

**United States: Publication of Financial Sector Assessment Program Documentation—  
Technical Note on Selected Issues on Oversight of Payment**

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FINANCIAL SECTOR ASSESSMENT PROGRAM

# UNITED STATES OF AMERICA

SELECTED ISSUES ON OVERSIGHT OF PAYMENT, CLEARING,  
AND SETTLEMENT SYSTEMS

## TECHNICAL NOTE

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INTERNATIONAL MONETARY FUND  
MONETARY AND CAPITAL MARKETS DEPARTMENT



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**GLOSSARY**

ACH	Automated Clearing House
BAC	Committee on Federal Reserve Bank Affairs
CCPs	Central Counterparties
CFTC	Commodity Futures Trading Commission
CHIPS	Clearing House Interbank Payment System
CLS	Continuous Linked Settlement
CPSS	Committee on Payments and Settlement Systems
CPSIPS	Core Principles for Systemically Important Payment Systems
DTC	Depository Trust Company
DTCC	Depository Trust & Clearing Corporation
FFIEC	Federal Financial Institutions Examination Council
FICC	Fixed Income Clearing Corporation
FRA	Federal Reserve Act
IOSCO	International Organization of Securities Commissions
MCA	Monetary Control Act
NSCC	National Securities Clearing Corporation
OCC	Options Clearing Corporation
OTC	Over the Counter
PSR	Payment System Risk
RBOPS	Reserve Bank Operations and Payment Systems
RTGS	Real Time Gross Settlement System
SEC	Securities and Exchange Commission
SSSs	Securities Settlement Systems
TCH	The Clearing House

## EXECUTIVE SUMMARY<sup>1</sup>

**This technical note reviews the Federal Reserve’s oversight of payment, clearing and settlement systems.**<sup>2</sup> Although the focus of the note is on payment systems oversight, it addresses, where relevant, the oversight of clearing and settlement systems due to their impact on financial stability and the strong interdependencies with payment systems. In doing so, the note refers to the four Responsibilities of the Central Bank in applying the Core Principles for Systemically Important Payment Systems (CPSIPS) and the Committee on Payment and Settlement Systems (CPSS) Principles for Effective Oversight.<sup>3</sup>

**As is typical for central banks, the Federal Reserve plays multiple and important roles in payment and settlement systems.** As a service provider, the Federal Reserve supplies a variety of payment services to depository institutions, the government and other entities. The Federal Reserve operates both the real time gross settlement system (RTGS)—Fedwire Funds—for payments, the Fedwire Securities system for book entry transfers of government securities, the National Settlement Service for settlement of private-sector systems, and on the retail payments side, an Automated Clearing House (ACH) and check collection services. These services are overseen by the Federal Reserve Board under authority provided in the Federal Reserve Act. The Federal Reserve also exercises a supervisory and regulatory responsibility over certain private-sector payment and settlement systems that have bank charters subject to Federal Reserve supervision or that fall under relevant supervisory provisions for bank service companies. Finally, the Federal Reserve fosters improvements in payment and settlement systems through a variety of means, including conducting research, promoting dialogue, providing leadership and acting as a catalyst for changes to private sector practices.

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<sup>1</sup> This Technical Note (TN) was prepared by Frédéric Hervo (external expert, Banque de France).

<sup>2</sup> This TN does not cover other U.S. agencies competences in the field of payment, clearing, and settlement systems.

<sup>3</sup> The four CPSIPS responsibilities are: A: the central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems; B: the central bank should ensure that the systems it operates comply with the core principles; C: the central bank should oversee observance with the core principles by systems it does not operate and it should have the ability to carry out this oversight; and D: the central bank, in promoting payment system safety and efficiency through the core principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.

The CPSS report on Central Bank Oversight of Payment and Settlement Systems of May 2005 has set five general principles for oversight (General oversight principle A: Transparency: “Central banks should set out publicly their oversight policies, including the policy requirements or standards for systems and the criteria for determining which systems these apply to;” General oversight principle B: “International standards: Central banks should adopt, where relevant, internationally recognised standards for payment and settlement systems;” General oversight principle C: Effective powers and capacity: “Central banks should have the powers and capacity to carry out their oversight responsibilities effectively;” General oversight principle D: Consistency: “Oversight standards should be applied consistently to comparable payment and settlement systems, including systems operated by the central bank;” General oversight principle E: Cooperation with other authorities: “Central banks, in promoting the safety and efficiency of payment and settlement systems, should cooperate with other relevant central banks and authorities”) and five principles for international cooperative oversight, which update the 1990 Lamfalussy principles for international oversight.

