proposed policy statement would apply to such arrangements as domestic, privately operated, large-dollar multilateral payment netting systems; offshore large-dollar multilateral payment netting systems; multilateral foreign exchange clearinghouses involving settlements in U.S. dollars; and multicurrency payment netting systems involving settlements in U.S. dollars. The inclusion of multilateral foreign exchange clearinghouses and multicurrency payment netting systems involving a settlement in U.S. dollars represents an expansion of existing policy, as neither of these arrangements are covered explicitly by the Board's current policy statement on payment system risk. The Board is proposing to apply the policy statement to such systems if they meet certain size criteria, in order to cover more completely the range of multilateral netting systems involving settlements in U.S. dollars that have the potential to increase systemic risk in the financial markets. These arrangements have the potential to generate the same types of risks as single currency systems. Moreover, the Lamfalussy Minimum Standards were developed explicitly to address, among other things, risks in multilateral foreign exchange netting arrangements.

The Board's proposed policy statement contains criteria that delimit the scope and application of the policy. Specifically, the policy will apply to systems that: (1) have three or more participants that net payments or foreign exchange contracts involving the U.S. dollar, whether or not netted amounts are legally binding; and either (2) have, or are likely to have, on any day, settlements with a system-wide aggregate value of net settlement credits (or debits) larger than $500 million (in U.S. dollars and any foreign currencies combined); or (3) routinely process individual payments or foreign exchange contracts, with a stated dollar value larger than $500,000. A multilateral netting system that meets the above criteria will be subject to the policy if (1) it is a state-chartered member of the Federal Reserve System, (2) any of its agent(s) or participants are state-chartered members of the Federal Reserve System, (3) its participants' net positions are settled through a Federal Reserve settlement account, (4) its participants settle their net positions in the multilateral netting system through their individual Federal Reserve accounts or the Federal Reserve account of the settlement agent(s), or (5) one or more bank holding companies have an investment in the multilateral netting system. The Board believes that these relatively simple criteria will enable the operators of multilateral netting systems to

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determine when they are subject to the policy and will provide that only systems which present systemic risk will be covered.

The Board believes that the Lamfalussy Minimum Standards may apply, for example, to all large-dollar multilateral payment netting systems irrespective of the type of financial instrument or contractual obligation netted by the system. However, the Board recognizes that in the case of privately operated large-dollar multilateral netting systems for the batch processing of paper-based as well as electronic payments, including privately operated Automated Clearing House ("ACH") systems, certain electronic controls that would be required to implement the Lamfalussy Minimum Standards may not be feasible. Further, the rights and responsibilities of parties within such systems as well as the characteristics of the instruments to be cleared or netted require further analysis. Consequently, the Board intends to study further the implications of the Lamfalussy Minimum Standards, and the arrangements to implement the Lamfalussy Minimum Standards, for privately operated large-dollar multilateral netting systems for the batch processing of paper-based as well as electronic payments. The Board expects that it may issue, in due course, a proposal for minimum standards for the design and operation of such systems.

Implementation of the Lamfalussy Minimum Standards. The Board believes that large-dollar multilateral netting systems, whether on-shore or off-shore, should meet in full the Lamfalussy Minimum Standards, as set forth in the proposed policy statement. The Board has developed five risk management measures that a large-dollar multilateral netting system would be expected to implement in order to satisfy Lamfalussy Minimum Standards III and IV, which deal with risk management and settlement completion. Risk management devices that lead to a substantially equivalent degree of risk management and control could also be adopted, as approved by the Board on a case-by-case basis. The proposed measures are: (1) a requirement that each participant establish bilateral net credit limits vis-a-vis each other participant in the system; (2) establish and monitor in real time system-specific net debit limits; (3) establish a system to reject or hold any payment or foreign exchange contract that would exceed the relevant bilateral and net debit limits; (4) establish liquidity resources, such as cash, committed lines of credit secured by collateral, or a combination thereof, at least equal to the largest single net debit position;[2] and (5) establish rules and procedures for the sharing of credit losses among the participants in a netting system.

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[2]The term "largest single net debit position" means the largest intraday net debit position of any individual participant at any time during the daily operating hours of the netting system.

