

FEDERAL RESERVE BANK OF SAN FRANCISCO
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**BANKING SUPERVISION AND REGULATION:
STRENGTHEN FINANCIAL SYSTEM RESILIENCY**

To State Member Banks, Bank
Holding Companies, U.S. Branches
and Agencies of Foreign Banks,
and Others Concerned,
in the Twelfth Federal Reserve District

Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System (SR 03-9 and Docket R-1128)

The Federal Reserve Board, U.S. Securities and Exchange Commission, and Office of the Comptroller of the Currency have published an *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System*. The white paper is part of the interagency effort to improve the resilience of the private-sector clearing and settlement infrastructure after September 11 and ensure the smooth operation of the financial system in the event of a wide-scale disruption. As discussed below, the sound practices apply most directly to organizations that are deemed to present a type of systemic risk to U.S. financial markets should they not be able to complete open transactions. Nevertheless, all banking organizations and other financial market participants are encouraged to review and consider implementation of the sound practices, particularly if a firm's transaction levels approach those deemed to be significant.

You may view and download the paper at <http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20030408/attachment.pdf>

The following is an overview of the paper:

Scope. The sound practices articulated in the paper expressly apply to “core clearing and settlement organizations” and “financial institutions that play significant roles in critical financial markets.” These two groups pose a type of systemic risk should they be unable to recover or resume critical activities that support critical markets.¹ Core clearing and settlement organizations are defined as large-value payment system operators and market utilities that provide critical clearing and settlement services for critical financial markets. The term also includes firms that provide clearing and settlement services that are integral to a critical financial market (i.e., their market share is significant enough to present systemic risk in the event of their sudden failure to carry on those activities because there are no viable immediate substitutes). Firms that play significant roles in critical financial markets are those that consistently clear or settle at least five percent of the value of transactions in a critical market. To allay any confusion, the agencies are contacting each firm that appears to meet the market share thresholds. If they conclude that the firm plays a significant role in one or more critical markets, the aforementioned agencies will review the firm's plans for implementing the sound practices.

¹ “Systemic risk” is defined as the risk that the failure of one participant in a transfer system or financial market to meet its required obligations will cause other participants to be unable to meet their obligations when due, causing significant liquidity or credit problems and threatening the stability of financial markets. The definition is drawn from *A glossary of terms used in payment and settlement systems*, Committee on Payment and Settlement Systems, Bank for International Settlements (2001).

Sound Practices. The paper describes four sound practices that pertain to appropriate back-up capacity for operations sites and data centers for the recovery and resumption of clearance and settlement activities in critical (wholesale) financial markets. The paper does not apply to recovery or resumption of retail financial services or require firms to enter into new transactions. The critical financial markets are defined as the markets for federal funds, foreign exchange, commercial paper, corporate equities and bonds, and government, agency and mortgage-backed securities. The four sound practices are:

1. Identify all the critical clearing and settlement activities in support of critical financial markets. These activities include the completion of pending large-value payments; clearance and settlement of material pending transactions; meeting material end-of-day funding and collateral obligations necessary to ensure the performance; and updating records of accounts.

2. Determine the appropriate recovery and resumption time objectives for critical clearing and settlement activities in support of critical financial markets. The paper establishes a “within the business day” recovery time objective for both core clearing organizations and significant firms. Core clearing and settlement organizations are expected to develop the capacity to *recover and resume* clearing and settlement activities within the business day on which the disruption occurs with the overall recovery goal of two hours after an event. Firms that play significant roles should plan to *recover* clearing and settlement activities as soon as possible after the core clearing and settlement organizations and within the business day on which a disruption occurs. Such firms should strive to achieve a four-hour recovery time capability in order to ensure that they will be able to meet a within-the-business-day recovery target. The two and four-hour recovery time targets are benchmarks for planning and testing recovery arrangements, and recognize the broad range of variables (e.g., timing, scope, and condition of critical infrastructure) that could affect a firm’s actual recovery time in a wide-scale disruption.

3. Maintain sufficient geographically dispersed resources to meet recovery and resumption objectives. Back-up arrangements should be as far away from the primary site as necessary to avoid being subject to the same set of risks as the primary location and should not rely on the same infrastructure components used by the primary site. The paper does not specify any specific mileage or staffing requirements for implementing this sound practice, and does not recommend that firms move their primary offices, operating sites, or data centers out of metropolitan locations. However, core clearing organizations are expected to establish back-up facilities a significant distance away from primary sites, even if they find it necessary to establish a tertiary site. Firms that play significant roles can meet this sound practice by establishing sites that are within the current range limit of synchronous data storage technology. An organization that uses synchronous back-up facilities or whose back-up sites depend primarily on the same labor pool as the primary site is expected to address the risk that a wide-scale disruption could impact either or both of the sites and their labor pools. Moreover, firms with such back-up arrangements should strive to develop even more distant back-up arrangements as part of their ongoing planning process.

4. Routinely use or test recovery and resumption arrangements. This includes regular tests of internal recovery and resumption arrangements as well as cross-organization tests to ensure the effectiveness and compatibility of recovery and resumption strategies within and across critical markets.

5. Implementation of Sound Practices. The paper calls for substantial implementation of the sound practices as soon as practicable and establishes implementation time frames. Core clearing and settlement organizations are expected to achieve substantially the sound practices by the end of 2004. The paper recognizes that some core clearing organizations can be given additional flexibility in establishing back-up facilities that are well outside of the current synchronous data storage range if they take near-term steps that result in substantially improved resilience. Firms that play significant roles in critical financial markets are expected to achieve substantially the sound practices within three years of publication of the paper. The paper recognizes that, in some cases, a firm may find it necessary to provide for a longer implementation period in light of its respective risk profile, level of resilience, and unique business circumstances. Plans are expected to include measurable milestones to assess progress in achieving the sound practices.

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Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's Internet site, at <http://www.frbsf.org/banking/letters>. Paper copies of SR 03-9 are available from our Corporate Services Department. To request copies to be sent by mail, please call (415) 974-2060.

For additional information about developing sound practices, please contact our Banking Supervision and Regulation Department at (415) 974-2927.

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