FEDERAL RESERVE SYSTEM

Docket No. R-1108

Policy Statement on Payments System Risk

Daylight Overdraft Capacity for Foreign Banking Organizations

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment on policy.

SUMMARY: The Board is requesting comment on proposed changes to its payments system risk (PSR) policy. The proposal would modify the criteria used to determine the U.S. capital equivalency for foreign banking organizations (FBOs). Specifically, the proposed policy would (1) eliminate the Basel Capital Accord (BCA) criteria used in the current policy to determine U.S. capital equivalency for FBOs, (2) replace the BCA criteria with the strength of support assessment (SOSA) rankings and financial holding company (FHC) status in determining U.S. capital equivalency for FBOs, and (3) raise the percentage of capital used in calculating U.S. capital equivalency for certain FBOs.

EFFECTIVE DATE: Comments must be received by August 6, 2001.

ADDRESSES: Comments, which should refer to Docket No. R-1108, may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, D.C. 20551 or mailed electronically to regs.comments@federalreserve.gov. Comments addressed to Ms. Johnson also may be delivered to the Board's mailroom between 8:45 a.m. and 5:15 p.m. and to the security control room outside of those hours. Both the mailroom and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in Room MP-500 between 9:00 a.m. and 5:00 p.m. weekdays, pursuant to §261.12, except as provided in §261.14, of the Board's Rules Regarding Availability of Information, 12 CFR 261.12 and 261.14.

FOR FURTHER INFORMATION CONTACT: Paul Bettge, Associate Director (202/452-3174), Stacy Coleman, Manager (202/452-2934), Myriam Payne, Project Leader (202/452-3219), or Adam Minehardt, Financial Services Analyst (202/452-2796), Division of Reserve Bank Operations and Payment Systems, Board of Governors of the Federal Reserve System.

SUPPLEMENTARY INFORMATION: This is one of five notices regarding payments system risk that the Board is issuing for public comment today. Two near-term proposals concern 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 interaffiliate transfer (Docket No. R-1106) and third-party access policies (Docket No. R-1100).

The Board requests that in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each. This will facilitate the Board's analysis of all comments received.

I. Background

In April 1985, the Board adopted a policy to reduce risk on large-dollar payments systems (50 FR 21120, May 22, 1985). This policy established maximum amounts of uncollateralized daylight credit, or net debit caps, that depository institutions are permitted to incur in their Federal Reserve accounts. Net debit caps for U.S. branches and agencies of foreign banks are calculated in the same manner as for domestic banks, by applying cap multiples from one of the six cap classes to a capital measure.[1,2] A depository institution's cap class and associated cap multiple either are determined through a self-assessment or a board-of-directors resolution or are assigned by the Administrative Reserve Bank.[3] All net debit caps, including those requested by an institution's board of directors, are granted at the discretion of the Federal Reserve. Under the current policy, the Federal Reserve Banks apply the cap multiple to 100 percent of domestic depository institutions' risk-based (or equivalent) capital. The capital measure used for an FBO, known as the U.S. capital equivalency, however, is substantially less than the FBO's total capital.

In 1987, the Board considered and decided against changing the original definition of U.S. capital equivalency (52 FR 29255, August 6, 1987). At the request of several FBOs, however, the Board requested comment again in June 1989 on alternatives for determining FBOs' U.S. capital equivalency used in calculating net debit caps for U.S. branches and agencies of foreign banks (54 FR 26108, June 21, 1989). After further analysis, in 1991, the Board adopted the current policy based on the BCA distinction (55 FR 22095, May 31, 1990).[4]

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[1] U.S. branches and agencies of foreign banks are entities contained within and controlled by a foreign banking organization. For the definition of "branch" and "agency", refer to 12 U.S.C. 3101 and 12 C.F.R.

[2] The net debit cap classes and their associated single-day multiples are a zero cap (0), an exempt-from-filing cap (equal to the lesser of $10 million or 0.2 times a capital measure), a de minimis cap (0.4); and three self-assessed caps, average (1.125), above average (1.875), and high (2.25). A net debit cap is calculated for the FBO and then distributed among its U.S. branches and agencies at the discretion of the FBO and the Administrative Reserve Bank.

[3] The Administrative Reserve Bank is responsible for managing an institution's account relationship with the Federal Reserve.