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The first two measures are contained in the Board's existing policy statement on Private Large-Dollar Funds Transfer Networks. The third measure is also contained in the existing policy statement but it applies only to bilateral net credit limits. In the proposed policy statement, the Board has expanded the third measure to apply also to system-specific net debit limits. Requirements (4) and (5) are new and would help ensure that the funds needed for settlement are available to multilateral clearing organizations at the proper moment and clarify how any losses will affect participants.

Timeframe for Implementation of the Lamfalussy Minimum Standards. The Board recognizes that not all existing large-dollar multilateral netting systems may meet the Lamfalussy Minimum Standards, and the associated requirements for implementation of those standards, contained in the proposed policy statement. The Board also recognizes that existing large-dollar multilateral netting systems will need a period of time in which to make any needed changes to their organization or operations. Consequently, the Board believes that an eighteen-month transition period would be appropriate for large-dollar multilateral netting systems that are operating on the date of any final action by the Board on the proposed policy. Such systems will be expected to comply fully with the policy statement within the eighteen-month transition period. Large-dollar multilateral netting systems established subsequent to the date of final adoption of the policy by the Board will be expected to comply fully with the policy statement, without benefit of a transition period.

Specific Issues On Which The Board Seeks Comment.

The Board seeks comment on all aspects of the proposed policy statement. In addition, the Board is seeking comment on the following specific issues:

1. The proposed criteria for identifying large-dollar multilateral netting systems subject to the policy statement.
    - Are the thresholds for system-wide aggregate daily net settlement debits or credits, as well as for the size of individual transactions, set at appropriate levels such that the policy will apply to those systems that pose systemic risk?
    - Are there other criteria the Board should consider in the determination of whether to apply the policy to a particular system?

2. The five risk management measures for implementation of the Lamfalussy Minimum Standards.
    - Do the requirements provide operators of large-dollar multilateral netting systems with appropriate

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and adequate mechanisms to control the credit, liquidity, and settlement risks inherent in such systems?

- What additional risk management measures would be useful?
- What alternative mechanisms would provide substantially equivalent degrees of risk management and control?

3. The timeframe for implementation of the Lamfalussy Minimum Standards.
   - Does the proposed eighteen-month transition period provide existing large-dollar multilateral netting systems with sufficient time to make any organizational or operational changes needed to meet the Lamfalussy Minimum Standards?

The Board also seeks comment on whether large-dollar multilateral netting systems that present a high degree of systemic risk should be expected to meet a standard for ensuring settlement that is higher than Lamfalussy Minimum Standard IV. Standard IV requires that a netting system be capable of ensuring the completion of daily settlement in the event that the participant with the largest net debit position is unable to settle its obligation to the system. For example, the Board could require that certain large-dollar multilateral netting systems would be expected to ensure timely completion of daily settlement in the event of an inability to settle by the participant with the largest net debit position, as well as the participants with the second or third largest net debit positions.

In multilateral netting systems that extend credit among participants, the failure of a participant could trigger a chain of defaults and liquidity problems at other participants or in the financial markets more generally. This concern is the basis for Lamfalussy Minimum Standard IV, which ensures that a default by a single net debtor, including the largest, will not, by itself, initiate a chain of defaults within the netting arrangement. A requirement that a netting system be able to ensure daily settlement in the event of settlement defaults by participants in addition to the largest net-debtor would be based on the risk of a simultaneous default by two or more participants. Such an event could be precipitated by financial market difficulties in the country of origin of the defaulting participants, or some other market disturbance that could cause financial institutions with similar or interlinked assets and liabilities simultaneously to experience liquidity or credit problems. Such simultaneous defaults, however, may be much less likely than a single default, and the incremental expected costs and benefits of requiring multilateral netting systems to meet a higher standard than Lamfalussy Minimum Standard IV must be

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carefully weighed.[3]

An additional consideration is which multilateral netting systems should be expected to meet a higher standard. The Board anticipates that any higher standard would be applied only to multilateral netting systems that present a high degree of systemic risk. In determining this degree of systemic risk, the Board could, as an example, utilize a threshold approach in which systems that exceed a particular measure would be expected to meet the higher standard. Such measures might include: (1) a specific dollar amount of the aggregate system-wide net debit positions; (2) the ratio of the net debit positions of selected members of a particular multilateral netting system relative to their capital; or (3) the ratio of an aggregate measure of net debit positions to the capital of a central counterparty (if one is used).