**A key conclusion of this note is the need to broaden the Federal Reserve's legal authority and powers to oversee systemically important payment, clearing and settlement systems that extend beyond systems with bank charters that fall within its prudential supervisory authority.** The systemic importance of payment and settlement systems and the extent to which these extend beyond the banking system argues in favor of enhancing the central bank's role in overseeing these systems. Encouragingly, the Administration's 2009 legislative proposal (Title VIII) recommends providing the Federal Reserve with the authority, in consultation with other relevant U.S. regulators, to designate systemically important financial market utilities. In cooperation with relevant U.S. regulators and complementary to existing supervisory and regulatory provisions, the Federal Reserve would have the authority to set risk management standards, and oversee such infrastructures irrespective of their charter. Such authority should help to improve the United States' ability to assess systemic risk, ensure consistent application of international risk management standards across systems, and coordinate its policy actions among relevant and interested regulators, on a national basis and with those abroad.

## I. SCOPE OF CURRENT FEDERAL RESERVE OVERSIGHT

1. **This note reviews the Federal Reserve’s oversight function, using the internationally agreed definition of central bank’s oversight of payment and settlement systems.** As defined in the CPSS report, “oversight of payment and settlement systems is a central bank function whereby the objectives of safety and efficiency are promoted by monitoring existing and planned systems, assessing them against these objectives and, where necessary, inducing change.”<sup>4</sup> Under this definition, “the concept of payment and settlement oversight is therefore distinct from prudential supervision and regulation, which focuses on the soundness of individual financial institutions.” The scope of the internationally agreed definition of oversight is intended to cover at least payment and settlement systems, including central counterparties (CCPs) and securities settlement systems (SSSs).

2. **The oversight policy of the Federal Reserve is primarily addressed to systemically important payment and settlement systems.** These include the two systems (Fedwire Funds, the RTGS payment system and Fedwire Securities, which is the Securities Settlement System for government securities) operated by the central bank as well as private sector payment and settlement systems, provided they are organized and chartered as a bank or Edge corporation subject to the prudential supervisory authority of the Federal Reserve.<sup>5</sup>

3. **Systemically important payment and settlement systems falling under the oversight authority of the Federal Reserve should adhere to internationally agreed standards.** The Federal Reserve’s oversight policy states that systemically important payment and settlement systems subject to Federal Reserve authority should comply with the international standards as incorporated in the policy. Among other things, these systems should demonstrate their compliance by completing and disclosing self-assessments, which are reviewed by the Federal Reserve. Compliance with the international standards is also considered when conducting supervisory examinations of systems. Rather than a stand-alone function, oversight of payment and settlement systems is considered by the Federal Reserve as a process involving several functional areas coordinating to prevent systemic risk and

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<sup>4</sup> See the CPSS report on “Central Bank Oversight of payment and Settlement Systems” Bank for international Settlements, Basel, 2005.

<sup>5</sup> Bank charters subject to Federal Reserve supervision include Edge Act corporations and state member banks. In addition, the Federal Reserve exercises certain supervisory responsibilities under the Bank Services Company Act, covering certain bank outsourced services. The Federal Reserve has supervisory responsibilities for CLS Bank (foreign exchange settlement system), the Depository Trust Company (a central securities depository), ICE Trust U.S. (a CCP for OTC credit derivatives), Warehouse Trust (a trade repository for OTC credit derivatives), and CHIPS (a large value funds transfer system, supervised a third party service provider, see paragraph 29). The Federal Reserve also has some limited supervisory authority to examine affiliates of the Depository Trust Company, namely the National Securities Clearing Corporation (a CCP for equities and corporate securities) and the Fixed Income Clearing Corporation (a CCP for U.S. government securities); both of those CCPs are subject to regulation by the SEC.



ensure the adequacy of the risk management framework of systemically important payment and settlement systems, and which requires close cooperation with external domestic and foreign authorities.

## **II. FEDERAL RESERVE'S ADHERENCE TO THE RESPONSIBILITIES OF THE CENTRAL BANK IN APPLYING THE CPSS CORE PRINCIPLES AND THE CPSS GENERAL OVERSIGHT PRINCIPLES**

### **A. Responsibility A and General Oversight Principles A and B: Transparency and Disclosure of Central Bank Objectives, Policies and Roles with Respect to Oversight of Systemically Important Systems**

4. **The objectives and policies of the Federal Reserve regarding payment and settlement systems are disclosed transparently, through the Federal Reserve Policy on Payment System Risk (“PSR policy”).** The PSR policy is comprised of two parts. The first one on “risk management in payments and settlement systems” sets the scope of the Fed’s policy towards payment and settlement systems, the general policy expectations and the standards used by the central bank. The second part is dedicated to the Federal Reserve daylight credit policies.

5. **The high level objectives of the Federal Reserve are to foster the safety and efficiency of payment and settlement systems.** This PSR policy sets out the related principles and minimum standards, regarding the management of risks in payment and settlement systems, including those operated by the Reserve Banks. The Federal Reserve Board encourages payment and settlement systems, and their primary regulators, to take the principles and minimum standards into consideration in the design, operation, monitoring, and assessing of these systems.

6. **The PSR Policy is amended from time to time, using a formal consultation process.** The Board publishes a request for comments on all proposed policy changes in the *Federal Register* (the official journal of the U.S. Federal Government). Comments received are made available publicly on the Federal Reserve Board’s website and the final action to adopt any policy changes includes comprehensive explanations about how the comments received during the public consultation have been considered.

