

authority available during these off-hours. Finally, if service providers provided the monitoring capabilities, originating depository institutions or correspondent institutions that permit customers or respondents to transmit ACH credit transactions directly to a Reserve Bank may not be able to rely on the service provider to provide effective controls over such transactions.

C. Other Controls

To ensure the integrity of ACH third-party and respondent access arrangements, the following provisions, which are generally consistent with those required in the Fedwire third-party access policy, would apply.

- An institution's board of directors would be required to approve the role and responsibilities of a service provider(s) that is not affiliated with the institution through at least 80 percent common ownership.
- A depository institution that uses an ACH third-party access arrangement would be required to have its auditors confirm compliance with the controls described in the policy at least annually.
- The service provider must be subject to examination by the appropriate federal depository institution regulatory agency(ies).
- The conditions under which these arrangements could be established would be set forth in the appendices of the Reserve Banks' uniform ACH operating circular. The uniform operating circular would serve as the legal agreement governing the arrangement between the institution and the service provider and/or correspondent and would govern arrangements of which the Reserve Banks otherwise may not be aware. The ACH Participation Agreement, which is used to document the various agreements between the Federal Reserve Banks and users of their ACH services, such as settlement arrangements and electronic connections, would serve to identify the institution and the service provider(s) or correspondent(s) in the third-party arrangement(s).

IV. Competitive Impact Analysis

In considering a change that has a substantial effect on payment system participants, the Board assesses whether the proposed change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve Banks in providing similar services and if such effects are due to legal differences or due to a dominant market position deriving from such legal differences.

The Federal Reserve Banks compete in providing ACH services to depository institutions with private-sector ACH operators. The intent of the proposed third-party access policy is to ensure the integrity of the ACH system. The proposed policy would apply equally to institutions using Federal Reserve Bank ACH services and to institutions that use the services of private ACH operators that transmit ACH transactions to the Federal Reserve Banks on their behalf. Therefore, the Board believes that although the proposal would impose requirements on private ACH operators, those requirements would not be any greater than the additional requirements the Federal Reserve would be placing on itself.

V. Request for Comments

The Board requests comments on all aspects of this proposal. The Board specifically requests comments on the following questions:

A. Current Arrangements and Controls

1. Under what types of arrangements do third parties initiate or transmit ACH credit transactions to the Federal Reserve Banks or private-sector ACH operators on behalf of depository institutions?
2. What are the unique risk characteristics of third-party processing arrangements and correspondent settlement arrangements that concern the institutions, service providers, and private ACH operators participating in such arrangements? Are the risks in these arrangements expected to increase in the future?
3. What controls are currently in place that permit institutions to control their risk in ACH third-party processing arrangements and correspondent settlement arrangements? Are these controls consistent with the type of controls required in the payment system risk policy?

B. Risk Monitoring Alternatives

4. How would the requirement to make personnel available after normal business hours affect institutions' ACH operating risk and costs? How would it affect the quality of the ACH service? Are there other operational issues or customer service issues associated with either risk control alternative?
5. Would monitoring capabilities provided by the Reserve Banks and private ACH operators or by the service providers be most effective in achieving the objectives of controlling risk in the ACH? Should the Board consider permitting depository institutions to

select between the two alternatives or should only one approach be adopted?

6. If only service providers were to provide monitoring capabilities, how would the activity of originating institutions' customers and respondent institutions that transmit ACH credit transactions directly to a Federal Reserve Bank or a private ACH operator be monitored?

7. What costs would be incurred by (a) private ACH operators to expand or develop their monitoring systems to permit their users to monitor ACH credit transactions at the customer level and (b) third-party service providers to develop such a monitoring mechanism?

8. How do the benefits derived from improving credit controls over access to the ACH service compare with the potential costs of implementing the proposal and the operational risk (i.e., possible untimely processing) that may be created by proposed controls?

9. Are there other monitoring alternatives that would be equally effective but pose fewer operational issues and be less costly?

10. Could depository institutions, private ACH operators, and service providers comply with the proposed policy if the final policy were effective 18 months after adoption by the Board? Could the parties comply within 12 months after adoption by the Board?

C. Proposed Policy Provisions

11. Do the provisions of the proposed policy address the credit risk concerns of institutions participating in ACH third-party processing arrangements? If not, explain your concerns and suggested alternative controls.

12. Could the risk monitoring controls effectively control credit risk if they were applied only to corporate customers or respondent institutions whose financial condition was considered weak? What issues might be raised if parties other than the responsible depository institution had information identifying financially weak customers or respondent institutions?

