



July 27, 2004

Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Attention: Jennifer J. Johnson, Esq.
Secretary

Re: Docket No. OP-1191 – Policy on
Payment-System Risk

Governors:

The Clearing House Association L.L.C. ("The Clearing House")¹ is pleased to comment on the proposed changes to Part II of the Board's Policy Statement on Payment System Risk.² The proposed changes would:

1. Clarify the scope of the Policy Statement making it clear that it covers payment systems operated by the Federal Reserve Banks.
2. Clarifies the risk-management expectations for all systems.

¹ Formerly named The New York Clearing House Association L.L.C. The Clearing House is affiliated with The Clearing House Payments Company L.L.C., which operates the Clearing House Interbank Payments System ("CHIPS," a funds-transfer system), Electronic Payments Network ("EPN," an automated clearing house), electronic-check presentments, and physical-check exchanges.

3. Updates the section dealing with systemically important payment systems by incorporating the Core Principles for Systemically Important Payment Systems ("Core Principles"), which replace the Lamfalussy Minimum Standards that have been an essential part of the Policy Statement for 10 years.
4. Revises the section on systemically important settlement systems by adopting the Recommendations for Securities Settlement Systems ("Recommendations").

The Clearing House applauds the Board's efforts to keep its Policy Statement up-to-date and consistent with international norms. These efforts, if followed consistently by regulators and central banks around the world, will ensure that payment systems, especially systemically important systems, the world over are held to the same standards and that those standards reflect the best current thinking on safety and soundness for payment and securities settlement systems.

We also support the Board's decision, consistent with Core Principles, to subject the Reserve Banks' payment systems to the same standards as their private-sector competitors. Although we recognize that Fedwire and the Reserve Banks' other payment systems have achieved high levels of safety, soundness, and resilience that have met or exceeded international norms, the Board's decision to explicitly subject them to its policy is an appropriate step and demonstrates the Federal Reserve's commitment to a level playing field for public and private-sector systems.

² 69 Fed. Reg. 22,512 (Apr 26, 2004).

Our comments on the particular issues raised by the Board follows:

1. *Do the benefits of a bright line quantitative threshold based on a system's daily gross settlement value outweigh the costs of using more complex factors to determine whether a system is covered by the policy? Should more qualitative or judgmental criteria be used instead? If a quantitative threshold is appropriate, does a threshold of \$5 billion a day continue to be reasonable? Should other quantitative criteria be considered?*

The Clearing House and its member banks believe that the quantitative criteria proposed are appropriate. The use of quantitative criteria will ensure that each system knows whether it is covered by the Policy Statement. If qualitative standards were to be used, there would be the risk that different examiners and regulators could interpret the standards differently and apply them inconsistently across networks. We believe that if the threshold is set at an appropriate level, a quantitative measure will capture all the systems that need to be captured, and that this approach will result in a level playing field among systems. In this regard, we believe that the \$5 billion per day remains a reasonable threshold. The Board may, however, wish to reassess the threshold periodically and every five years or so request public comment on whether the threshold should be raised in light of inflation over the intervening period.

2. *Is the definition of what constitutes a system, and explicit exemptions from this definition, reasonable and appropriate?*

The Clearing House agrees that the definition of what makes a system is reasonable and appropriate. The exclusions (bilateral relationship such as traditional correspondent banking

and traditional government-securities clearing services) are also appropriate. We believe that the exclusion for clearance or settlement systems for exchange-traded futures and options are also appropriate, more for the fact that these systems use central counterparties, making them more like bilateral arrangements that are excluded from the policy, rather than differences in regulatory oversight. To the extent that these systems are similar to the payment and securities-settlement system covered by the Board's policy, we would encourage the Board to work with the CFTC and the SEC to bring them under similar safety and soundness standards.

3. *Do the general policy expectations of a sound risk-management framework, laid out in part B of the revised policy, give more structure and specific guidance to system operators and participants than the current policy's primary focus on types of risks and the general need to manage these risks?*

The Clearing House believes that the risk-management framework set out in Part B is clear and appropriate. It is a distinct improvement over the current, more general standards.

With respect to the general policy expectations, The Clearing House believes that it would be helpful for the Board to include in the discussion of the risk-identification and risk-management criteria some consideration of the risks that institutions can present to systems by not managing their customers' direct access to payments system. Payments systems depend on their participants to manage their activity to ensure that they can meet the obligations they incur on the system. In some instances, however, financial institutions have entered into arrangements with customers or third-party service providers that allow the customers or service providers to send transactions

directly to a payment system with the financial institution exercising little or no oversight over what is being sent in its name. At the end of the day, of course, it is the financial institution that is responsible for these payments; institutions run significant individual risks and also can present significant risks to the other participants and their customers if they do not exercise an appropriate level of oversight over these arrangements.

We believe that the Board's policy should require systems (including Reserve Bank systems) (i) to have in place requirements that an appropriate authority (board or senior management) approve any direct-access arrangement, and (ii) that each system provide tools for institutions to manage the risks that arise from allowing customers or service providers to send payments directly to the system. These controls should include at a minimum gross debit limits. We strongly believe that the Board should consider making use of these tools mandatory.

4. *In applying the Core Principles and the Recommendations, do the six criteria presented in the proposed policy appear reasonable for determining if a system is systemically important? Are there other factors that the Board should consider when determining whether a system is systemically important?*

The Clearing House believes that the six criteria that the Board proposes to determine if a system is systemically important are for the most part appropriate. The Board may wish to add a seventh criteria: whether a failure of the system would cause significant or extended loss of investor or consumer confidence.

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We hope these comments are helpful. If you have any questions, please call Joseph R. Alexander, Senior Counsel, at (212) 612-9334.

Very truly yours,

A handwritten signature in cursive script, appearing to read "J. Alexander". The signature is written in dark ink and is positioned below the typed name "Joseph R. Alexander".