The Board is seeking specific comments on:

4. Application of a higher standard for individual large-dollar multilateral netting systems that may present a high degree of systemic risk.
   - What factors should be considered in analyzing the incremental expected costs and benefits of requiring multilateral netting systems to meet a higher standard than Lamfalussy Minimum Standard IV?
   - Should a quantitative threshold level be established? What indicator or indicators should be employed in setting a threshold?

COMPETITIVE IMPACT ANALYSIS:

The Board has established procedures for assessing the competitive impact of rule or policy changes that have a substantial impact on payments system participants.[4] Under these procedures, the Board will assess whether a change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve

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[3]For example, costs would presumably include the opportunity cost of pledging collateral to ensure settlement and of taking any other steps to ensure that funds will be available for settlement, while benefits would include avoidance of potential credit losses, liquidity effects, or both, through the greater protection afforded by a higher standard. The expected benefits, in particular, may be difficult to quantify. In addition, there may well be other measures of costs and benefits that would be appropriate to apply in the analysis of a higher standard.

[4]These procedures are described in the Board's policy statement "The Federal Reserve in the Payments System," as revised in March 1990. (55 FR 11648, March 29, 1990).

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in providing similar services due to differing legal powers or constraints, or due to a dominant market position of the Federal Reserve deriving from such differences. If no reasonable modifications would mitigate the adverse competitive effects, the Board will determine whether the anticipated benefits are significant enough to proceed with the change despite the adverse effects.

The Board does not believe that the Lamfalussy Minimum Standards will have a direct and material impact on the ability of other service providers to compete effectively with the Reserve Banks' payments services. The Board notes that in several cases the payment services potentially covered by the policy statement are not offered by the Federal Reserve Banks. For example, the Federal Reserve Banks do not offer services relating to the electronic clearing and settlement of payments or contracts in foreign currencies.

In the case of domestic large-dollar multilateral netting systems, a number of the risk control measures proposed to meet the Lamfalussy Minimum Standards as well as certain of the standards themselves have grown out of the experience of the private sector in developing robust netting arrangements and are currently employed in multilateral netting systems. To the extent an incremental burden might be imposed on large-dollar systems, the need to reduce and control the large potential systemic risks of such systems would justify the adoption of prudent standards and measures to control risk. The Board does not expect at this time, however, that the adoption of the Lamfalussy Minimum Standards would have a direct and material impact on the ability of other service providers to compete with the Federal Reserve Banks.

Federal Reserve System Policy Statement on Payments System Risk

The Board proposes to amend its "Federal Reserve System Policy Statement on Payments System Risk" under the heading "II. Policies for Private-Sector Networks" by replacing in the heading the word "Networks" with the word "Systems;" deleting "A. Private Large-Dollar Funds Transfer Networks" in its entirety and replacing that part with "A. Privately Operated Large-Dollar Multilateral Netting Systems;" and deleting "C. Offshore Dollar Clearing and Settlement Systems" and redesignating "D. Private Small-Dollar Clearing and Settlement Systems" as "C. Private Small-Dollar Clearing and Settlement Systems."

II. POLICIES FOR PRIVATE-SECTOR SYSTEMS

A. Privately Operated Large-Dollar Multilateral Netting Systems

Large-dollar multilateral netting systems can create a significant degree of credit and liquidity risk for their

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participants and also expose the U.S. payments system and financial markets to systemic risk. In the context of large-dollar multilateral netting systems, systemic risk is the risk that the inability of one institution within such a system, including a central counterparty if one exists, to meet its obligations when due will lead to the illiquidity or failure of other institutions, either within the particular system or in the financial markets as a whole.

Large-dollar multilateral netting systems may produce efficiencies in the clearance and settlement of payments and financial contracts. At the same time, multilateral netting may obscure, concentrate, and redistribute the credit and liquidity risks associated with clearance and settlement. As the size of netted positions increases, for example, so do the potential liquidity effects on such systems and their participants, as well as third parties, in the event of a settlement failure. In addition, if the high volumes of interrelated large-value financial contracts and payments, which reflect money and capital market activity, are not settled in a timely manner, there is a significant potential for widespread financial market disruption.