13. Should a depository institution be responsible for monitoring the financial stability of its service providers and adopting procedures necessary to ensure that the activities of the service provider were controlled appropriately?

By order of the Board of Governors of the Federal Reserve System, August 9, 1995.

William W. Wiles,
Secretary of the Board.

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FEDERAL RESERVE SYSTEM

[Docket No. R-0890]

Federal Reserve Payment System Risk Policy**AGENCY:** Board of Governors of the Federal Reserve System.**ACTION:** Policy statement.

SUMMARY: The Board has approved certain modifications to its Fedwire third-party access policy to clarify its applicability and to reduce the administrative burden of several provisions. Some depository institutions have entered into arrangements under which a third party provides operating facilities for their Fedwire services; under such arrangements, the third party's actions may result in a debit to the institution's reserve or clearing account at a Federal Reserve Bank. The policy provides important safeguards to both depository institutions participating in third-party access arrangements and to the Reserve Banks. Among other things, the policy requires depository institutions to impose prudent controls over Fedwire funds transfers and book-entry securities transfers initiated, received, or otherwise processed on their behalf by a third-party service provider. These policy modifications are interim modifications, pending the completion of a broader review of supervisory policies that should be applicable to outsourcing arrangements. The review may result in further modifications to the policy; however, the Board believes that any further modifications will be in the same general direction as those made today. The Federal Reserve Banks will not approve any new third-party access arrangements involving a foreign service provider, pending further analysis of issues associated with such arrangements.

EFFECTIVE DATE: August 10, 1995.**FOR FURTHER INFORMATION CONTACT:**

Gayle Brett, Manager (202/452-2934) or Lisa K. Hoskins, Project Leader (202/452-3437), Fedwire Payments, Division of Reserve Bank Operations and Payment Systems; for the hearing impaired *only*: Telecommunications Device for the Deaf, Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:**I. Background**

Fedwire is the large-value payment mechanism owned and operated by the Federal Reserve Banks. Fedwire provides depository institutions with real-time gross settlement in central bank money of funds transfers and

book-entry securities transfers made for their own account or on behalf of their customers. Typically, each depository institution that holds an account at the Federal Reserve processes its own transfers and accesses Fedwire directly. In some cases, however, a depository institution accesses Fedwire through a third-party access arrangement in which a service provider, acting as agent for a depository institution, initiates payments that are posted to the institution's account at the Federal Reserve. Third-party access arrangements are a form of outsourcing. Depository institutions use service providers to perform a number of functions, including customer accounting, check and automated clearing house (ACH) processing, and the processing and/or transmission of large-value funds and securities transfers. Depository institutions have increasingly viewed outsourcing arrangements as one way to reduce operating costs.

During the mid-1980s, the Board and Reserve Banks became concerned about the credit exposure faced by depository institutions that contracted with a third-party service provider to process Fedwire funds transfers on their behalf. Due to the concerns raised about the legal, supervisory, and payments system risk implications of such arrangements, a moratorium on approving additional arrangements was imposed in 1985 until these issues could be reviewed and guidelines established.

In July 1987, the Board approved a set of conditions under which Fedwire third-party access arrangements could be established, as part of its payment system risk reduction policy (52 FR 29255, August 6, 1987). Specifically, the Board adopted a policy placing certain conditions on the ability of a service provider to initiate Fedwire transfers from a participant's reserve or clearing account held at the Federal Reserve.¹ The Board's original policy addressed two types of arrangements. Where the service provider and the participant are not affiliated, the participant must authorize each individual transfer before it is sent to a Reserve Bank. Where the service provider and the participant are affiliated, the participant may establish limits within which the

service provider is authorized to act. For purposes of the policy, an affiliated service provider is defined as an organization that has at least 80 percent common ownership with the participant.

Since the third-party access policy went into effect, the Federal Reserve Banks have approved approximately 500 third-party service arrangements.² During this time a number of issues and requests for clarification have been raised with respect to the policy. These questions relate to: (1) the circumstances under which line-of-credit arrangements can be used; (2) the responsibility of a participant to monitor its reserve or clearing account in line-of-credit arrangements; (3) the need for a participant to have backup capabilities in the event the Federal Reserve Bank terminates the arrangement; and (4) the duties that may be assigned to personnel employed by the parties to the arrangement.

Issues also were raised about the scope of the policy. Questions of scope include: (1) whether the policy applies to arrangements for book-entry securities transfers as well as funds transfers; (2) whether the policy applies to arrangements in which a service provider serves as a communications link but does not process the transfers; (3) whether the policy applies when an institution contracts with a third party to process transfers that subsequently are routed through the participant to the Reserve Bank; and (4) whether the policy applies to arrangements in which the service provider is located outside the United States.