[4] The BCA was developed by the Basel Committee on Banking Supervision and endorsed by the central bank governors of the Group of Ten countries. The BCA provides a framework for assessing the capital adequacy of a depository institution by risk weighting its assets and off-balance sheet exposures primarily based on credit risk.

FBOs from countries that adhere to the BCA are currently eligible to use as their U.S. capital equivalency the greater of 10 percent of their capital or 5 percent of their liabilities to nonrelated parties.[5] FBOs from countries that do not adhere to the BCA may use as their U.S. capital equivalency the greater of 5 percent of their liabilities to nonrelated parties or the amount of capital that would be required of a national bank being organized at each location.[6] Under the current policy, if the home country supervisor of an FBO does not adhere to the BCA, the U.S. branch or agency of the FBO may still incur daylight overdrafts above its net debit cap up to a maximum equal to its cap multiple times 10 percent of its capital, provided that any overdrafts above the net debit cap are collateralized.

In 2000, as part of a broad review of the PSR policy, the Board again assessed the determination of U.S. capital equivalency for FBOs. The review included analysis of trends of daylight credit, consideration of supervisory issues, analysis of new or emerging payments system initiatives, and discussions with FBOs.

II. Discussion

A. FBO Liquidity Issues

A few FBOs have indicated that their net debit caps constrain their business activity and place them at a competitive disadvantage to U.S. depository institutions. These FBOs assert that certain U.S. depository institutions hold a significant portion of their assets in foreign markets but are able to use 100 percent of their total risk-based capital in establishing their caps, while the PSR policy does not recognize the FBOs' worldwide financial strength. During 2000, approximately 35 percent of U.S. branches and agencies of foreign banks with nonzero net debit caps had cap utilization levels of 75 percent or more.[7] In contrast, less than 5 percent of domestically chartered institutions use more than 50 percent of their net debit caps for their average daily peak daylight overdrafts.

A number of FBOs have expressed concern over being able to meet the intraday liquidity requirements of the Continuous Linked Settlement (CLS) system and the new Clearing House Interbank Payments System with intraday finality (new CHIPS). CLS Bank is being designed as a multi-currency facility for settling foreign exchange transactions. Under the proposed procedures, participating institutions will be required to make daily U.S. dollar payments to CLS Bank over Fedwire during the early hours of the Fedwire funds transfer operating day. Because U.S. financial money markets are not currently active during those hours, a number of CLS members assert that they will use Federal Reserve daylight credit to fund their CLS-related payment obligations and have requested that the Federal Reserve grant them additional intraday credit.[8]

[5] Liabilities to nonrelated parties include acceptances, but exclude accrued expenses and amounts due and other liabilities to offices, branches, and subsidiaries of the foreign bank of each agency or branch.
[6] The latter measure is not normally reported to the Federal Reserve. If an FBO desires to use this measure as its capital equivalency, the Administrative Reserve Bank must be notified to make special arrangements.
[7] In this context, cap utilization is equal to an FBO's average daily peak daylight overdraft divided by the FBO's net debit cap.
[8] For additional information on payment system initiatives, refer to the Payments Risk Committee's report entitled "Intraday Liquidity Management in the Evolving Payment System: A Study of the Impact of the Euro, CLS Bank, and CHIPS Finality," New York, April 2000. http://www.ny.frb.org/prc/intraday.html.

On January 22, 2001, the Clearing House Interbank Payments Company L.L.C. converted CHIPS from an end-of-day multilateral net settlement system to one that provides real-time final settlement for all payment orders as they are released.[9] To accomplish real-time final settlement, each CHIPS participant must transfer (directly or through another participant) a predetermined amount into the CHIPS "prefunded balance account" on the books of the Federal Reserve Bank of New York. While new CHIPS settles all of the payment orders when they are released, some payment orders remain unreleased at the end of the day. These payment orders are netted and set off against one another on a multilateral basis, with each participant in a net debit closing position transferring the amount of its closing position requirement into the prefunded balance account. Many CHIPS participants use Federal Reserve daylight credit to pay their end-of-day closing position requirements on CHIPS. Some of these participants have stated that making these Fedwire payments has, on occasion, increased their demand for intraday credit.

