FEDERAL RESERVE SYSTEM

Docket No. R-1106

Policy Statement on Payments System Risk

Interaffiliate Transfers

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy Statement.

SUMMARY: The Board is rescinding section I.F., entitled Interaffiliate Transfers, of its payments system risk (PSR) policy. The Board adopted the interaffiliate transfer policy in 1987 to address potential risks resulting from a lack of an arm's-length credit decision among affiliates.

EFFECTIVE DATE: January 1, 2002.

FOR FURTHER INFORMATION CONTACT: Paul Bettge, Associate Director (202/452-3174) or Stacy Coleman, Manager (202/452-2934), Division of Reserve Bank Operations and Payment Systems.

SUPPLEMENTARY INFORMATION: The Board is issuing this notice in conjunction with five other notices requesting comment on the PSR policy. Three near-term proposals concern the net debit cap calculation for U.S. branches and agencies of foreign banks (Docket No. R-1108), modifications to the procedures for posting electronic check presentments to depository institutions' Federal Reserve accounts for purposes of measuring daylight overdrafts (Docket No. R-1109), and the book-entry securities transfer limit (Docket No. R-1110). In addition, the Board is requesting comment on the benefits and drawbacks to several potential longer-term changes to the Board's policy, including lowering self-assessed net debit caps, eliminating the two-week average caps, implementing a two-tiered pricing system for collateralized and uncollateralized daylight overdrafts, and rejecting payments with settlement-day finality that would cause an institution to exceed its daylight overdraft capacity level (Docket No. R-1111). The Board is also issuing today an interim policy statement and requesting comment on the broader use of collateral for daylight overdraft purposes (Docket No. R-1107). Furthermore, to reduce burden associated with the PSR policy, the Board recently rescinded the third-party access policy (Docket No. R-1100).

I. Background

In April 1985, the Board adopted the PSR policy to reduce the risks that large-dollar payments systems presented to the Federal Reserve Banks, to the banking system, and to other sectors of the economy (50 FR 21120, May 22, 1985). An integral component of this policy is a program to control the use of intraday Federal Reserve credit, commonly referred to as daylight overdrafts. The PSR policy establishes maximum limits (net debit caps) on daylight overdrafts in depository institutions' accounts at Federal Reserve Banks.

At the time it adopted the PSR policy, the Board also explored allowing depository institutions affiliated through common holding company ownership to consolidate their Fedwire activity and net debit caps for the purpose of monitoring compliance with the PSR policy. The Board determined, however, that while the operations of some holding companies are centrally managed, the regulatory and supervisory framework within which their subsidiaries operate is based on the separate corporate charter of each subsidiary. Therefore, the PSR policy requires that depository institutions be monitored for compliance on a separate legal-entity basis.

Although the Board prohibited affiliated depository institutions from outright consolidation of their Fedwire activity and net debit caps, a depository institution could simulate consolidation by sending Fedwire funds transfers to an affiliated institution in amounts not to exceed its net debit cap. The institution would have to repay the funds before the end of the day. The Board, however, identified two potential risks associated with depository institutions transferring their net debit caps to affiliated institutions: increased credit risk to the Federal Reserve Banks and systemic risk among affiliated depository institutions, resulting from a lack of an arm's-length relationship among affiliates. The Board believed that this lack of an arm's-length relationship among affiliates, in some cases, might weaken the independence of credit judgment exercised by one affiliate in advancing funds to another. The concern that common ownership erodes an arm's-length credit decision grew out of the bank failures in the 1930s, which pointed to the relationship between depository institutions and their affiliates as a source of instability for the depository institutions.[1]

To address these risks, the Board modified the PSR policy in 1987 to permit interaffiliate transfers that are intended to concentrate the daylight overdraft capacity of affiliated institutions in one or more institutions provided that: (1) each sending institution's board of directors specifically approves, at least once each year, the intraday extension of credit to the specified affiliate(s) and sends a copy of the directors' resolution to its Federal Reserve Bank and (2) during regular examination, each sending institution's primary federal supervisor reviews the timeliness of board-of-directors resolutions, the establishment by the institution of limits on credit extensions to each affiliate, the establishment by the institution of controls to ensure that credit extensions stay within such limits, and whether credit extensions have in fact stayed within those limits (52 FR 29255, August 6, 1987).

