PRC PAYMENTS RISK COMMITTEE

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Best Practices for Payments, Clearing, and Settlement Activities

Report of the Payments Risk Committee

As of November 2018

Sponsored by the Federal Reserve Bank of New York, the Payments Risk Committee is a private sector group that includes senior managers from several major banks in the United States. The Committee identifies and analyzes issues of mutual interest related to risk in payment, clearing, and settlement systems. Where appropriate, the Committee seeks to foster broader industry awareness and discussion and to develop input on public and private sector initiatives. Current members of the Committee are representatives of the Bank of America N.A., The Bank of New York Mellon, Citibank N.A., Deutsche Bank AG, Goldman Sachs, HSBC Bank USA, JPMorgan Chase, Morgan Stanley, MUFG Bank, State Street Bank and Trust Company, UBS AG, and Wells Fargo.

Introduction

The Payments Risk Committee ("PRC" or the "Committee") is a private-sector body sponsored by the Federal Reserve Bank of New York that works to identify and analyze risks in payments, clearing and settlement of financial transactions. The primary goal of the Committee is to foster enhancements to the safety and efficiency of financial market infrastructure, which includes identifying opportunities to strengthen the clearing and settlement of financial transactions.

Financial market infrastructures and their bank customers provide core infrastructure for the economy by facilitating a wide range of large value transfers (e.g., foreign exchange settlements, derivatives clearing, and government securities clearing). Because of the complexity of the interconnections between banks in the payments, clearing, and settlement ("PCS ") environment, and the importance of these activities, the Committee recognizes the importance of shared practices that enhance the safety and efficiency of PCS activities across the network of participants.

These best practices seek to affirm sound existing practices and suggest enhancements to generally practiced behavior. The best practices are not intended as binding rules or regulatory guidance.[1] As each bank considers these best practices, it should take into account its own unique characteristics, such as asset size, transaction volume, and the level of the bank's integration within the financial market infrastructure.[2]

The best practices effort will be a living document structured so that new practices can be added or existing practices can be modified to address changes and challenges over time.

[1] In addition to considering these best practices, banks should be sure that they are following all applicable laws and regulations at all times. In some cases, Financial Market Infrastructure rule books may set more stringent requirements that supersede best practices.

[2] For the most part, the Committee recommends that these best practices apply in their entirety to any large and medium sized financial institutions that are material participants in any of the major Financial Market Infrastructure in the United States, although there may be some applicability to participants in global FMUs.

Payment Lifecycle

The PRC defines the payment lifecycle as the interval of time beginning when a direct participant in a wholesale payment system first receives an instruction from the originator or originating bank (customer), and ending when such payment is settled and available to the beneficiary at their bank. The PRC focuses on practices related to operations, risk management and liquidity management. These practices, taken together, could reduce systemic risk amongst each bank that may play different roles in the PCS system by:

- Achieving final settlement as early in the day as practicable, without creating undue risks, which may include credit, operational, and liquidity risks.[3]
- Providing settled funds to the beneficiaries as early in the day as practicable, without creating undue risks among originating, intermediary, and beneficiary's banks in the payment lifecycle.
- Reducing the potential for failed payments, particularly for settlement late in the business day.

While a shorter lifecycle does not necessarily increase turnover of liquidity, the chances of liquidity being used multiple times can be enhanced with shorter payment lifecycles. Banks should therefore seek to shorten the payment lifecycle in a safe and efficient manner, taking a holistic view of the various risks they face and mitigating these during the lifecycle.

1. Promoting timely payment lifecycle

A bank should have internal policies and guidelines to manage wholesale payment flows throughout the settlement day:

A bank should have internal guidelines or benchmarks regarding payments throughput. In this context, payment throughput is the value/volume of payments to be settled by the bank in the wholesale payment system by certain times in the day.

- Internal guidelines should incorporate any throughput requirements established by the wholesale payment system if applicable.
- Internal guidelines should be commensurate for the bank's business model, risk appetite, customer base, and composition of payments.
- Banks should monitor adherence to their internal guidelines and should review their guidelines periodically, potentially under the auspices of a Key Risk Indicator ("KRI").

[3] CPMI-IOSCO defines final settlement as "the irrevocable and unconditional transfer of an asset or financial instrument, or the discharge of an obligation in accordance with the terms of the underlying contract." See paragraph 3.8.1 of the CPMI-IOSCO *Principles for financial market infrastructures*, available at https://www.bis.org/cpmi/publ/d101a.pdf.