In considering modifications to the Fedwire third-party access policy, the Board has determined that it would be useful to undertake a broader review of supervisory policies that should be applicable to a larger range of outsourcing arrangements. The staff has begun to review broader issues relating to outsourcing generally, including, for example, the extent to which termination backup requirements should apply to other critical functions outsourced by banks and whether foreign service provider arrangements should be subject to special conditions. It is possible that the Board will modify further the Fedwire third-party access policy following completion of the

¹ The original issues surrounding third-party access arrangements arose in the context of funds transfer arrangements, and the language of the original policy reflected this orientation. Board staff subsequently interpreted the policy to include Fedwire book-entry securities transfer arrangements within its scope. Board staff also interpreted the policy to cover all situations where transfer instructions are not communicated directly to the Reserve Bank by the sending bank, but rather are transmitted indirectly through another entity.

² The number of current arrangements is less than the number approved because of mergers and changes in relationships between participants and service providers. Because some of the approved arrangements involved multiple participants using the same service provider, however, there may be more than 500 Fedwire participants currently using third-party service providers for Fedwire processing.

study. The Board believes, however, that any additional modifications to this policy are likely to be consistent with the changes made today to reduce further the costs imposed by the policy.

II. Provision-by-Provision Analysis

The following identifies each provision of the revised Fedwire third-party access policy and discusses how and why it differs from the original policy provision.

A. Scope

Revised Provision

The Board will allow third-party access arrangements whereby a sending or receiving institution ("the participant") designates another depository institution or other entity ("the service provider") to initiate, receive, and/or otherwise process Fedwire funds transfers or book-entry securities transfers that are posted to the participant's reserve or clearing account held at the Federal Reserve, provided the following conditions are met:³

Original Provision

The Board will allow, under certain conditions, arrangements by which a depository institution or other entity ("the service provider") could initiate Fedwire transfers from the Federal Reserve account of another depository institution ("the participant"). Such arrangements will be permitted provided:

The original policy applied to arrangements where funds transfers or book-entry securities transfers were charged or credited to a depository institution's reserve or clearing account held at the Federal Reserve and for which the depository institution did not provide its transfer instructions directly to the Federal Reserve, but rather transmitted its instructions indirectly through another entity. The revised policy applies to the arrangements described above, as well as arrangements where an institution contracts with a third party to process transfers that subsequently are routed through the participant to the Reserve Bank. The Board believes that, whenever a service provider plays a role in processing Fedwire funds transfers or book-entry securities transfers that affect the participant's reserve or clearing account, the arrangement should be subject to the third-party access policy. The revised policy governs all

³ This policy applies to third-party access arrangements in which an office of the participant located outside the U.S. acts as service provider by initiating, receiving, or otherwise processing Fedwire transfers on behalf of the U.S. participant.

arrangements in which a service provider has the operational ability to add or modify transfer instructions that will be posted to the participant's reserve or clearing account held at the Federal Reserve. As a result, communications carriers whose sole job is to transmit transfer instructions between entities are excluded from this policy.

The original policy is silent on whether the service provider can be located outside the United States. The Reserve Banks have not approved any such arrangements; however, several inquiries have been received during the last few years. Such arrangements raise a number of supervisory issues. In addition, because the original third-party access policy applies only to arrangements where the service provider is a separate legal entity from the participant, a Fedwire participant could designate an office of its bank located outside the U.S. to process Fedwire transfers on its behalf without obtaining prior approval from the Reserve Bank. The Reserve Bank and the primary regulator may be unaware of such an arrangement until discovered in the course of an examination. The Board believes that many of the issues that arise with respect to foreign service providers also arise when a foreign office of a Fedwire participant processes that participant's Fedwire transfers. Consequently, the Board has broadened the scope of the policy to include such arrangements. Any existing arrangements involving a foreign service provider must be reported promptly to the participant's Reserve Bank. The Reserve Bank will work with the participant and its primary supervisor to determine the extent to which the arrangement complies with the policy and the appropriateness of the arrangement. No new arrangements involving the outsourcing of Fedwire processing to a foreign service provider will be approved by the Reserve Banks pending the completion of the Board's analysis of issues associated with foreign service provider arrangements.