7. **The PSR policy clearly defines the criteria used to determine which systems the policies of the Federal Reserve are applied to.** These criteria encompass quantitative and qualitative elements. The Fed’s policy applies to public and private sector payment and settlement systems that expect to settle a daily aggregate gross value exceeding US\$5 billion during the next 12 months. These systems may be organized, located, or operated within the United States (domestic systems), outside the United States (offshore systems), or both (cross-border systems) and may involve other currencies in addition to U.S. dollar (multi-

currency systems). The policy also applies to any system based or operated in the United States that engages in the settlement of foreign currencies transactions if that system would be otherwise subject to the policy. The policy defines a system as a multilateral arrangement and does not apply to bilateral relationships between financial institutions and their customers, such as traditional correspondent banking and government securities clearing services. Accordingly, the two clearing banks are not currently overseen as systems although their role in the clearing and settlement of securities transactions and tri-party repos is of a systemic importance and may be compared to an infrastructure.<sup>6</sup>

8. **The threshold of a daily turnover of US\$5 billion is a necessary but not a sufficient condition for a system to be defined by the Federal Reserve as being of a systemic importance and accordingly to fall within its PSR policy.** Systems that are subject to the Federal Reserve Board’s authority may be considered systemically important upon consideration of additional qualitative factors stated in the policy, including whether:

- the system has the potential to create significant liquidity disruptions or dislocations should it fail to perform or settle as expected;
- the system has the potential to create large credit or liquidity exposures relative to participants’ financial capacity;
- the system settles a high proportion of large-value or interbank transactions;
- the system settles transactions for important financial markets;
- the system provides settlement for other systems; and
- the system is the only system for settlement of a given financial instrument.

Systems above the US\$5 billion threshold that are not considered systemically important are monitored and the system’s potential systemic importance is periodically reassessed.

9. **The Federal Reserve uses the international standards for the oversight of payment and settlement systems.** The Board encourages and expects payment and settlement systems within the scope of its policy to implement a risk management framework appropriate for the risks the system poses to the system operator, system participants, and other relevant parties as well as the financial system more broadly. In addition to establishing a risk management framework, the Board expects systemically important systems subject to its authority to meet as “policy expectations” the Core Principles for Systemically Important Payment Systems, the Recommendations for Securities Settlement Systems and the Recommendations for Central Counterparties, as applicable. The three sets of international standards are explicitly adopted by and quoted in the PSR policy statement.

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<sup>6</sup> The clearing banks are subject to prudential supervision by the relevant banking regulators.

10. **The international standards are supplemented in the area of operational risk management by the interagency paper on sound practices to strengthen the operational resilience of the U.S. financial system.** This paper was issued in 2003 by the Federal Reserve, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission in the post 9/11 context and focuses on restoration of settlement activities after a wide-scale disruption. The sound practices focus on the appropriate back-up for recovery and resumption of clearance and settlement activities in wholesale financial markets.

**B. Responsibility B and General Oversight Principle D: Consistent Implementation of Oversight Standards to Systems Operated by the Central Bank**

11. **The Federal Reserve Act (FRA)<sup>7</sup> provides the authority for the Federal Reserve Board (Board) to exercise general supervision over the Federal Reserve Banks, including their provision of payment and settlement services.** It also requires the Board to order at least once a year an examination of each Reserve Bank and to order an annual independent audit of the financial statements of each Reserve Bank.

12. **Under the authority provided by the FRA, the Board oversees and examines the Reserve Banks' provision of payment and settlement services, and, for those services of systemic importance, their compliance with the principles and minimum standards incorporated in the PSR Policy.** The Board publishes an assessment against the relevant international standards for the Fedwire Funds and Securities Services on the same frequency (every two years as a minimum) as that expected of self assessments by private-sector systemically-important systems.

13. **The Board is thus responsible for the oversight of Federal Reserve payment and settlement services, while the Reserve Banks are responsible for the provision of these services.** This legal separation of oversight and provision of services facilitates the Board's oversight of the Reserve Bank's payment and settlement services by ensuring that oversight is autonomous from the governance, management and operational arrangements of the systems.

