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Proposed Amendments to Policy on Payment System Risk

Federal Reserve Proposes Amendments to Policy on Payment System Risk Affecting Foreign Banking Organizations

SUMMARY

The Federal Reserve has proposed[1] amendments to the provisions of its Policy on Payment System Risk (the "PSR Policy") relating to the establishment of "net debit caps" – *i.e.*, the maximum amount of uncollateralized daylight overdrafts that an institution can incur in its Federal Reserve account – for U.S. branches and agencies of foreign banking organizations. The proposed amendments would remove from the PSR Policy all references to the Strength of Support Assessment, or "SOSA", rankings the Federal Reserve has assigned to foreign banking organizations. The proposal is related to the Federal Reserve's decision to eliminate the SOSA for all purposes. The proposal would also remove references to the "financial holding company" status of a foreign banking organization as a factor in determining a net debit cap, and make other conforming and simplifying changes. While the changes will result in reductions in net debit caps for a number of organizations, the Federal Reserve asserts that these changes will not have a significant practical impact. In support of this assertion, the Federal Reserve observed that the affected institutions generally have not incurred overdrafts that would exceed their new net debit caps, including during the 2007-2009 financial crisis. Further, the Federal Reserve believes that the affected institutions would generally be able to obtain increased overdraft capacity through the pledge of collateral. Comments on the proposal will be due 60 days after the proposal is published in the Federal Register.

BACKGROUND

The Federal Reserve Policy on Payment System Risk[2] is published by the Board of Governors of the Federal Reserve System (the "Federal Reserve") to address risks that payments and securities settlement systems present to the financial system and to the Federal Reserve Banks, through their operation of the Fedwire Funds Service and Fedwire Securities Service. The PSR Policy states the Federal Reserve's policy expectations relating to risk management for systemically significant financial market infrastructures, including the Fedwire services, and to other payment systems within the scope of the policy, and describes the manner in which the Federal Reserve will interact with other domestic and foreign authorities with respect to payment systems over which it does not have exclusive authority. The PSR Policy also states the Federal Reserve's policies relating to the provision of intraday credit by Federal Reserve Banks to ensure the smooth functioning of payment and settlement systems, while controlling the resulting credit risk to the Federal Reserve Banks. The proposed amendments affect the maximum levels of daylight overdrafts that depository institutions may incur in their Federal Reserve accounts.

EXISTING PROVISIONS RELATING TO THE DETERMINATION OF NET DEBIT CAPS

A financial institution that maintains an account at a Federal Reserve Bank may utilize Fedwire, ACH, and other services offered by the Federal Reserve Bank. These services may result in debits and credits to the financial institution's account at the Federal Reserve Bank over the course of the business day. The Federal Reserve requires each financial institution that incurs daylight overdrafts in its Federal Reserve account – *i.e.,* a temporary overdraft in the account that is covered by the end of the business day – to establish a "net debit cap". The net debit cap is the "maximum amount of uncollateralized daylight overdrafts that the institution can incur in its Federal Reserve account".[3] Permitting a net debit cap of greater than zero, and granting an extension of intraday credit, is within the discretion of the Federal Reserve Bank and, in any event, an institution must be financially healthy and have regular access to the discount window in order to have a net debit cap greater than zero (a "positive net debit cap").

Under the current PSR Policy, a financial institution's net debit cap is calculated on the basis of (1) its "capital measure" and (2) its "cap multiple". The "capital measure" is based on the capital of the financial institution; the "cap multiple" is determined by the financial institution's "cap category", which reflects the institution's "creditworthiness". "An institution with a higher capital measure or a higher cap category (and thus a higher cap multiple) will qualify for a higher net debit cap than an institution with a lower capital measure or lower cap category". For a foreign banking organization ("FBO"), both the capital measure and the cap category can be affected by a financial institution's SOSA ranking, and the capital measure can be affected by whether the FBO is a financial holding company ("FHC") under the Bank Holding Company Act. The proposal would not change the use of a capital measure, cap category and cap multiple, but would modify the ways in which they are determined to eliminate the references to the SOSA ranking and to the institution's FHC status.