II. Discussion

Recognizing that significant changes have occurred in the banking, payments, and regulatory environment in the past few years, the Board decided to conduct a broad review of the Federal Reserve's daylight credit policies. As part of its review, the Board considered the effectiveness of the interaffiliate transfer policy. Because of the policy's limited use and the credit risk management techniques available to the Reserve Banks, the Board decided to rescind

[1] In addition, the Basle Committee's Core Principles requires that transactions between banks and related companies and individuals should be on an arm's length basis, be effectively monitored, and appropriate steps should be taken to mitigate risks. Core Principles for Effective Banking Supervision, Basle Committee on Banking Supervision, September 1997.

the policy.

The Board evaluated the interaffiliate transfer policy's effectiveness and found that very few institutions are using interaffiliate transfers to consolidate their Fedwire activity and daylight overdraft capacity. The Board also notes that those institutions engaging in interaffiliate transfers, primarily insured depository institutions owned by the same bank holding company, appear to be managing their Federal Reserve accounts prudently. In addition, subsequent to the adoption of the interaffiliate transfer policy, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 included a cross-guarantee provision that allows the Federal Deposit Insurance Corporation (FDIC) to recover part of its resolution cost by seeking reimbursement from affiliated institutions.[2] The Board notes that, under the cross-guarantee provisions, an insured depository institution is generally liable for any loss incurred by the FDIC in connection with the default of a commonly controlled insured depository institution. Furthermore, the Federal Reserve Banks retain the right to reduce or eliminate the credit exposure that they will accept for any depository institution by reducing the institution's net debit cap or monitoring the institution's Fedwire funds transfers and enhanced net settlement transactions in real time. The Board believes that these controls mitigate any increased credit risk to the Federal Reserve or systemic risk from interaffiliate transfers intended to simulate daylight overdraft cap consolidation.

The Board also believes that any institution-specific supervisory concerns associated with interaffiliate credit extensions are more appropriately addressed through the existing supervisory process, including through regulatory restrictions on interaffiliate transactions embodied in sections 23A and 23B of the Federal Reserve Act.[3] Sections 23A and 23B of the Federal Reserve Act are intended to limit the risks to an insured depository institution from transactions with its affiliates. In May 2001, the Board published an interim final rule that (1) requires, under section 23A, that institutions establish and maintain policies and procedures to manage the credit exposure arising from the institutions' intraday extensions of credit to affiliates and (2) clarifies that intraday extensions of credit by an insured depository institution to an affiliate are subject to the market terms requirement of section 23B (Docket No. R-1104).

The Board notes that the interim rule under sections 23A and 23B could restrict the ability of depository institutions to consolidate their daylight overdraft caps. Because of statutory exemptions, however, the market terms requirement of section 23B and the policies and procedures requirement of the interim rule generally would not apply to intraday credit extensions between affiliated insured depository institutions. Thus, intraday credit extensions between affiliated depository institutions, including the consolidating transfers discussed above, would generally be permissible under sections 23A and 23B provided they are conducted in a safe and sound manner. On the other hand, intraday credit extensions designed to transfer the daylight overdraft cap of an insured depository institution to an affiliate that is not an insured depository institution, such as a branch or agency of a foreign bank affiliate, would be subject to the market terms requirement of section 23B and the policies and procedures requirement of the interim rule.

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[2] 12 U.S.C. 1468.
[3] 12 U.S.C. 371c.

Because the risks addressed by the interaffiliate transfer policy are appropriately addressed through the existing supervisory process, the Board is rescinding the interaffiliate transfer policy, part I, section F of the Policy Statement on Payments System Risk.[4] Upon rescission of the interaffiliate transfer policy, depository institutions will no longer be required to submit a board-of-directors resolution to their Reserve Banks; however, institutions are expected to comply with supervisory and regulatory requirements regarding affiliate relationships and exposures, including sections 23A and 23B, as described in 12 CFR 250.248, 12 CFR Part 223, and any future rulemaking.

By order of the Board of Governors of the Federal Reserve System, May 30, 2001.

(Signed) Jennifer J. Johnson

Jennifer J. Johnson,

Secretary of the Board.

[4] The current part I, section G of the policy, Monitoring, will be designated as section F.