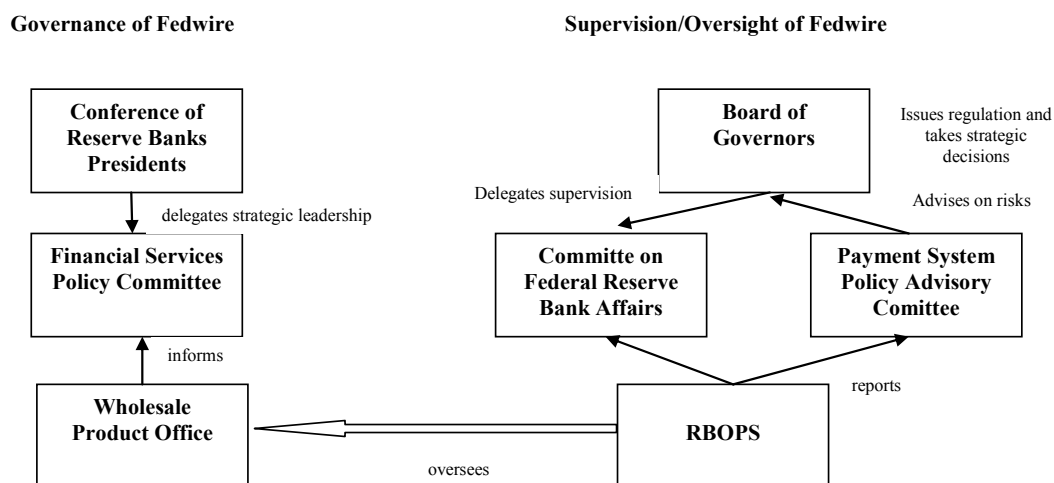
14. **To complement its oversight and policy responsibilities on payment system issues, the Board has established two internal committees.** The Committee on Federal Reserve Bank Affairs (BAC) is in charge of the general supervision over Reserve Bank

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<sup>7</sup> The Board's oversight authority over the Reserve Banks is set forth in several provisions of the Federal Reserve Act, including Section 11(a), which provides the Board authority to examine the Reserve Banks and obtain Reserve Bank records and information; Section 11(j), which provides the Board's authority to exercise general supervision of the Reserve Banks; Section 11B, which requires the Board to order an annual independent audit of the financial statements of each Reserve Bank; and Section 21(7), which requires the Board to order an examination of each Reserve Bank at least annually.

operations, including budgets, the pricing of payments services and strategic plans. The Payments System Policy Advisory Committee advises the Board on issues related to risk management and the relationships between wholesale payment systems and financial markets. The oversight responsibilities of the Board over certain payment and settlement systems, including the operation of Fedwire Funds and Securities, are carried out by the Division of Reserve Bank Operations and Payment Systems (RBOPS). Figure 1 below illustrates these organizational relationships.

Figure 1: Governance and Oversight Framework for Fedwire Funds and Securities



15. **The RBOPS division carries out its oversight tasks for Fedwire Funds and Securities in various ways.** Typical oversight activities include the conduct of on-site and off-site reviews of Reserve Banks, oversight of major projects and initiatives, assessments of Reserve Banks' annual budgets and performance, and assessments of Fedwire against relevant international standards. In carrying out these activities, RBOPS assesses the extent to which the services are provided in a secure, resilient, and well controlled manner and the extent to which the services comply with relevant policies and standards. Additionally, a significant oversight responsibility is to monitor the Reserve Banks' expenses and revenues, as well as to review compliance with the Board's pricing policy and the Monetary Control Act (MCA) of 1980. The MCA requires that fees for Reserve Bank payment services to depository institutions, over the long run, recover actual and imputed costs incurred to provide the services. The Board also conducts a competitive impact analysis when the Reserve Banks are considering operational changes to their priced services, to determine any potential adverse effect on the ability of other service providers to compete effectively with the Reserve Banks in providing similar services.

### C. Responsibility C and General Oversight Principle C: Ability to Carry Out Oversight of Private-Sector Systemically Important Systems

#### Legal powers

16. **Under the current U.S. legal framework, there is no single statutory provision granting a general oversight authority to the Federal Reserve or any other regulator over the full range of systemically important payment, clearing and settlement infrastructures in the United States.** Whereas the oversight authority of the Board on Fedwire Funds and Securities derives from the provisions of the Federal Reserve Act regarding the supervision of Reserve Banks operations, the current basis for the Federal Reserve's oversight of private sector systems derives from a range of statutory responsibilities for banking supervision and the provision of payment and settlement services. The Federal Reserve's oversight with respect to private sector systems, therefore, depends on whether or not the system is organized and chartered as a bank or Edge corporation subject to the prudential supervisory authority of the Federal Reserve. The basis of regulation and supervision by the Securities and Exchange Commission and the Commodity Futures Trading Commission, however, is determined by whether a system clears or settles securities or futures products. Some clearing and settlement systems are dually regulated depending on their charters and the markets they clear for.

17. **Currently, the Federal Reserve supervises several payment, clearing, and settlement systems that are organized as banks, including Continuous Linked Settlement (CLS) Bank, Depository Trust Company (DTC), ICE Trust (a CCP for credit derivatives), and Warehouse Trust (a trade repository for credit derivatives).** Federal Reserve supervision in these cases is due to the legal status of these entities rather than the activities they are engaged in. However, regulation and supervision of securities and futures clearance and settlement systems in the U.S. is based on activity (*i.e.*, securities clearing agencies are regulated by the SEC and futures clearing houses are regulated by the CFTC). CLS Bank is an Edge corporation headquartered in New York, and DTC, ICE Trust, and Warehouse Trust are limited purpose trust companies, chartered in New York and member banks of the Federal Reserve System. DTC as a securities settlement system is a clearing agency registered with and regulated by the SEC in conjunction with the Federal Reserve.

