FEDERAL RESERVE SYSTEM

Docket No. R–1111

Policy Statement on Payments System Risk

Potential Longer-Term Policy Direction

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: The Board is announcing its decision not to pursue in the foreseeable future the following policy options as part of a potential longer-term direction for the Board's payments system risk policy (PSR policy): (1) lowering self-assessed net debit caps and eliminating two-week average caps and (2) rejecting all payments with settlement-day finality that would cause an institution to exceed its daylight overdraft capacity level. The Board will, however, continue analyzing the benefits and drawbacks of a two-tiered pricing regime for daylight overdrafts in which institutions that pledge collateral to the Reserve Banks would pay a lower fee on their collateralized daylight overdrafts than on their uncollateralized daylight overdrafts.

FOR FURTHER INFORMATION CONTACT: Jeff Stehm, Assistant Director (202/452-2217), Stacy Coleman, Manager (202/452-2934), or John Gibbons, Senior Financial Services Analyst (202/452-6409), Division of Reserve Bank Operations and Payment Systems; for users of Telecommunication Devices for the Deaf (TDD) only, contact 202/263-4869.

SUPPLEMENTARY INFORMATION:

I. Background

In June 2001, the Board requested comment on a number of modifications to the PSR policy, including several near-term changes and a potential longer-term direction.[1] These requests for comment resulted from a broad review of the Board's PSR policy. This review evaluated the effectiveness of the Board's daylight credit policies, recognizing that significant changes had occurred in the banking, payments, and regulatory environment in the past few years. In conducting its review, the Board evaluated the effect of past policy actions on depository institutions' behavior and on the markets generally and also considered the effect of various payment system initiatives on payments activity and the demand for daylight credit.

Following the public comment period for the near-term changes, the Board made several changes to the policy, including allowing depository institutions with self-assessed net debit caps to pledge collateral to the Federal Reserve in order to access additional daylight overdraft capacity above their net debit cap levels and modifying the criteria used to determine a foreign banking organization's U.S. capital equivalency measure (66 FR 64419, December 13, 2001). Currently, the Board is focusing on the potential longer-term direction for the PSR policy. The policy options identified in the request for comment included the following: (1) lowering self-assessed net debit caps and eliminating two-week average caps, (2) rejecting all

[1] The Board's current policy is described in the *Policy Statement on Payments System Risk*. The policy statement can be found at http://www.federalreserve.gov/paymentsystems/psr/policy.pdf.

payments with settlement-day finality that would cause an institution to exceed its daylight overdraft capacity level, referred to as universal real-time monitoring (URTM), and (3) implementing a two-tiered pricing regime for daylight overdrafts in which institutions that pledge collateral to the Reserve Banks would pay a lower fee on their collateralized daylight overdrafts than on their uncollateralized daylight overdrafts (66 FR 30208, June 5, 2001).[2]

II. Summary of Comments and Analysis

The following section describes the options proposed in June 2001 for a potential longer-term PSR policy direction, summarizes and analyzes the comments received on the proposals, and discusses the rationale for not pursuing lower self-assessed net debit caps or URTM in the foreseeable future and for continuing to analyze a two-tiered pricing regime.

The Board received a total of thirty-six comment letters on its potential longer-term PSR policy direction. The commenters included nineteen commercial banking organizations and seven of their trade associations, three clearing organizations, two other trade associations, and five Federal Reserve Banks. Not all commenters, however, addressed each of the options identified in the potential longer-term direction.

A. Net Debit Cap Levels

The Board evaluated the benefits and drawbacks of reducing self-assessed single-day net debit caps to levels near those of the current two-week average caps and eliminating two-week average net debit caps. Under the Board's PSR policy, the Reserve Banks establish limits or net debit caps on the maximum amount of uncollateralized daylight credit that depository institutions may incur in their Federal Reserve accounts. Net debit caps are calculated by applying a cap multiple from one of six cap classes to a depository institution's capital measure. An institution may request a self-assessed cap (average, above average, or high) by completing a self-assessment.[3] Alternatively, a depository institution may request a de minimis cap by submitting a board-of-director resolution to its Reserve Bank, or its Reserve Bank may assign an exempt-from-filing cap. A Reserve Bank also may assign a zero cap in consideration of certain factors, or a depository institution that wants to restrict its own use of Federal Reserve daylight credit may request a zero cap.