Certain types of netting system rules may also create sizable systemic liquidity risks, if employed by systems that process large-value payments that are central to the operation of financial markets. For example, privately operated payment systems that permit a system operator to unwind, recast, or otherwise reverse same-day funds transfers made by system participants, whether for reasons of general financial market stress or because of the inability of a system participant to settle its obligations on time, can obscure and greatly increase the level of systemic liquidity risk associated with the system. As a general matter, the Board does not view a same-day recast, unwind, or reversal of payments as a satisfactory mechanism for managing liquidity and settlement risks in large-dollar multilateral netting arrangements.

The Board also recognizes that the development of offshore multilateral netting systems for large-dollar payments and foreign exchange contracts may raise concerns about systemic risk that extend beyond the potential for disturbances to payment and settlement systems, or financial markets, in the United States. For example, the offshore clearing of U.S. dollar payments, for subsequent net settlement in the United States, may create transactional and other efficiencies for participants in such offshore systems. At the same time, these arrangements have the potential to concentrate settlement risks at clearing organizations and their associated settlement agents either in the United States or abroad. If the allocation of credit and liquidity risks associated with the netting is not clearly defined, understood, and managed, offshore dollar-clearing arrangements may also obscure, or even increase, the level of

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systemic risk in U.S. and offshore large-dollar payments systems, as well as in the international dollar settlement process. Poorly designed and managed systems may, therefore, increase risks to the international banking and financial system. In addition, offshore arrangements have the potential to operate without sufficient official oversight.

As the Federal Reserve implements fees for daylight overdrafts, along with other risk management measures, it also is important that risks not simply be shifted from the Federal Reserve's payment services to private, inadequately structured multilateral netting arrangements, either domestically or in other countries. For example, the Board has been concerned that the steps being taken to reduce systemic risk in U.S. large-dollar payments systems may themselves induce the further development of "offshore" large-dollar multilateral netting systems. These offshore systems can settle directly through payments on Fedwire or indirectly through a private large-dollar clearing system, which in turn settles on a net basis using Fedwire.

In response to potential systemic risks and the possibility that efforts to avoid risk controls will lead to inadequately structured and managed systems, the Board is adopting minimum standards within which privately operated large-dollar multilateral netting systems should operate. The minimum standards apply whether or not these systems operate domestically or in other countries. These minimum standards are identical to those set out in the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (Lamfalussy Report).[5] The Board recognizes that from time to time, in specific cases, questions of interpretation of these standards, as they apply to large-dollar multilateral netting systems, may have to be resolved by the Board.

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[5] In November 1990, the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries produced a report on multilateral netting schemes. The Committee was chaired by Mr. Alexandre Lamfalussy, General Manager of the Bank for International Settlements. That report recognized that netting arrangements for interbank payment orders and forward-value contractual commitments, such as foreign exchange contracts, have the potential to improve the efficiency and the stability of interbank settlements through the reduction of costs along with credit and liquidity risks, provided certain conditions are met. In this regard, the Lamfalussy Report developed and discussed, in some detail, both "Minimum Standards for Netting Schemes" and "Principles for Co-operative Central Bank Oversight" of such arrangements.

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It is important to note that the Board's adoption of the Lamfalussy Minimum Standards in no way diminishes the primary responsibilities of participants in, and operators of, large-dollar netting systems for ensuring that these systems have adequate credit, liquidity, and operational safeguards. It is the Board's intent to heighten awareness of the risks associated with multilateral netting arrangements and of the need for their prudent management. The Board also seeks to provide the financial system with a set of minimum criteria, which have been discussed by the G-10 central banks, against which structural and risk management features of large-dollar multilateral netting systems can be evaluated.

Scope and Application of the Policy. This policy statement is directed toward any privately operated, multilateral netting system that settles, or seeks to settle, U.S. dollar obligations through payments affecting one or more accounts at Federal Reserve Banks, either directly or indirectly ("multilateral netting systems"). Multilateral netting systems include clearing house organizations, with or without a central counterparty, for netting payments or foreign exchange contracts among financial institutions.

The scope of the policy statement is limited to multilateral netting systems that involve large-dollar settlements or payments. In particular, such systems that: (1) have three or more participants that net payments or foreign exchange contracts involving the U.S. dollar, whether or not netted amounts are legally binding; and either (2) have, or are likely to have, on any day, settlements with a system-wide aggregate value of net settlement credits (or debits) larger than $500 million (in U.S. dollars and any foreign currencies combined); or (3) routinely process individual payments or foreign exchange contracts, with a stated dollar value larger than $500,000.