18. **Clearing House Interbank Payment System (CHIPS), operated by The Clearing House (TCH), is not chartered as a bank, but is supervised by the Federal Reserve and other banking supervisors as a third-party service provider.** The federal banking supervisors have authority under the Bank Services Company Act to examine service providers to which banks have outsourced key services to the same extent as if the services were being performed by the bank itself on its own premises. This gives grounds for the bank supervisors of CHIPS' participants to examine CHIPS operations and the manner in which the clearing and settlement services that banks have outsourced to CHIPS are conducted. The

agencies contributing to the examination of CHIPS are the relevant banking supervisors for the various CHIPS participants, i.e., the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the New York State Banking Department, and the Federal Reserve.

19. **The Federal Reserve has only a limited examination authority over the two CCP affiliates of DTC**, the National Securities Clearing Corporation (NSCC) and the Fixed Income Clearing Corporation (FICC)<sup>8</sup>, and no authority over the CCPs for exchange-traded derivatives such as the Chicago Mercantile Exchange Clearing House and The Options Clearing Corporation (OCC). Those CCPs are subject to regulation by the SEC and CFTC. NSCC, FICC, and OCC clear and settle securities transactions and, accordingly, are registered with the SEC as clearing agencies under the Exchange Act and are supervised and regulated by the SEC; CCPs for exchange traded futures and options on futures are supervised and regulated by the Commodity Futures Trading Commission (CFTC). The OCC also clears a small volume of transactions in futures and options on futures and, accordingly, is also registered with the CFTC as a derivatives clearing organization.

20. **Despite the functional similarities of these systems, no single authority oversees all critical systems from a systemic risk perspective.** The supervision and oversight of payment, clearing and settlement systems is spread across several regulators depending on the system's charter or the markets it clears for. As part of the financial regulatory reform, it is desirable to clearly entrust the Federal Reserve with an oversight authority for all systemically important payment, clearing and settlement systems, irrespective of their legal status. In cooperation with other agencies and complementary to existing supervisory and regulatory provisions, this would allow the Federal Reserve to address systemic risk consistently and to strengthen its authority to induce change where necessary. More details are provided in Chapter III.

### **Methodology and resources**

21. **The Federal Reserve conducts its oversight of private sector systems by mobilizing and coordinating among its various relevant competencies and functions within the Federal Reserve System.** This approach involves coordination and cooperation among the banking supervision function and payment policy function of the Federal Reserve Bank of New York, and the banking supervision function and payments oversight function of the Board of Governors. While this cooperative framework is not formalized, it operates effectively.

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<sup>8</sup> FICC is the CCP for trades in government securities (and provides clearing services for mortgage-backed securities). NSCC is the CCP for trades in equities, corporate and municipal bonds, exchange-traded and unit investment funds. See for more details the assessment of DTC against CPSS/ISOCO Recommendations for SSS and the assessments of FICC and NSCC against the CPSS/IOSCO Recommendations for CCPs.

22. **In line with their respective charters, the Federal Reserve’s day-to-day supervision over CLS Bank, ICE Trust, Warehouse Trust and DTC is conducted by the banking supervisory department of the Federal Reserve Bank of New York.** The unit in charge of “large complex banking organizations” covers these four entities and one of the two major clearing banks. This organizational approach takes into account the highly specialized activities and risk profiles of the entities involved in clearing and settlement. Based upon an assessment of the ranking of the different risks relevant for each of the systems, a yearly supervisory program is defined, encompassing a comprehensive review of the activities, a range of more focused discrete examinations, and an assessment of new products developments. This program is formally submitted for approval each year to a senior Federal Reserve committee that reviews the program and discusses required supervisory resources. The on-site and off-site examinations are performed by joint teams, gathering resources from the different supervisory and oversight functions of the Federal Reserve Bank of New York and of the Board of Governors. The examinations are based upon the standards in the Federal Reserve oversight policy and applicable supervisory standards, such as the Federal Reserve Commercial Bank Examination Manual and Federal Financial Institutions Examination Council (FFIEC) standards and methodologies. The overall assessment of the system leads to define a comprehensive rating of the risk management of the operator. Once achieved, the assessment is shared with the management and the board of directors for the system, through a formal process. In case of gaps, an action plan including a timetable for its implementation is required from the system. The implementation of the corrective measures is subject to a follow-up. Continuous monitoring of the systems involves, among other things, regular meetings with managers of the different functions of the systems’ operator. In the case of DTC, Federal Reserve supervisors also work closely with the SEC under the framework set forth in the Securities Exchange Act of 1934.

#### **Analysis of Fed’s oversight approach and authority**

23. **The strong linkage between the Fed’s oversight of payment and settlement systems and its bank supervision powers is a source of strength.** The Fed’s statutory powers and tools to obtain sufficient information and induce change are very strongly-founded and effective on those systems chartered as a state member bank or Edge corporation, namely CLS Bank, ICE Trust, Warehouse Trust and DTC. The conduct of the Fed’s oversight of these systems is informed by the possibility for Federal Reserve payment system overseers to take part in on-site examinations conducted by Federal Reserve banking supervisors, which is not a widespread oversight practice among central banks. Both the Fed’s supervisory and oversight assessments of these systems also benefit from the various perspectives and expertise of the different functions within the Federal Reserve System.