B. Control of Credit-Granting Process

Revised Condition (#1)

The participant retains operational control of the credit-granting process by (1) individually authorizing each funds or securities transfer, or (2) establishing individual customer transfer limits and a transfer limit for the participant's own activity, within which the service provider can act. The transfer limit could be a combination of the account balance and established credit limits. For the purposes of this policy, these arrangements are called "line-of-credit arrangements."

Original Condition (#1)

The institution whose account is being charged (the "institution") retains control of the credit-granting process by individually approving each transfer or establishing credit limits within which the service provider can act.

Original Condition (#12)

No individual with decision-making responsibilities relating to the funds-transfer area may hold such a position in more than one affiliated institution participating in an approved arrangement.

The Board believes that it is important for the participant to retain operational control of the credit-granting process under a third-party access arrangement. The revised language (1) clarifies that this condition applies to both funds transfer and book-entry securities transfer arrangements; (2) removes the restriction that line-of-credit arrangements are permissible only where the service provider and participant are affiliated organizations;⁴ and (3) deletes the condition in the original policy that no individual with decision-making responsibilities related to Fedwire may hold such a position in multiple institutions participating in the arrangement.

The Board believes that the participant can retain operational control of the credit-granting process either by individually authorizing each transfer based on specific parameters (e.g., customer account balance and/or available credit line) or by permitting the service provider to make the same decisions the participant would have made based on the specific parameters established by the participant. Therefore, the Board does not believe it is necessary to limit the circumstances in which line-of-credit arrangements can be used. The revised policy clarifies further that the transfer limits in line-of-credit arrangements must be established by the participant for individual customer activity and for the participant's own activity. Some participants may prefer to establish lines of credit for certain categories of transfers (e.g., customer activity), but to authorize individual transfers for other categories (e.g., the participant's own activity).

The original provision prohibiting an individual with Fedwire-related responsibilities from holding such a position in multiple institutions participating in the arrangement was intended to ensure that a participant retains control of its reserve account and of its credit-granting function and does

⁴In original condition 2, line-of-credit arrangements were limited to participants that used affiliated service providers.

not effectively relinquish control of these functions to the service provider. The Board believes that this condition has posed problems in cases where an individual with Fedwire-related responsibilities is an officer of multiple holding company affiliates that wished to establish Fedwire third-party access arrangements. The Board has deleted this specific provision from the revised policy, but continues to believe that it is important that the participant retain operational control of the establishment of criteria for approving Fedwire transfers handled by the service provider.

C. Transfers That Would Exceed the Established Transfer Limit

Revised Condition (#2)

In funds transfer line-of-credit arrangements, the service provider must have procedures in place and the operational ability to ensure that a funds transfer that would exceed the established transfer limit is not permitted without first obtaining the participant's approval. In book-entry securities transfer line-of-credit arrangements, the service provider must have procedures in place and the operational ability to provide the participant with timely notification of an incoming transfer that exceeds the applicable limit and must act upon the participant's instructions to accept or reverse the transfer accordingly.

Original Condition (#3)

The service provider must not permit or initiate transfers that would exceed individual credit limits without first obtaining the institution's permission.

The Board believes that it is important to retain the condition that customer credit limits are operationally binding on the service provider and that the service provider may not exceed those limits without the participant's permission. The language of this condition has been revised to distinguish between arrangements involving Fedwire funds transfers and book-entry securities transfers. In a funds transfer, the participant's reserve or clearing account held at the Reserve Bank is debited when the transfer is processed; therefore, transfer limits or controls must be in place before the transfer is made. In a book-entry securities transfer, however, the participant's reserve/clearing account is debited for each incoming transfer; therefore, transfer limits can only be monitored in an *ex post* fashion. As a result, the service provider must be able to notify the participant in a timely manner about incoming transfers that exceed the applicable limit so that the participant can instruct the service provider to accept or reverse the transfer accordingly.

D. Posting Transfers and Responsibility for Account Management

Revised Condition (#3)

Transfers will be posted to the participant's reserve or clearing account held at the Federal Reserve, and the participant will remain responsible for managing its Federal Reserve account, with respect to both its intraday and overnight positions. The participant must be able to monitor transfer activity conducted on its behalf.

Original Condition (#5)

All funds-transfer activity must be posted to the institution's account, and the institution will remain responsible for its account.

Original Condition (#9)

The institution must have the ability to monitor transfers being made on its behalf.

The revised condition (1) eliminates the language that limits the condition to funds-transfer activity; (2) clarifies that responsibility for management of the participant's reserve or clearing account, including control over daylight overdrafts, remains with the participant; and (3) incorporates the requirement that the participant be able to monitor its transfer activity.