In addition to the concerns raised by FBOs, the Board recognizes the continued globalization of the financial industry and that many FBOs have established substantial operations within the United States. Furthermore, FBOs might increase their U.S. activities with the business opportunities created by the Gramm-Leach-Bliley Act (Public Law 106-102) (GLB Act). As their U.S. business expands, FBOs could have a corresponding increase in their need for use of the U.S. payments system and daylight credit.

B. National Treatment Considerations

While the Board understands the concerns of the foreign banking community, FBO participants in the payments system present risks that domestic depository institutions do not pose to the same extent and, accordingly, some differential treatment is warranted. Additional risks posed by FBOs include increased legal risk in pursuing claims against insolvent FBOs under the laws of various countries and increased supervisory risk in the monitoring of FBOs.

FBOs present special legal risks to the Federal Reserve because of the differences in insolvency laws and public policy associated with the various FBOs' home countries. In international financial transactions, the overall risk borne by each party is affected not only by the governing law set out in the contract, but also by the law governing the possible insolvency of its counterparty. The insolvency of an international bank presents significant legal issues in enforcing particular provisions of a financial contract (such as close-out netting or irrevocability provisions) against third parties (such as the liquidator or supervisor of the failed bank). The insolvent party's national law also may permit the liquidator to subordinate other parties' claims (such as by permitting the home country tax authorities to have first priority in bankruptcy), may reclassify or impose a stay on the right the nondefaulting party has to collateral pledged by the defaulting party in support of a particular transaction, or may require a separate proceeding to be initiated against the head office in addition to any proceeding against the branch.

It is not practicable for the Federal Reserve to undertake and keep current extensive analysis of the legal risks presented by the insolvency law(s) applicable to each FBO with a Federal Reserve account in order to quantify precisely the legal risk that the Federal Reserve incurs by providing intraday credit to that institution. It is reasonable, however, for the

[9] CHIPCo is the affiliate of The New York Clearing House Association L.L.C. that owns and operates CHIPS.

Federal Reserve to recognize that FBOs generally present additional legal risks to the payments system and, accordingly, limit its exposure to these institutions.

In addition to the legal risks associated with FBO failures, the Federal Reserve faces elevated supervisory risks when monitoring FBOs. In some countries, supervisory information available to U.S. regulators may be less timely and not comparable to similar information used in the supervision of U.S. depository institutions. U.S. bank supervisors also lack a consolidated view of the FBO's risk management process and are unable to test its implementation on a global basis. Furthermore, FBO risk profiles differ due to varying industry and regulatory structures across countries.

III. Proposed Changes to PSR Policy

The Board is requesting comment on the following policy changes related to the determination of FBOs' U.S. capital equivalency used in calculating net debit caps for their U.S. branches and agencies. Specifically, the proposed policy would allow

1. FBOs that hold an FHC classification to use 35 percent of their capital as their U.S. capital equivalency. The Board believes that the capital and management requirements for FHCs and the heightened monitoring and supervision to which FHCs are subject justify permitting these FBOs to incur a higher level of daylight overdrafts.

2. FBOs that are not FHCs and are ranked SOSA 1 to use 25 percent of capital as their U.S. capital equivalency. The Board believes that achieving the standards of the SOSA 1 ranking provide sufficient support for increasing the percentage of capital used for net debit cap calculations to 25 percent.[10]

3. FBOs that are not FHCs and are ranked SOSA 2 to use 10 percent of their capital as their U.S. capital equivalency.

4. FBOs that are not FHCs and are ranked SOSA 3 to use 5 percent of the FBO's "net due to related depository institutions."[11] Recognizing that net debit caps are granted at the discretion of the Federal Reserve, the Reserve Banks could require certain SOSA 3-ranked FBOs to fully collateralize their net debit caps.

The Board believes its proposal to permit the use of higher percentages of capital for FBOs that hold an FHC classification or a SOSA 1-ranking will provide sufficiently larger daylight overdraft capacity to those institutions whose payment activity is currently constrained by their net debit caps. The Board believes that the benefits to the payments system of

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[10] The SOSA ranking is composed of four factors including the FBO's financial condition and prospects; the system of supervision in the FBO's home country; the record of the home country's government in support of the banking system or other sources of support for the FBO; and transfer risk concerns. Transfer risk relates to the FBO's ability to access and transmit U.S. dollars, which is an essential factor in determining whether an FBO can support its U.S. operations. The SOSA ranking is based on a scale of 1 through 3 with 1 representing the lowest level of supervisory concern.