24. **The supervisory resources allocated to carry out oversight of the private sector payment systems falling within the authority of the Federal Reserve System appear sufficient and adequate.** Full time supervisory staff is dedicated to each Federal Reserve

supervised system. Supervisory staff can also, when needed, draw on additional and more specialized expertise (technology, legal, modeling, risk experts, etc.).

25. **The Federal Reserve’s present approach to payment system oversight also has the benefit of facilitating close cooperation between payments systems oversight and banking supervision.** This reflects the important responsibility that the Federal Reserve Board has as a banking supervisor.

26. **An important drawback is the limited authority of the Federal Reserve over nonbank, systemically important payment and settlement systems.** The oversight ability of the Federal Reserve is strongest for systems chartered as banks and falling under its direct banking supervisory authority. For systems without bank charters, the Federal Reserve’s oversight authority is limited. This limitation does not seem consistent with (i) the tight interdependencies between payment and settlement systems, (ii) the strong rationale for the central bank to have a comprehensive and holistic view on all potential sources of systemic risk at stake in the settlement infrastructure, as well as (iii) the need for the Federal Reserve to have the same authority to enforce its oversight policy and induce change where necessary, irrespective of the way the system is chartered. CHIPS, which is not chartered as bank, is one example of a system over which the Federal Reserve has somewhat more limited oversight authority. The CHIPS system is supervised by the federal banking supervisors, including the Federal Reserve, as a “third party service provider,” under the Bank Services Company Act (see paragraph 18). The December 2007 self-assessment of CHIPS against CPSIPS suggests that TCH has voluntarily agreed to some form of supervision.<sup>9</sup> Both the limitations of the Bank Services Company Act and CHIPS “voluntary” view could complicate or even limit the enforcement of recommendations resulting from the oversight findings of the Federal Reserve over CHIPS.

27. **The extent to which the bank supervisory methodology for examining payment and settlement systems fully addresses issues covered by the international oversight standards is unclear.** Although the Federal Reserve’s PSR policy explicitly states that it will be guided by the international standards when exercising its supervisory authority, there is no procedure or manual that provides explicit mapping between examination procedures and the PSR policy standards.

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<sup>9</sup> The assessment states that “PaymentsCo has agreed to be subject to the Comptroller’s supervision and examination. PaymentsCo also invites the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Office of Thrift Supervision, and the New York State Banking Department to conduct examinations of its information-technology operations.” OCC and Federal Reserve staff believes the statutory authority to conduct CHIPS exams is sound. Authority to enforce supervisory findings directly against the service provider (CHIPS), however, is lacking (nonetheless, the agencies have direct enforcement authority over CHIPS participants, and could limit their use of the service provider if the provider rejects supervisory findings).



28. **There is scope for enhancing the disclosure of the Federal Reserve’s assessments of the payments system.** Pursuant to the PSR policy, systemically important payment and settlement systems are expected to complete, disclose publicly the results and update at a minimum every two years a self-assessment against the applicable set of international standards (the CPSIPS for payment systems). This policy helps ensure appropriate risk management principles and facilitates access by interested stakeholders to information based upon standardized international standard. Pursuant to the PSR policy, this self-assessment framework does not preclude the Federal Reserve to independently assess compliance of systemically important systems under its jurisdiction. The Board discloses its assessment of the compliance of Fedwire Funds and Securities but does not disclose its assessments of other systems. This reflects the constraints of Board regulations regarding the confidentiality of bank supervisory information, which prevent public disclosure of supervisory information including assessments based on such information. The various stakeholders (including systems’ participants) have therefore no means to check to which extent the self-assessments disclosed by the systems reflect and comply with the Board’s own assessments. Therefore, consideration could be given to steps to ensure that potential gaps, if any, in these assessments are closed in a transparent manner.

**D. Responsibility D and General Oversight Principle E: Cooperation with Other Central Banks and with Other Relevant Domestic and Foreign Authorities**

29. **The criticality of cooperation both domestically and internationally in the oversight process of Federal Reserve is acknowledged by the PSR policy.** The PSR Policy states that “where the Board does not have direct or exclusive supervisory or regulatory authority over systems covered by this policy, it will work with other domestic and foreign financial system authorities to promote effective risk management in payments and securities settlement systems. The Board encourages other relevant authorities to consider the principles embodied in this policy when evaluating the payments and securities settlement risks posed by and to the systems and individual system participants that they oversee, supervise, or regulate.”