E. Board of Directors' Approval

Revised Condition (#4)

The participant's board of directors must approve the role and responsibilities of a service provider(s) that is not affiliated with the participant through at least 80 percent common ownership. In line-of-credit arrangements, the participant's board of directors must approve the intraday overdraft limit for the activity to be processed by the service provider and the credit limits for any inter-affiliate funds transfers.⁵

Original Condition (#4)

The service provider must have the operational ability to ensure that the aggregate funds-transfer activity of the institution does not result in daylight overdrafts in excess of the institution's cap.

Original Condition (#6)

The institution's board of directors must approve the specifics of the arrangement, including (a) the operational transfer of its funds-transfer activity to the service provider, (b) the net debit cap for the activity to be processed by the service provider, and (c) the credit limits for any inter-affiliate funds transfers.

The Board has modified this condition to: (1) Limit the participant's board of directors' review of the roles

⁵ In cases where a U.S. branch of a foreign bank wishes to be a participant in an arrangement subject to this policy, and its board of directors has a more limited role in the bank's management than a U.S. board, the role and responsibilities of the service provider should be reviewed by senior management at the foreign bank's head office that exercises authority over the foreign bank equivalent to the authority exercised by a board of directors over a U.S. depository institution.

and responsibilities of the service provider to arrangements where the service provider is not affiliated with the participant; (2) eliminate the language that limits the condition to funds-transfer arrangements; (3) clarify that certain issues to be considered by the board of directors are pertinent only to line-of-credit arrangements; and (4) encompass arrangements where more than one service provider handles a participant's transfer activity. The Board also acknowledges that the board of directors of a foreign bank might have more limited responsibilities than those typical of a U.S. board and has indicated that whatever body exercises similar authority in these situations would be the appropriate decision-maker with respect to the provisions of this policy that fall within the purview of a participant's board of directors.

F. Backup

Revised Condition (#5)

The Board expects all participants to ensure that their Fedwire operations could be resumed in a reasonable period of time in the event of an operating outage, consistent with the requirement to maintain adequate contingency backup capabilities as set forth in the interagency policy (FFIEC SP-5, July 1989). A participant is not relieved of such responsibility because it contracts with a service provider.

Revised Condition (#6)

In cases where the service provider is not affiliated with the participant through at least 80 percent common ownership, the participant must be able to continue Fedwire operations if the participant is unable to continue its service provider arrangement (e.g., in the event the Reserve Bank or the participant's primary supervisor terminates the service provider arrangement).

Original Condition (#8)

The institution must have adequate backup procedures and facilities to cover equipment failure or other developments affecting the adequacy of the service being provided. This backup must provide the Reserve Bank with the ability to terminate a service-provider arrangement.

The original backup requirement had two facets: (1) contingency backup to enable recovery in the event of an operating outage and (2) the ability of the participant to continue transfer activity in the event the arrangement with the service provider is terminated. The Board expects all Fedwire participants to maintain adequate contingency backup capabilities in accordance with the policy adopted by the federal banking regulatory agencies; a participant is not relieved of such responsibility because it contracts with a service provider. Revised condition #5 references explicitly the interagency policy that requires a depository

institution to have contingency backup capabilities more broadly than for Fedwire processing.

The original "termination backup" requirement provided the participant's Reserve Bank with the flexibility to terminate an arrangement if it determined that the service provider was in a precarious financial condition, was performing its responsibilities in an unsafe and unsound manner, or was otherwise jeopardizing the condition of the participant. The termination backup requirement can be satisfied either by (1) retaining the capability to perform the functions internally that have been delegated to the service provider; or (2) making arrangements with an alternate service provider to take over these functions in the event that the arrangement must be terminated.

The Board recognizes that the termination backup requirement may have made third-party access arrangements impractical for some large institutions, due to the expense required either to have the internal capability to take over the functions of the service provider or to arrange with a backup service provider that has the capability and necessary software to assume these functions on short notice. This condition could prevent some institutions from benefiting from the cost savings that could be derived from a third-party access arrangement.

The Board has limited the termination backup requirement to arrangements in which the service provider is not affiliated with the participant. Most of the arrangements that have been approved to date involve affiliated parties. In arrangements where the service provider is affiliated with the participant, the participant is likely to have information about the service provider that would enable the participant to take actions to foster improvements in the financial condition and/or operating controls of the service provider before the situation deteriorates to the point that the Reserve Bank or the participant's primary supervisor would be likely to terminate the arrangement. The Board believes it is necessary at this time to retain the termination backup requirement for unaffiliated service provider arrangements in order to provide the Reserve Bank or the participant's primary supervisor with a higher level of supervisory control over such arrangements.