A multilateral netting system that meets the above criteria is subject to the policy if (1) it is a state-chartered member of the Federal Reserve System, (2) any of its agent(s) or participants are state-chartered members of the Federal Reserve System, (3) its participants' net positions are settled through a Federal Reserve settlement account, (4) its participants settle their net positions in the multilateral netting system through their individual Federal Reserve accounts or the Federal Reserve account of the settlement agent(s), or (5) one or more bank holding companies have an investment in the multilateral netting system. The Board also reserves the right to apply the elements of this policy to any non-dollar system based, or operated, in the United States that engages in the multilateral clearing or netting of non-dollar payments among financial institutions and that would otherwise be subject to this policy. This policy does not apply to systems dealing with exchange-traded futures and

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options. Systems in the United States that undertake only the clearance and settlement of debt and equity securities are subject to the Board's policy statement on "Private Delivery-Against-Payment Securities Systems."

In applying the policy, the Board seeks to distinguish between routine banking relationships and arrangements that create a multilateral "system" for clearing and settling U.S. dollar payment and other obligations. This policy statement is not intended to apply to routine bilateral relationships between financial institutions, such as those involved in correspondent banking. In certain borderline cases, for example involving netting systems operated by a single financial institution and that combine elements of bilateral and multilateral netting, a case-by-case determination that an arrangement is a large-dollar multilateral netting system may be necessary for the purpose of applying this policy statement.

In general, the participation in, and operation of, a multilateral netting system is governed by rules and procedures designed to facilitate multilateral clearance and settlement. Settlement risks are typically shared by the participants in some fashion, either implicitly or through employment of explicit loss-sharing and liquidity arrangements. In contrast, correspondent banking relationships generally focus on bilateral relationships and risks; the risk of a settlement failure typically falls, at least initially and sometimes primarily, on the service provider's or settlement agent's liquidity and capital.

The Board believes that the Lamfalussy Minimum Standards may apply, for example, to all large-dollar multilateral payment netting systems irrespective of the type of financial instrument or contractual obligation netted by the system. However, the Board recognizes that in the case of privately operated large-dollar multilateral netting systems for the batch processing of paper-based as well as electronic payments, including privately operated Automated Clearing House (ACH) systems, certain electronic controls that would be required to implement the Lamfalussy Minimum Standards may not be feasible. Further, the rights and responsibilities of parties within such systems may require further analysis. Consequently, the Board intends to study further the implications of the Lamfalussy Minimum Standards, and the arrangements to implement the Lamfalussy Minimum Standards, for privately operated large-dollar multilateral netting systems for the batch processing of paper-based as well as electronic payments. As such, the Board does not intend to apply the Lamfalussy Minimum Standards to these systems at this time.

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Lamfalussy Minimum Standards for the Design and Operation of Privately Operated Large-Dollar Multilateral Netting Systems. The Federal Reserve's policy on privately operated large-dollar multilateral netting systems is designed to strike an appropriate balance between the requirements of market efficiency and payments system stability. A direct means of achieving this balance is to ensure that large-dollar multilateral netting systems are designed and operated so that the participants and service providers have both the incentives and the ability to manage the associated credit and liquidity risks. The Board's approach to privately operated large-dollar multilateral netting systems will be guided by the following minimum standards for such systems:[6]

1. Netting systems should have a well-founded legal basis under all relevant jurisdictions.

2. Netting system participants should have a clear understanding of the impact of the particular system on each of the financial risks affected by the netting process.

3. Multilateral netting systems should have clearly-defined procedures for the management of credit risks and liquidity risks which specify the respective responsibilities of the netting provider and the participants. These procedures should also ensure that all parties have both the incentives and the capabilities to manage and contain each of the risks they bear and that limits are placed on the maximum level of credit exposure that can be produced by each participant.

4. Multilateral netting systems should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single net debit position.

5. Multilateral netting systems should have objective and publicly-disclosed criteria for admission which permit fair and open access.

6. All netting systems should ensure the operational reliability of technical systems and the availability of backup facilities capable of completing daily processing requirements.