[11] The Reserve Banks may review other relevant information when considering whether to permit SOSA 3-ranked FBOs access to intraday credit. The PSR policy allows Reserve Banks to deny any depository institution access to Federal Reserve intraday credit based on any applicable information.

increasing the U.S. capital equivalency for FBOs that hold an FHC classification or a SOSA 1-ranking outweigh the potential increase in credit risk to the Federal Reserve.

In addition, an interim policy statement (Docket No. R-1107) that was published elsewhere in today's Federal Register allows depository institutions that have self-assessed net debit caps to pledge collateral to the Federal Reserve Banks in order to incur additional daylight overdrafts above their net debit cap levels. An FBO whose U.S. branch or agency has a self-assessed net debit cap and is in need of additional capacity may consult with its Administrative Reserve Bank on pledging collateral for this purpose.[12]

A. Supervisory Rankings

The Board considered how the SOSA rankings might alleviate some concerns about the timeliness and reliability of supervisory information. SOSA rankings reflect an assessment of an FBO's ability to provide financial, liquidity, and management support to its U.S. operations. In October 2000, SOSA rankings were made available to the FBOs' management and home country supervisor.[13] Previously, SOSA rankings were used for internal Federal Reserve purposes only. SOSA rankings provide broader information about the condition of the FBO, its supervision, and the home country, whereas the BCA distinction provides information only about the home country treatment of bank capital adequacy. Furthermore, the BCA designation reflects the one-time adoption of BCA standards by a country's supervisory authority, while U.S. bank supervisors update the SOSA rankings regularly.

The Board also considered the FHC status created by the GLB Act. The GLB Act authorizes bank holding companies (BHCs) and FBOs that are well capitalized and well managed, as those terms are defined in the statute and the Board's regulations, to elect FHC status and thereby engage in securities, insurance, and other activities that are financial in nature or incidental to a financial activity and that are otherwise impermissible for BHCs. FHCs must continue to meet the applicable capital and management standards in order to maintain their status and are subject to enhanced reporting requirements. The Board believes that, like the SOSA ranking, FHC status is preferable to the BCA distinction in determining the risk posed by FBOs to the U.S. payments system.[14]

The Board, therefore, proposes to replace the current BCA distinction in the PSR policy with a combined SOSA-FHC structure and to increase the percentage of capital used in calculating net debit caps for certain U.S. branches and agencies of foreign banks. The Board believes that the SOSA ranking provides more specific, more comprehensive, and more timely information than the BCA distinction. As result, the Board believes that the definition of U.S. capital equivalency can be expanded further for FBOs that are FHCs or have a SOSA 1 ranking.

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[12] The interim policy statement expands the prior policy that permitted certain FBOs to pledge collateral to reach a maximum daylight overdraft capacity equal to their cap multiple times 10 percent of their capital.

[13] For full text, see SR Letter 00-14 (SUP), Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations, October 23, 2000.

[14] While applying for FHC status is voluntary, the regulatory burden associated with applying is minimal for most institutions.

B. Alternative Measure of U.S. Capital Equivalency

Under the current policy, an FBO from a country that does not adhere to the BCA must use an alternative measure for its U.S. capital equivalency that is not based on total capital. Currently, the alternative measure is 5 percent of "liabilities to nonrelated parties" or the amount of capital that would be required of a national bank being organized at a specific location. The Board believes that using an alternative measure of U.S. capital equivalency when an FBO's home country does not adhere to the BCA is appropriate given concerns over the potential lack of timely supervisory information regarding these FBOs and the Federal Reserve's inability to monitor each FBO's non-U.S. operations.

While the Board proposes to eliminate the BCA criteria used in the current policy, the Board continues to support using an alternative measure of U.S. capital equivalency for U.S. branches and agencies of foreign banks that represent the greatest levels of supervisory concern. The Board believes that this alternative measure should be applied only to those FBOs that may exhibit significant financial or supervisory weaknesses, specifically SOSA 3-ranked FBOs under the proposed policy. In achieving this end, the Board believes that the alternative measure of U.S. capital equivalency for SOSA 3-ranked FBOs should reflect the capital investment of the FBO in its U.S. operations rather than its total capital.