30. **The Federal Reserve’s oversight process involves close cooperation among various functions within the Federal Reserve as well as with other domestic regulators.** As illustrated in Figure 2, payment system experts, bank supervisors, market experts, and monetary staff as well as economic researchers contribute to the policymaking and to the implementation of the oversight of payment and settlement systems. This brings appropriate skills to bear in assessing the various sources of risks and inefficiencies in the clearing and settlement process, and also ensures that different supervisory perspectives are taken into account. Indeed, in its oversight of payment and settlement systems, the Federal Reserve cooperates closely with other banking supervisors (for TCH/CHIPS the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the New York State Banking Department), and also with market regulators,

the SEC and the CFTC.<sup>10</sup> Furthermore, the established framework for the regulation of securities clearance and settlement systems in the Securities Exchange Act of 1934 gives joint authority to the SEC and the Federal Reserve with respect to certain SEC registered clearing agencies that are organized as banks, such as DTC.

31. **The Federal Reserve also cooperates internationally.** In working with foreign financial system authorities, the Board is guided by the international principles for cooperative oversight, namely the central bank Responsibilities in applying the CPSIPS, the Recommendation 18 of the Recommendations for Securities Settlement Systems, and the “Principles for Cooperative Central Bank Oversight of Cross-border and Multi-currency Netting and Settlement Schemes” and related documents.<sup>11</sup>

32. **The Federal Reserve leads a cooperative oversight arrangement for CLS Bank, composed of the G-10 and other central banks of issue for the currencies eligible for settlement in CLS.** The Protocol adopted in 2008 for the Cooperative Oversight Arrangement of CLS provides an arrangement for the central banks of issue of currencies eligible for settlement in the CLS system to fulfill their oversight responsibilities, including exchange of information.

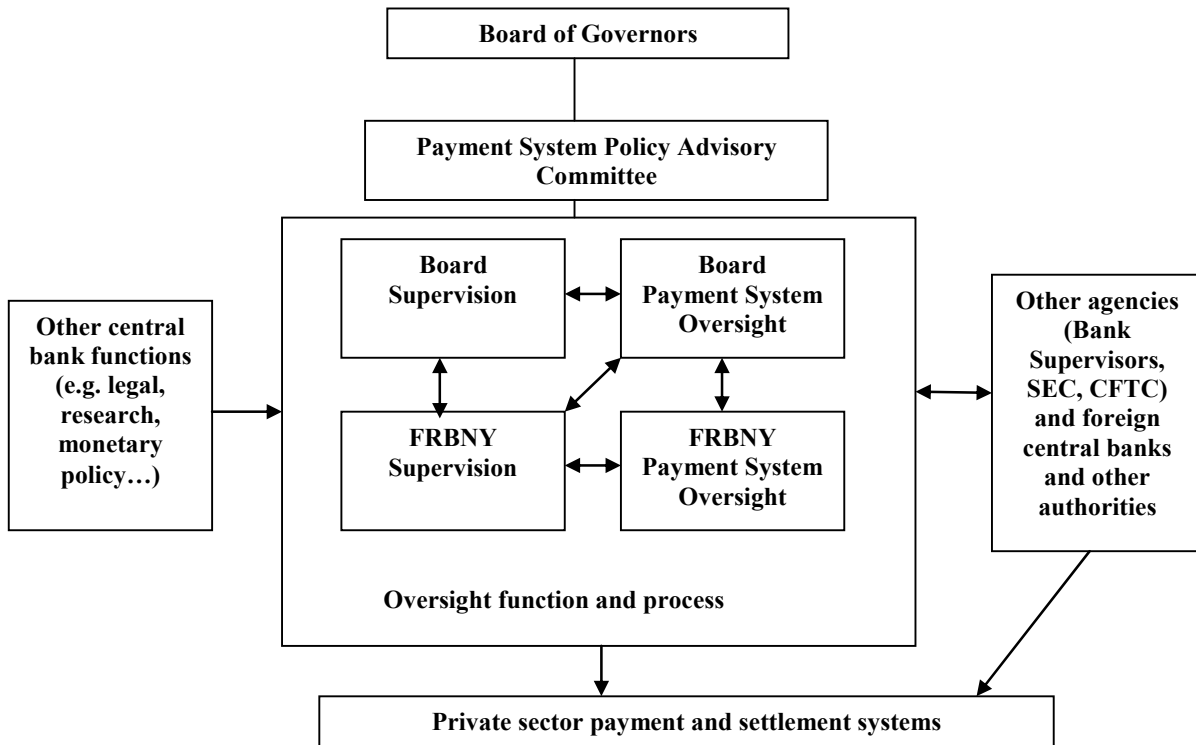
33. **The Federal Reserve is currently working with relevant foreign and other domestic authorities to develop a formal cooperative oversight arrangement for the DTCC Warehouse Trust, the trade repository for credit derivatives.** It also continues to facilitate a number of cooperative regulatory forums on over-the-counter (OTC) derivatives clearing and participates in a cooperative oversight arrangement, led by the National Bank of Belgium, for SWIFT.

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<sup>10</sup> For more details on the arrangements for securities clearing and settlement systems as well as an assessment of their effectiveness, see IMF assessments of DTC and Fedwire Securities against CPSS/IOSCO Recommendations for SSSs and IMF assessments of NSCC and FICC against the CPSS/IOSCO Recommendations for CCPs.