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[6]These standards are identical to the minimum standards for netting systems in the Lamfalussy Report, with the exception that the words "netting system" have been substituted for "netting scheme" in minimum standards one, two, and six, and the words "particular system" have been substituted for "particular scheme" in standard two.

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The Federal Reserve reserves the right to prohibit the use of Federal Reserve payment services to support funds transfers that are used to settle, directly or indirectly, obligations on large-dollar multilateral netting systems that do not meet the Lamfalussy Minimum Standards. The Federal Reserve will also take appropriate supervisory steps, or refer matters to the appropriate supervisory or regulatory authority, in cases of systems not in compliance with the aforementioned Lamfalussy Minimum Standards, or their equivalent. Moreover, in order for Federal Reserve Banks to monitor properly the use of intraday credit, no future or existing privately operated large-dollar multilateral netting system will be permitted to settle on the books of a Federal Reserve Bank unless its participants authorize the system to provide position data to the Reserve Bank on request.

<u>Implementation of the Lamfalussy Minimum Standards</u>. The Board believes that large-dollar multilateral netting systems, whether onshore or offshore, should meet in full the Lamfalussy Minimum Standards, as set forth in this policy statement. In order to satisfy the Lamfalussy Minimum Standards, the Board expects that individual large-dollar multilateral netting systems will meet the following risk management standards, or their equivalent: (1) a requirement that each participant establish bilateral net credit limits vis-à-vis each other participant in the system; (2) establish and monitor in real-time system-specific net debit limits for each participant; (3) establish real-time controls to reject or hold any payment or foreign exchange contract that would exceed the relevant bilateral and net debit limits; (4) establish liquidity resources, such as cash, committed lines of credit secured by collateral, or a combination thereof, at least equal to the largest single net debit position;[7] and (5) establish rules and procedures for the sharing of credit losses among the participants in the netting system. The Board will consider, on a case-by-case basis, alternative risk management measures that provide for risk management systems and controls that are equivalent to the five measures listed above. The Board notes that the Lamfalussy Minimum Standards and the arrangements to implement the Lamfalussy Minimum Standards, as discussed above, in no way diminish the responsibilities of the participants in, and the operator of, a large-dollar multilateral netting system to determine if additional safeguards would be appropriate.

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[7]The term "largest single net debit position" means the largest intraday net debit position of any individual participant at any time during the daily operating hours of the netting system.

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Timeframe for Implementation of the Lamfalussy Minimum Standards. The Board recognizes that not all existing large-dollar multilateral netting systems may meet the Lamfalussy Minimum Standards, and the associated requirements for implementation of those standards, set forth in this policy statement. The Board also recognizes that existing large-dollar multilateral netting systems will need a period of time in which to make any needed changes to their organization and operations. Consequently, the Board believes that an eighteen-month transition period would be appropriate for large-dollar multilateral netting systems that are operating on [insert date of final adoption by the Board]. Such systems will be expected to comply fully with the policy statement by [insert date eighteen months after the date of final adoption by the Board]. Large-dollar multilateral netting systems established subsequent to [insert date of final adoption by the Board] will be expected to comply fully with the policy statement, without benefit of a transition period.

The Board intends to review periodically the scale and nature of the credit, liquidity, and settlement risks in privately operated large-dollar multilateral netting systems. Operators of such systems should ensure that as the scale of risks in their systems increase, risk management systems are designed and operated to control the increased scale of risk. The Board expects that over time, whenever systems are changed or redesigned, significant attention will be given to the issue of risk management in order to ensure that high standards of risk control are achieved.

In addition, offshore, large-dollar multilateral netting systems and multicurrency netting systems should at a minimum be subject to oversight or supervision, as a system, by the Federal Reserve, or by another relevant central bank or supervisory authority. The Board recognizes that central banks have common policy objectives with respect to large-value netting arrangements. Accordingly, the Board expects that it will cooperate, as necessary, with other central banks and foreign banking supervisors in the application of the aforementioned Lamfalussy Minimum Standards to offshore and multicurrency systems. In this regard, the Principles for Co-operative Central Bank Oversight outlined in the Lamfalussy Report provide an important international framework for cooperation.

By order of the Board of Governors of the Federal Reserve System, July 12, 1994.

(Signed) William W. Wiles

William W. Wiles
Secretary of the Board