The Board notes that federal banking regulators currently do not require depository institutions to provide equivalent termination backup capabilities for other critical functions, such as customer deposit accounting

(e.g., demand deposit accounting, or DDA) and loan processing, which provide management with information that may be necessary to approve Fedwire funds transfers and securities transfers. The Board plans to evaluate, as part of its broader review of outsourcing generally, the extent to which the "termination backup" requirement should apply to other business applications/functions that are outsourced to a third-party service provider, especially where there are dependencies between such functions and the Fedwire funds transfer and securities transfer services.

G. Consistency With Corporate Separateness and Branching Restrictions

Revised Condition (#7)

The participant must certify that the arrangement is consistent with corporate separateness and does not violate branching restrictions.

Original Condition (#10)

The institution must provide an opinion of counsel that the arrangement is consistent with corporate separateness and does not violate branching restrictions.

The third-party access policy raises potential concerns regarding maintenance of separate corporate identities between the service provider and the participant. Moreover, given the definition of "branch" as a location at which deposits are received, checks paid, or money lent, certain third-party access arrangements may raise questions regarding whether the location of the service provider is deemed a branch of the participant. The Board believes that the participant should carefully review the arrangement for consistency with corporate separateness and state branching restrictions. Although the participant may desire an opinion of counsel to make this certification, the Board believes that the participant's certification that the arrangement is consistent with corporate separateness and branching restrictions is sufficient and that the Reserve Bank need not require a copy of an opinion of counsel addressing these issues.

H. Compliance With Applicable Laws and Regulations

Revised Condition (#8)

The participant must certify that the specifics of the arrangement will allow the participant to comply with all applicable state and federal laws and regulations governing the participant, including, for example, retaining and making accessible records in accordance with the regulations adopted under the Bank Secrecy Act.

Original Condition

None.

In clarifying the scope of the policy, the Board believes it is important that the participant in a third-party access arrangement certify that the arrangement will be established in such a way to allow the participant to comply with all applicable state and federal laws and regulations, particularly those associated with record retention and availability of records, as required under the Bank Secrecy Act regulations (31 CFR Part 103). If, subsequent to establishing an arrangement, the Reserve Bank receives information that the operations or activities of the participant or its service provider do not comply with applicable state and federal laws and regulations, the Reserve Bank may terminate the third-party access arrangement.

I. Primary Supervisor

Revised Condition (#9)

The participant's primary supervisor(s) must affirmatively state in writing that it does not object to the arrangement.

Original Condition (#11)

The primary supervisor must not object to the arrangement.

The Board believes that it is important for the participant's primary supervisor(s) to review, and affirmatively not object to, each proposed third-party access arrangement. The provision has been modified further to recognize that some state-chartered institutions must inform both state and federal supervisors.

J. Audit Program

Revised Condition (#10)

The participant must have in place an adequate audit program to review the arrangement at least annually to confirm that these requirements are being met.

Original Condition (#13)

The institution must have in place an adequate audit program to review the arrangements at least annually to confirm that these requirements are being met.

The Board continues to believe that, because an agent is effecting transfers to and from the participant's reserve or clearing account held at the Federal Reserve and because the arrangement originally approved may change over time, it is in the interest of the participant to have its auditors confirm compliance with proper procedures.

K. Service Provider Examination

Revised Condition (#11)

The service provider must be subject to examination by the appropriate federal depository institution regulatory agency(ies).⁶ Original Condition (#2)⁷

The service provider must be an affiliate of the institution, or, if the institution approves each individual transaction, an unaffiliated company. All service providers must be subject to examination.

Depository institution service providers are subject to examination by the institution's primary supervisor. Service providers that are nonbank subsidiaries of a bank holding company are subject to examination by the Federal Reserve. Service providers that are not depository institutions or affiliates of bank holding companies may be subject to examination pursuant to the Bank Services Corporation Act.⁸ Service providers that are subsidiaries of banks are subject to examination by the parent bank's primary supervisor(s). The Board believes that the service provider must acknowledge that it is subject to examination by the appropriate federal depository institution regulatory agency(ies). The requirement that the service provider be subject to examination also applies to arrangements where the participant's service provider arranges for a separate service provider to handle the participant's Fedwire transfers.

L. Agreements

Revised Condition (#12)

The participant and the service provider(s) must execute an agreement with the relevant Reserve Bank(s) incorporating these conditions.