<sup>11</sup> Usually referred to as “Lamfalussy principles for international cooperative oversight,” these principles which guide cooperative oversight between central banks were set out in the 1990 “*Report of the Committee on Interbank Netting Schemes of the central banks of the Group of Ten countries*” and updated in the 2005 CPSS report on “*Central Bank Oversight of Payment and Settlement Systems*.” They recommend: (i) informing other central banks that may have an interest in the prudent design and management of the cross-border and multi-currency system; (ii) assigning the primary oversight responsibility to a central bank (iii) periodically assessing the design and operation of the system as a whole to be performed by the central bank with the primary responsibility in consultation with the other central banks, (iv) leaving the determination of the adequacy of a system’s settlement and failure-to-settle procedures in a currency as a joint responsibility of the central bank of issue and the authority with primary responsibility for oversight of the system and (v) leaving scope for a central bank to discourage the use of an unsound system.

Figure 2. Overview of Internal Federal Reserve Functional Relationships and External Cooperation for Oversight of Private Sector Systems



### III. LEGISLATIVE REFORM PROPOSALS CONCERNING OVERSIGHT OF SYSTEMICALLY IMPORTANT PAYMENT, CLEARING AND SETTLEMENT SYSTEMS

34. **Recent legislative proposals concerning oversight of systemically important payment, clearing, and settlement systems and activities would help improve the United States' ability to assess systemic risk arising from market infrastructures.** The Administration's 2009 legislative proposals recommend providing the Federal Reserve with the authority, in consultation with the Financial Services Oversight Council, which would be comprised of other relevant U.S. financial regulators, to designate payment, clearing and settlement systems as systemically important, to prescribe risk management standards, and to oversee such systems from a systemic risk perspective in conjunction with the systems' primary supervisor. Such authority should help to improve the United States' ability to assess systemic risk, ensure consistent application of international risk management standards across systems, and coordinate policy actions among relevant and interest regulators. This enhanced authority would be in addition to existing supervisory and regulatory authority of other agencies. Its implementation would therefore further facilitate the cooperation already in place with other relevant agencies (e.g., SEC and CFTC).

35. **A strengthened legal authority would help the Federal Reserve better monitor, mitigate and respond to systemic risk arising from payment, clearing, and settlement systems and activities.** More specifically, it should enable (i) strengthened oversight of CHIPS by providing a federal agency with a direct authority over the system; (ii) more consistent oversight, from a systemic risk perspective, of both bank-chartered and nonbank payment, clearing, and settlement systems; and (iii) a better alignment of the United States' oversight framework for all payment, clearing, and settlement systems of a systemic importance, including strengthened coordination among relevant supervisors. These proposals would also give the Federal Reserve an enhanced role in the oversight of systemically important payment, clearing, and settlement activities, including the payments role of the two, systemically important clearing banks. Box 1 below provides a summary of the Administration's proposal, as available at the time of the mission.

### **Box 1. Overview of the Administration's Proposal (Title VIII) on Payment, Clearing and Settlement Supervision**

In order to mitigate systemic risk in the financial system and promote financial stability, the Administration's proposal would provide the Board of Governors of the Federal Reserve System (Board) with an enhanced role in supervising risk management of systemically important financial market utilities and of systemically important payment, clearing, and settlement activities conducted by financial institutions.

The Board would be authorized to designate a financial market utility or a payment, clearing, or settlement activity as systemically important, and established procedures and criteria for making and withdrawing such a designation. Criteria for designation and rescission of designation include the aggregate monetary value of transactions processed and the effect that a failure of a financial market utility or payment, clearing, or settlement activity would have on the financial system. The Board would have to consult with the Financial Services Oversight Council and the relevant supervisory agency before making a designation.

In consultation with the Financial Services Oversight Council, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, the Board would be able to set risk management standards for the designated financial market utilities and for the designated payment, clearing, and settlement activities of financial institutions.

The law would not modify the primary responsibility currently entrusted to the different regulatory and supervisory agencies of the respective payment, clearing and settlement systems. However, the Board would be allowed to participate in examinations made by other agencies and would be the supervisory agency for designated financial market utilities that do not otherwise fall within the authority of an agency. The Board would also be granted back-up authority to conduct examinations and to take enforcement actions against a designated financial market utility if there were an imminent risk of substantial harm to the financial system.

The Board would be entitled to collect information from financial market utilities and financial institutions engaged in designated payment, clearing, or settlement activities in order to assess systemic importance. Sharing of relevant information and coordination among financial regulators would also be facilitated.

Federal Reserve Banks would also be entitled to open an account, provide access to the discount window credit and pay interest on balances maintained for a designated financial market utility. The extension of central bank credit facilities to financial market utilities would provide for an additional liquidity buffer in case of abnormal market conditions and link this possibility to their adequate oversight and strict observance of risk management standards.

[Summarized on the basis of the Administration's proposed legislation dated 22 July 2009. Subsequent legislative proposals have revised certain aspects of Title VIII.]