Twenty-nine organizations commented on lowering the single-day net debit cap and eliminating the two-week average cap. Of those organizations, sixteen did not support the proposal. Commenters generally did not support lowering the single-day net debit cap and eliminating the two-week average cap because of concerns about reduced flexibility in a depository institution's ability to process payments. Of the thirteen commenters that supported a lower single-day net debit cap and the elimination of the two-week average cap, most believed that Reserve Banks could reduce potential credit exposure while not affecting most depository institutions' ability to process payments. Several commenters also noted that eliminating the two-week average cap could reduce some of the policy's administrative burden. Finally, several commenters stated that institutions affected by a lower single-day net debit cap should have sufficient flexibility because depository institutions can now gain additional overdraft capacity by pledging collateral.

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[2] Payments with settlement-day finality include Fedwire funds and book-entry securities transfers, net settlement service (NSS) transactions, automated clearing house (ACH) credit transactions, and cash withdrawals.

[3] The self-assessment requires an institution to evaluate and rate its creditworthiness, intraday funds management and controls, customer credit policies and controls, operating controls, and contingency procedures to support a higher daylight overdraft cap.

Three commenters that supported lowering net debit cap levels recommended that the Board lower them gradually to allow institutions an adjustment period and to allow the Federal Reserve time to evaluate the effects of lower net debit caps on the payments system. One organization that supported lowering net debit caps recommended that the policy allow institutions to exceed their net debit cap up to 20 percent on an infrequent basis without requiring collateral. Another organization supported lowering net debit caps as long as limits on collateralized daylight overdraft capacity above the net debit cap were set sufficiently high that institutions would not experience liquidity constraints.

The Board believes that reducing self-assessed net debit caps and eliminating two-week average caps generally would not affect most depository institutions' account-management and payment activities. In its request for comment, the Board noted that 96 percent of depository institutions with self-assessed net debit caps use less than 50 percent of their daylight overdraft capacity for their average peak overdrafts. Furthermore, Reserve Banks' credit exposure would be reduced by less than 5 percent if those institutions with self-assessed net debit caps that currently use more than 50 percent of their daylight overdraft capacity reduced their peak overdrafts to within the proposed net debit cap limits. As a result, lower net debit caps likely would not materially reduce Reserve Bank credit exposure. The current net debit cap limits do, however, provide institutions greater flexibility in managing their payments flows. In addition, the actual or potential liquidity implications of payment system initiatives, such as the Continuous Linked Settlement (CLS) system, have not been fully realized both in terms of the liquidity demands resulting from its implementation and its interaction with other payment systems. These potential liquidity demands, especially in times of financial market stress, need to be understood more fully for the Board to evaluate thoroughly the benefits and drawbacks of lowering self-assessed single-day net debit caps and eliminating two-week average caps.

The drawbacks of reduced flexibility in managing payment flows during a period of structural change in the payments system appear to outweigh the potential efficiencies gained by reducing administrative burden from lowering single-day net debit caps and eliminating two-week average caps. Accordingly, the Board will not consider lowering self-assessed single-day net debit caps and eliminating two-week average caps as a policy option in the foreseeable future.

B. Monitoring in Real Time All Institutions' Payments With Settlement-Day Finality

The Board also evaluated the benefits and drawbacks of URTM, which is defined as using the Reserve Banks' Account Balance Monitoring System (ABMS) to reject any payment with settlement-day finality that would cause an account holder's overdrafts to exceed its net debit cap.[4]

Thirty-one organizations commented on URTM. Of those organizations that responded, twenty-four did not support implementing URTM. Most commenters did not support URTM because of concerns that it could be unnecessarily restrictive for healthy depository institutions and could cause or exacerbate disruptions in the payments system. Many