Cap Category: Under the PSR Policy, there are six cap categories: high, above average, average, de minimis, exempt-from-filing, and zero. Each cap category corresponds to a cap multiple. A financial institution that wishes to establish a net debit cap category of high, above average, or average must perform a self-assessment of its own creditworthiness, as well as other factors relating to its operational capabilities, controls and policies. For domestic institutions, the creditworthiness component of the self-assessment is required to take into account the institution's supervisory rating and prompt corrective action ("PCA") designation.[4] Because FBOs do not receive PCA designations, the existing PSR Policy utilizes the FBO's SOSA ranking, together with its supervisory rating. The SOSA ranking is also used by Reserve Banks to determine whether to permit an FBO to have a de minimis or exempt-from-filing cap category, although no-self-assessment is required to obtain these cap categories.

Capital Measure: In most cases, under the existing PSR Policy, a financial institution's "capital measure" is a number derived from the size of its capital base. For domestic institutions, the capital measure is equal to 100 percent of the institution's risk-based capital. For FBOs, in most cases, the capital measure is a percentage of its worldwide capital base, ranging from 5 percent to 35 percent. The percentage applicable to any particular FBO is based on its SOSA ranking and whether the FBO is an FHC. A better SOSA ranking results in a higher capital measure, as does the fact that the FBO is an FHC.

In addition to being used in determining an FBO's net debit cap, these factors are used to determine whether the FBO can utilize a streamlined procedure to expand its overdraft capacity by pledging collateral to its Federal Reserve Bank to secure daylight overdrafts that exceed the FBO's net debit cap. An institution may apply for a maximum daylight overdraft capacity ("max cap") that allows it to incur overdrafts in an aggregate amount equal to the net debit cap and its additional collateralized capacity. The application process is simplified for FBOs with a SOSA ranking of 1 or FHC status.

REASONS FOR THE PROPOSED CHANGES

On December 7, 2017, the Federal Reserve announced that it would eliminate the SOSA ranking from its FBO supervision program.[5] When the SOSA ranking was adopted in its current form, the Federal Reserve considered it a significant tool supporting its ability to supervise the U.S. operations of foreign banks.[6] The decision to eliminate it "recognizes that Federal Reserve supervisory staff now have more timely access to a variety of resources for information on FBO parent banks, home country accounting practices and financial systems, and international supervisory and regulatory developments".[7] The only current use of SOSA rankings by the Federal Reserve is in setting guidelines related to FBO access to intraday credit from the Federal Reserve Banks and to the discount window.[8] Accordingly, the Federal Reserve found that continuing with SOSA rankings was an inefficient use of Federal Reserve resources and should be discontinued.

The Federal Reserve also found that relying on FHC status was an inappropriate basis for granting an FBO greater daylight overdraft capacity, because an FBO may retain that status – albeit subject to limits on its ability to enjoy the powers granted to an FHC – even when it is not well capitalized. As a result, FHC status is not necessarily a reliable indicator of capital strength.

PROPOSED REPLACEMENT CRITERIA

The Federal Reserve proposed new criteria for determining the cap category of an FBO and the availability of the streamlined process for obtaining a max cap:

- Many undercapitalized FBOs, and all significantly or critically undercapitalized FBOs, would have "below standard" creditworthiness and would generally be ineligible for a positive net debit cap.
- If an FBO is based in a country that adheres to the Basel Capital Accords, the FBO's creditworthiness self-assessment would generally be based on the U.S. Operations Supervisory Composite Rating assigned to the FBO by the Federal Reserve, and on the PCA designation that would apply to the FBO if it were subject to the Federal Reserve's Regulation H.
- If an FBO is not based in a country that adheres to the Basel Capital Accords, it would be required to perform a full assessment of its creditworthiness.
- As is the case today, each institution would also be required to assess its intraday funds-management procedures, its procedures for evaluating the financial condition of and establishing intraday credit limits for its customers, and its operating controls and contingency procedures to determine whether they are sufficient.
- An FBO that is well capitalized could request the streamlined procedure for obtaining a max cap. Other FBOs could not.

With respect to the capital measure, the Federal Reserve proposes that the capital measure of every FBO would equal 10 percent of its worldwide capital. There would be no adjustment for creditworthiness or operational capabilities, all of which would be addressed in the determination of the FBO's cap category.

The proposal simply deletes references to the SOSA rating, without replacing it with another supervisory rating. With respect to the creditworthiness self-assessment, the Federal Reserve concluded that using equivalent PCA designations in conjunction with supervisory ratings would better protect the Reserve Banks from credit risk, because an equivalent PCA designation would provide insight into an FBO's worldwide financial profile and its ability to support its U.S. branches and agencies.