A bank should avoid late day concentration of payments

In general, if a bank delays payments activity and accumulates liquidity, this can lead to late day concentrations of payments.[4] Late day concentrations could cause systemic liquidity imbalances as other banks delay payments as they await anticipated receipt of funds. To maintain an efficient wholesale payments system, banks are encouraged to optimize the timeliness of payments.

- On a real time basis, a bank should strive to update (i) its own balances with the wholesale payments system, (ii) its customer balances held on the bank's books, and (iii) credit line availability.
- A bank should establish appropriate intraday credit limits for customers to efficiently release payments from credit risk queues.
- A bank should prefund payments in the wholesale payments system, if relevant.
- A bank should have internal processes to identify payments that should be prefunded by customers and ensure funds are available early if appropriate.

2. Optimizing payments processing operations

A bank should conduct end to end straight through processing of payments.

Banks should conduct end to end straight through processing of payments and perfect each critical operational step to minimize most, if not all, delays in the lifecycle. A bank should:

- Minimize manual intervention in payment queues (e.g. due to payment message formatting errors) to allow payments to be processed straight through the wholesale payments system and all other banks in lifecycle.
- Net payments with counterparties bilaterally, where appropriate, to improve settlement efficiency while ensuring transparency on underlying transactions and discharge of contractual obligations is not compromised. A bank should encourage its customers to bilaterally net payments with their counterparties, where appropriate. All netting should be legally enforceable.
- Monitor and manage all relevant internal payment queues, such as repair, sanctions screening, credit risk, and liquidity management to avoid excessive backlogs of payments during the business day.
- Connect to external PCS systems and begin processing as soon as they are open for the day.

[4] Basel Committee on Banking Supervision's Risk Concentration Principles (1999) define liquidity concentration as an exposure with the potential to produce losses large enough to threaten a financial institution's health or ability to maintain its core operations (Basel December 1999). https://www.bis.org/publ/bcbs63.pdf

- Continuously monitor systems (internal service layers as well as external PCS systems) interfacing with an internal core payment system to ensure that they are operating effectively.
- Conduct frequent testing to help ensure the capacity, durability and redundancy of payment infrastructure in times of stress.

A bank should reconcile payments activity intraday

In addition to conventional end-of-day reconciliation, banks should reconcile incoming and outgoing payments intraday and against expected/historical flows. Banks should strive to reconcile in real-time. More frequent reconciliation can help banks detect any issues or anomalous activities, such as pending credits/receipts of funds, suspected fraudulent transactions, and irreconcilable receives. Frequent reconciliation also enables banks to recover payments data more readily. Banks that detect any issues should remediate them as soon as possible, and if appropriate, advise payment system operators.

A bank should have communication guidelines in place to address issues or reporting as applicable:

A bank should establish communications protocols among its internal functions (for example, operations, treasury and front office) as well as with customers, its own counterparties and PCS service providers. A bank should:

- Provide real time or near real time reporting to customers on their balances and activities.
- Maintain lines of communication between the treasury, operations, and front office team to ensure unusual intraday liquidity requirements (amount/timing) are quickly detected, escalated, and continuously monitored. Additionally, escalation protocols should be clear, well understood, and tested regularly.
- Have standardized reporting, which includes baseline requirements and thresholds that are shared across all internal payment functional areas.
- Communicate with customers, external PCS system providers, and other stakeholders as applicable should they experience an outage to avoid further delays in payment execution.

3. Identifying and prioritizing time sensitive payments

A bank should identify and prioritize its own and customers' time sensitive and critical payments.

A bank should first define and identify time sensitive and critical payments and then be able to prioritize them.[5] The implication of missing these critical payments could result in financial penalty, default, reputational, and legal risk. More importantly, executing time sensitive and critical payments as early as possible would reduce overall systemic risk by reducing late day concentration of payments, avoiding a

[5] BCBS 248: Time-specific obligations are defined: obligations which must be settled at a specific time within the day or have an expected intraday settlement deadline (Basel April 2013). https://www.bis.org/publ/bcbs248.pdf

critical payment failure, and avoiding settlement delays in PCS systems. Those payments could include critical payments related to PCS infrastructures, funds transfers that support critical Federal Reserve operations, and customer designated priority payments. A bank should:

- Have a process in place to identify proprietary and customers' time sensitive and critical payments.
- Monitor time sensitive and critical payments in various queues in the internal payment system.
- Have a documented and tested escalation process concerning issues in executing time sensitive and critical payments.
- Have a process in place to prioritize time sensitive and critical payments with proper controls.
- Have the ability to extract and back up procedures to execute time sensitive and critical payments in the event of system delays or failures.