Original Condition (#7)

The institution and the service provider must execute an agreement with the relevant Reserve Banks delineating the terms of the agreement.

This condition was revised to reflect the possibility that a participant's transfer activity may be handled operationally by more than one service

⁶The U.S. federal depository institution regulatory agency(ies) must be able to examine any aspects of the service provider as may be necessary to assess the adequacy of the operations and financial condition of the service provider.

⁷The "affiliation" requirement for line-of-credit arrangements is discussed in the context of revised condition 1.

⁸Section 7(c) of the Bank Services Corporation Act provides that " * * * whenever a bank that is regularly examined by an appropriate Federal banking agency * * * causes to be performed for itself, by contract or otherwise, any services authorized under this Act, whether on or off its premises * * * such performance shall be subject to regulation and examination by such agency to the same extent as if such services were being performed by the bank itself on its own premises."

provider in a given third-party access arrangement. The Reserve Banks have indicated that the conditions under which these arrangements could be established will be set forth in uniform appendices to the Fedwire funds transfer and book-entry securities transfer operating circulars. The uniform operating circular appendices would replace the individual comprehensive legal agreements that are currently used in most districts; would be easier to modify; and would govern arrangements of which the Reserve Bank otherwise may not be aware (for example, arrangements where transfers are processed by a service provider but transmitted to the Reserve Bank by the participant). The appendices to the operating circulars will include a model letter certifying compliance with circular requirements that would be signed by the participant and the service provider(s). Such a letter could be useful in the event that a service provider, especially a non-depository institution, may not have agreed to abide by the terms of the Reserve Bank operating circular through the general agreement. The Board believes that it is not necessary for Reserve Banks to obtain new agreements for existing arrangements because the revised policy is less restrictive than the original policy.

M. Review and Approval of Proposed Arrangements

Revised Condition (Closing Paragraph)

The Federal Reserve Bank is responsible for approving each proposed Fedwire third-party access arrangement. In a proposed arrangement in which the participant is not affiliated through at least 80 percent common ownership with the service provider and where the participant is owned by one of the 50 largest bank holding companies (based on consolidated assets), the Directors of the Division of Reserve Bank Operations and Payment Systems and the Division of Banking Supervision and Regulation must concur with the arrangement.

Original Condition (Closing paragraph)

In order to ensure consistency with the Board's policy, each new arrangement should be reviewed by the Director of the Division of Federal Reserve Bank Operations prior to approval by the Reserve Bank.

The Reserve Banks are responsible for approving proposed Fedwire third-party access arrangements before they become operational. Under the original policy, approval of all proposed arrangements was subject to review by Board staff. The Board believes that, given the number of existing third-party access arrangements, establishment of such arrangements has become more routine. Therefore, the Board has eliminated the

requirement for Board staff review of most third-party access arrangements. The Board has retained, however, the requirement that Board staff review arrangements where the service provider is unaffiliated with the participant, and the participant is owned by one of the 50 largest bank holding companies (based on consolidated assets) before Reserve Bank approval. The Board believes that greater scrutiny of this subset of arrangements is warranted due to the significant value of the Fedwire transfers that would be handled by a service provider that is not affiliated with the participant.

III. Effective Date

The revised Fedwire third-party access policy becomes effective immediately. Existing Fedwire arrangements must comply by March 1, 1996. All arrangements established after the effective date must comply with the policy when established.

IV. Competitive Impact Analysis

The Board assesses the competitive impact of changes that may have a substantial effect on payment system participants. In particular, the Board assesses whether a proposed change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve Banks in providing similar services and whether such effects are due to legal differences or due to a dominant market position deriving from such legal differences.

The Federal Reserve Banks' Fedwire funds transfer and book-entry securities transfer services provide real-time gross settlement in central bank money. While these services cannot be duplicated by private-sector service providers, banks can make large-dollar funds transfers through other systems, such as CHIPS, or through correspondent book transfers, although these transactions have attributes that differ from Fedwire transfers. Similarly, there are private-sector securities clearing and/or settlement systems, such as the Government Securities Clearing Corporation and the Participants Trust Company, that facilitate primary and secondary market trades of U.S. Treasury and agency securities. Other transactions involving U.S. government securities may be cleared and settled on the books of banks to the extent that the counterparties are customers of the same bank.

The Board's third-party access policy places conditions on arrangements in which a Fedwire participant may contract with another organization to

initiate, receive, or otherwise process Fedwire transfers. The Board has revised the policy to clarify its scope and reduce its administrative and operational burden. Neither the original nor the revised policy adversely affects the ability of other service providers to compete with the Federal Reserve Banks to provide funds transfer or securities transfer services.