[4] ABMS provides intraday account information to the Reserve Banks and depository institutions. It serves as both an information source and a monitoring tool. ABMS is used primarily to give authorized Reserve Bank personnel a mechanism to control and monitor account activity for selected institutions. It also provides a means for institutions to obtain information concerning their intraday balances for managing daylight overdrafts. This information includes opening balances, a depository institution's daylight overdraft capacity and collateral limits, Fedwire funds and book-entry securities transfers, net settlement service transactions, and other payment activity.

commenters also highlighted URTM's potential effects on ACH credit originations. In particular, several commenters raised concerns about URTM requiring prefunding for ACH credit originations and the potential negative effects on the value-dating aspect of ACH.[5] One commenter that supported URTM, however, stated that preventing institutions from exceeding their net debit cap with overdrafts due to payments with settlement-day finality would reduce risk in the payments system. Another commenter supported URTM because it likely would have only negligible effects on delays in the payments system and payments would be rejected or processed based on real-time balances.

If the Board were to implement URTM, a number of commenters recommended that it do so gradually to minimize potential disruptions to the payments system. For example, some commenters recommended introducing URTM by rejecting only Fedwire funds transfers at first and adding additional payment types later. Several commenters also recommended pending payments, instead of rejecting them, and making individual credit decisions on each payment. Under URTM the potential volume of payments that might be pended and need to be reviewed to make a credit decision could increase significantly, especially in times of market stress. Payments processing could be negatively affected as a result. In addition, the order in which payments could be released and an institution's access to its pended payments queue are issues that would need to be addressed in considering this option.

The Board believes the primary benefit of URTM is that it allows Reserve Banks to better manage the small, yet important, risk that a depository institution could unexpectedly fail with a significant daylight overdraft position that far exceeds its net debit cap. The Board, however, also recognizes the benefits of financially healthy depository institutions having flexibility in managing their payment activity, especially during times of financial market stress. A policy that places a hard cap on daylight credit might cause or exacerbate disruptions for a given depository institution's payment flows or the payments system more generally. In addition, the liquidity implications related to CLS and its interaction with other payments systems need to be understood more fully for the Board to evaluate thoroughly the benefits and drawbacks of URTM. Concerns over disrupting the payments system, especially during times of market stress, likely outweigh the benefits of managing daylight overdrafts for unexpected failures of depository institutions. As a result, the Board will not implement URTM as a policy option in the foreseeable future.

C. Two-Tiered Pricing Regime

The Board will continue evaluating the benefits and drawbacks of implementing a two-tiered pricing regime that would assess a lower fee on collateralized daylight overdrafts than on uncollateralized daylight overdrafts. In evaluating the level of the daylight overdraft fee, the Board is considering policy changes that might more efficiently balance the costs, risks, and benefits associated with the provision of Federal Reserve intraday credit.

The daylight overdraft fee is a critical component of the PSR policy, and its modification in 1995 was the impetus for the Board's PSR policy review.[6] During the policy review, the Board compared Federal Reserve daylight credit extensions and private-sector lending under line-of-credit arrangements in assessing policy alternatives that might create a

[5] Value dating allows originators to submit ACH transactions for settlement on a later, specified date.
[6] The current daylight overdraft fee is 36 basis points, quoted as an annual rate on the basis of a 24-hour day. To obtain the daily overdraft fee for the standard Fedwire operating day, the 36-basis-point fee is multiplied by the fraction of the 24-hour day during which Fedwire is scheduled to operate. For example, under the current 18-hour Fedwire operating day, the effective daylight overdraft fee equals 27 basis points.

more efficient balance of the costs, risks, and benefits associated with Federal Reserve intraday credit. The most notable distinction between daylight credit extensions and private-sector lending is that private-sector lenders usually charge a lower rate when loans are collateralized. Collateralized lending generally carries a lower interest rate than uncollateralized lending because taking collateral lowers the lender's risk, allowing for a lower credit risk premium. In most situations, the Reserve Banks do not require collateral when extending daylight credit to depository institutions.[7] When Reserve Banks accept or require collateral for daylight credit extensions, however, the same daylight overdraft fee applies to both collateralized and uncollateralized daylight overdrafts. The Board also notes that the majority of Federal Reserve daylight credit extensions are currently implicitly collateralized because any collateral that a depository institution pledges to a Reserve Bank can be used to offset any of the institution's obligations to the Reserve Bank.[8]

Twenty-six organizations commented on two-tiered pricing. Twenty-two of those organizations supported some form of a two-tiered pricing regime. Most commenters favored a two-tiered pricing mechanism because they believed that it would reduce risk to the public sector and provide depository institutions the ability to weigh the costs and benefits of lower-rate collateralized credit with higher-rate uncollateralized credit.