As an alternative measure for U.S. capital equivalency, the Board intends to replace the use of "liabilities to nonrelated parties" with "net due to related depository institutions."[15] "Liabilities to nonrelated parties" may increase relative to assets when an institution becomes financially weaker and could unduly increase the institution's overdraft capacity. "Net due to related depository institutions" reflects the amounts owed to the parent by the branch and can be viewed as the capital investment by the FBO parent in its U.S. operations. In addition, the Board notes that this policy change would not affect any SOSA 3-ranked FBOs at this time.

C. Capital Reporting

In order to comply with the proposed policy changes, most U.S. branches and agencies of foreign banks requesting a net debit cap will need to complete the form "Annual Daylight Overdraft Capital Report for U.S. Branches and Agencies of Foreign Banks" (form FR 2225) to report capital that is used as the basis for their caps.[16] Given that the form is short and does not require any calculations, the Board believes the cost of completing this form is not significant or burdensome. Currently, only five FBOs that have nonzero net debit caps do not file form FR 2225. These five FBOs would have to submit form FR 2225 to comply with the revised policy.[17]

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[15] Reporting Form FFIEC 002/002S. Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks. Schedule RAL – Assets and Liabilities: Liabilities: item 4 –"Liabilities to nonrelated parties" and item 5 - "Net due to related depository institutions."

[16] SOSA 3-ranked FBOs would not be required to file FR 2225 because they would not be eligible to base their U.S. capital equivalency on capital.

[17] In 1998, the Board surveyed FBOs that filed FR 2225 to estimate the burden to the public of completing the form. As a result of the survey, the Board estimated the annual burden of completing FR 2225 to be one hour per FBO.

IV. Request for Comment

The Board requests comments on all aspects of the proposed policy changes outlined above. The Board is also requesting comments on the following questions:

1. If the proposed policy changes are adopted, will the resulting net debit cap levels combined with the broader use of collateral outlined in the interim policy statement also published today for comment (Docket No. R-1107) provide a reasonable and prudent level of daylight overdraft capacity to address the liquidity needs of FBOs?

2. Recognizing differences in risk between FBOs and domestic depository institutions, would the proposed policy provide FBOs appropriate access to the U.S. payments system?

3. With regard to calculating U.S. capital equivalency, is "net due to related depository institutions" an appropriate proxy for SOSA 3-ranked FBOs' U.S. capital equivalency?

V. Competitive Impact Analysis

Under its competitive equity policy, the Board assesses the competitive impact of changes that have a substantial effect of payments system participants.[18] The Board believes these modifications to its payments system risk program will have no adverse effect on the ability of other service providers to compete effectively with the Federal Reserve Banks in providing similar services.

VI. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. ch. 3506; 5 CFR 1320 appendix A.1), the Board has reviewed the request for comments under the authority delegated to the Board by the Office of Management and Budget. The collection of information pursuant to the Paperwork Reduction Act contained in the policy statement will not unduly burden depository institutions.

VII. Federal Reserve Policy Statement on Payments System Risk

The Board proposes to replace section I.C.2. of the "Federal Reserve Policy Statement on Payments System Risk" as follows:

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

For U.S. branches and agencies 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 a foreign banking organization's (FBO's) U.S. capital equivalency.[10]

- For FBOs that are financial holding companies (FHCs), U.S. capital equivalency is equal to 35 percent of capital.

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

- For FBOs that are not FHCs and have a strength of support assessment ranking (SOSA) of 1, U.S. capital equivalency is equal to 25 percent of capital.

- For FBOs that are not FHCs and are ranked a SOSA 2, U.S. capital equivalency is equal to 10 percent of capital.

- For FBOs that are not FHCs and are ranked a SOSA 3, U.S. capital equivalency is equal to 5 percent of the FBO's "net due to related depository institutions."

Given the heightened supervisory concerns associated with SOSA 3-ranked FBOs, a Reserve Bank may deny a SOSA 3-ranked FBO access to intraday credit. In the event a Reserve Bank grants a net debit cap to a SOSA 3-ranked FBO, the Reserve Bank may require the net debit cap to be fully collateralized.

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[10] 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.

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.