EFFECT ON PAYMENT SYSTEMS ACCESS

While the proposed changes would result in a reduction in the net debit caps of a number of FBOs,[9] the Federal Reserve asserted that this reduction would have no adverse impact on the FBOs because, with very few exceptions, they have not utilized the full amount of their current overdraft capacity even during the 2007-2009 financial crisis:

> since 2015, only 25 of 62 FBOs with a positive net debit cap have used any daylight overdraft capacity, the highest average cap utilization by an FBO was 28.5 percent, and only two FBOs had an average cap utilization greater than 25 percent. Even during the 2007–09 financial

> crisis, when the use of intraday credit spiked amid the market turmoil near the end of 2008, 51 of 58 FBOs with a positive net debit cap used capacity, the highest average cap utilization was 65 percent, and only seven FBOs had an average cap utilization greater than 25 percent.[10]

Acknowledging that the low utilization of overdraft capacity in recent years may reflect the unusually high reserve balances held by FBOs at the Federal Reserve during those years, the Federal Reserve asserted that the adjusted net debit caps would not constrain most FBOs' U.S. operations even if FBOs hold lower reserves in the future.[11] At the same time, the proposal notes that FBOs currently have net debit caps that are large as compared to those of domestic institutions, while at the same time having relatively low levels of U.S. assets. While "[t]he Board recognizes that its proposed changes to the capital measure calculation may increase the instances in which FBOs need additional daylight overdraft capacity", the proposal suggests that an FBO can apply for a higher cap, or for a max cap, in order to obtain additional capacity. Recognizing that principles of national treatment require that FBOs generally be treated no less favorably than similarly situated domestic banks, the proposal notes that an FBO incurring daylight overdrafts may present legal risks to the Federal Reserve that are "above and beyond the risks posed by domestic institutions". These greater risks, the proposal suggests, justify a more constrained approach to determining FBO net debit caps – albeit an approach that is "well tailored" to the actual needs of FBOs.

REQUEST FOR COMMENTS

The Federal Reserve requests comment on all aspects of the proposal, including whether FBOs would require a transition period to adjust to the proposed changes. Comments will be due within 60 days of the publication of the proposed amendments in the Federal Register.

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ENDNOTES

[1] *See* Federal Reserve Policy on Payment System Risk; U.S. Branches and Agencies of Foreign Banking Organizations, 82 Fed. Reg. 58764 (Dec. 14, 2017).

[2] *See* Federal Reserve Policy on Payment System Risk (as amended effective September 15, 2017), *available at* https://www.federalreserve.gov/paymentsystems/files/psr_policy.pdf.

[3] 82 Fed. Reg. at 58764.

[4] *See* Federal Deposit Insurance Act, 12 U.S.C. 1831o.

[5] Board of Governors of the Federal Reserve System, SR 17-13: Elimination of the Strength of Support Assessment (SOSA) for all Foreign Banking Organizations subject to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations (Dec. 7, 2017), *available at* https://www.federalreserve.gov/supervisionreg/srletters/sr1713.htm.

[6] The SOSA rating, in its current form, was adopted in 2000. "SOSA rankings, which reflect an assessment of an FBO's ability to provide financial, liquidity and management support to its U.S. operations, have been found by U.S. supervisors to be an effective and reliable tool in supervising the U.S. activities of foreign banks. These rankings are also used in connection with other U.S. regulatory matters requiring a supervisory view of a foreign banking organization." Board of Governors of the Federal Reserve System, SR 00-14: Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations (Oct. 23, 2000), *available at* https://www.federalreserve.gov/boarddocs/srletters/2000/sr0014.htm.

[7] SR 17-13: Elimination of the Strength of Support Assessment (SOSA) for all Foreign Banking Organizations subject to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations, *supra* note 5.

[8] The proposal notes that adjustments to the discount window access criteria will also be required.

[9] The proposal would reduce net debit caps for 20 of the 49 FBOs that currently maintain a positive net debit cap. "Aggregate FBO net debit caps would be reduced by 57%, seventeen FBOs would have their net debit caps reduced by 71%, and three FBOs would have their net debit caps reduced by 60%." 82 Fed. Reg. at 58768 n.49.

[10] 82 Fed. Reg. at 58768.

[11] *Id.*

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