V. Policy Statement

The Board has amended its "Federal Reserve System Policy Statement on Payments System Risk" under the heading "I. Federal Reserve Policy" by replacing "G. Third-party access arrangements" with the following:

G. Fedwire Third-Party Access Policy

The Board will allow third-party access arrangements whereby a sending or receiving institution ("the participant") designates another depository institution or other entity ("the service provider") to initiate, receive, and/or otherwise process Fedwire funds transfers or book-entry securities transfers that are posted to the participant's reserve or clearing account held at the Federal Reserve, provided the following conditions are met:¹

1. The participant retains operational control of the credit-granting process by (1) individually authorizing each funds or securities transfer, or (2) establishing individual customer transfer limits and a transfer limit for the participant's own activity, within which the service provider can act. The transfer limit could be a combination of the account balance and established credit limits. For the purposes of this policy, these arrangements are called "line-of-credit arrangements."

2. In funds transfer line-of-credit arrangements, the service provider must have procedures in place and the operational ability to ensure that a funds transfer that would exceed the established transfer limit is not permitted without first obtaining the participant's approval. In book-entry securities transfer line-of-credit

¹ This policy applies to third-party access arrangements in which an office of the participant located outside the United States acts as service provider by initiating, receiving, or otherwise processing Fedwire transfers on behalf of the U.S. participant.

arrangements, the service provider must have procedures in place and the operational ability to provide the participant with timely notification of an incoming transfer that exceeds the applicable limit and must act upon the participant's instructions to accept or reverse the transfer accordingly.

3. Transfers will be posted to the participant's reserve or clearing account held at the Federal Reserve, and the participant will remain responsible for managing its Federal Reserve account, with respect to both its intraday and overnight positions. The participant must be able to monitor transfer activity conducted on its behalf.

4. The participant's board of directors must approve the role and responsibilities of a service provider(s) that is not affiliated with the participant through at least 80 percent common ownership. In line-of-credit arrangements, the participant's board of directors must approve the intraday overdraft limit for the activity to be processed by the service provider and the credit limits for any inter-affiliate funds transfers.²

5. The Board expects all participants to ensure that their Fedwire operations could be resumed in a reasonable period of time in the event of an operating outage, consistent with the requirement to maintain adequate contingency backup capabilities as set forth in the interagency policy (FFIEC SP-5, July 1989). A participant is not relieved of such responsibility because it contracts with a service provider.

6. In cases where the service provider is not affiliated with the participant through at least 80 percent common ownership, the participant must be able to continue Fedwire operations if the participant is unable to continue its service provider arrangement (e.g., in the event the Reserve Bank or the participant's primary supervisor

² In cases where a U.S. branch of a foreign bank wishes to be a participant in an arrangement subject to this policy, and its board of directors has a more limited role in the bank's management than a U.S. board, the role and responsibilities of the service provider should be reviewed by senior management at the foreign bank's head office that exercises authority over the foreign bank equivalent to the authority exercised by a board of directors over a U.S. depository institution.

terminates the service provider arrangement).

7. The participant must certify that the arrangement is consistent with corporate separateness and does not violate branching restrictions.

8. The participant must certify that the specifics of the arrangement will allow the participant to comply with all applicable state and federal laws and regulations governing the participant, including, for example, retaining and making accessible records in accordance with the regulations adopted under the Bank Secrecy Act.

9. The participant's primary supervisor(s) must affirmatively state in writing that it does not object to the arrangement.

10. The participant must have in place an adequate audit program to review the arrangement at least annually to confirm that these requirements are being met.

11. The service provider must be subject to examination by the appropriate federal depository institution regulatory agency(ies).³

12. The participant and the service provider(s) must execute an agreement with the relevant Reserve Bank(s) incorporating these conditions.

The Federal Reserve Bank is responsible for approving each proposed Fedwire third-party access arrangement. In a proposed arrangement in which the participant is not affiliated through at least 80 percent common ownership with the service provider and where the participant is owned by one of the 50 largest bank holding companies (based on consolidated assets), the Directors of the Division of Reserve Bank Operations and Payment Systems and the Division of Banking Supervision and Regulation must concur with the arrangement.

By order of the Board of Governors of the Federal Reserve System, August 9, 1995.

William W. Wiles,

Secretary of the Board.

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³ The U.S. federal depository institution regulatory agency(ies) must be able to examine any aspects of the service provider as may be necessary to assess the adequacy of the operations and financial condition of the service provider.