One commenter that did not support two-tiered pricing stated that many smaller community banks might not be able to pledge collateral to receive a lower price, possibly placing them at a competitive disadvantage relative to larger depository institutions that likely are capable of pledging sufficient collateral to receive a lower price on most of their overdrafts. The Board is sensitive to policies that place certain depository institutions at a competitive advantage relative to other depository institutions. Most small depository institutions, however, generally do not pay daylight overdraft fees because they use little or no daylight credit. When pricing was introduced, the Board purposely permitted a minimal level of free overdrafts for most depository institutions based on the institution's capital. The purpose was to exempt from fees a very large number of depository institutions that account for a very small portion of total overdrafts.[9] As a result, the Board does not believe that small depository institutions would be disadvantaged by a two-tiered pricing policy relative to large depository institutions.

A number of commenters indicated that they would support two-tiered pricing only if lower-priced collateralized daylight credit could be used before uncollateralized daylight credit. In developing a two-tiered pricing regime, the Board intends to allow depository institutions with collateral pledged to the Federal Reserve to be charged the collateralized price for intraday credit used up to the level of collateral pledged as long as the collateral is not securing other outstanding obligations. Any additional intraday credit used that was uncollateralized would be priced higher. Moreover, depository institutions with self-assessed net debit caps that have been approved for collateralized daylight overdraft capacity above their net debit caps would be able to use the collateral pledged for this purpose to receive the collateralized price on the first dollars of daylight credit used. A few other commenters indicated

[7] The current policy allows depository institutions with self-assessed net debit caps to pledge collateral to gain additional capacity above their net debit caps.

[8] The majority of the collateral pledged to the Reserve Banks is pledged for discount window purposes. Federal Reserve Operating Circulars 1 and 10 provide Reserve Banks with a security interest in any of a depository institution's assets in the possession or control of, or maintained with, a Reserve Bank. These assets include collateral pledged to the Reserve Banks as well as items in the process of collection and any investment property that the institution may legally encumber.

[9] For depository institutions with regular access to the discount window, Reserve Banks also waive daylight overdraft fees if the charge for a reserve maintenance period is twenty-five dollars or less.

that they support two-tiered pricing only if the rate for collateralized daylight credit is lower than the current rate.

Because two-tiered pricing may help balance the costs and benefits of providing daylight credit, and such a policy is more consistent with standard industry practices, the Board will continue to analyze the benefits and drawbacks of two-tiered pricing, taking into consideration the issues raised by commenters.

III. Competitive Impact Analysis

The Board has established procedures for assessing the competitive impact of rule or policy changes that have a substantial impact on payments system participants.[10] Under these procedures, the Board assesses whether a change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services due to differing legal powers or constraints, or due to a dominant market position of the Federal Reserve deriving from such differences. If no reasonable modifications will mitigate the adverse competitive effects, the Board will determine whether the expected benefits are significant enough to proceed with the change despite the adverse effects. The Board believes maintaining the status quo while continuing to analyze two-tiered pricing will have no adverse effect on the ability of other service providers to compete effectively with the Federal Reserve Banks in providing similar services.

IV. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. ch. 3506; 5 CFR 1320 Appendix A.1), the Board has reviewed this notice under the authority delegated to the Board by the Office of Management and Budget. No collections of information pursuant to the Paperwork Reduction Act are contained in this notice.

By order of the Board of Governors of the Federal Reserve System, August 19, 2002.

(signed) Jennifer J. Johnson
Jennifer J. Johnson
Secretary of the Board.

[10] These procedures are described in the Board's policy statement "The Federal Reserve in the Payments System," as revised in March 1990 (55 FR 11648, March 29, 1990).