FEDERAL RESERVE SYSTEM

Docket No. R-1110

Policy Statement on Payments System Risk

$50 Million Fedwire Securities Transfer Limit

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment on policy.

SUMMARY: The Board is requesting comment on the desirability of retaining the current $50 million limit on the transaction size of book-entry securities transfers on Fedwire.

EFFECTIVE DATE: Comments must be received by August 6, 2001.

ADDRESSES: Comments, which should refer to Docket No. R-1110, may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, D.C. 20551 or mailed electronically to regs.comments@federalreserve.gov. Comments addressed to Ms. Johnson also may be delivered to the Board's mailroom between 8:45 a.m. and 5:15 p.m. and to the security control room outside of those hours. Both the mailroom and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in Room MP-500 between 9:00 a.m. and 5:00 p.m. weekdays, pursuant to §261.12, except as provided in §261.14, of the Board's Rules Regarding Availability of Information, 12 CFR 261.12 and 261.14.

FOR FURTHER INFORMATION CONTACT: Paul Bettge, Associate Director (202/452-3174), Stacy Coleman, Manager (202/452-2934), or Doug Conover, Financial Services Analyst (202/452-2887), Division of Reserve Bank Operations and Payment Systems.

SUPPLEMENTARY INFORMATION: This is one of five notices regarding payments system risk that the Board is issuing for public comment today. Two near-term proposals concern the net debit cap calculation for U.S. branches and agencies of foreign banks (Docket No. R-1108) and modifications to the procedures for posting electronic check presentments to depository institutions' Federal Reserve accounts for purposes of measuring daylight overdrafts (Docket No. R-1109). In addition, the Board is requesting comment on the benefits and drawbacks to several potential longer-term changes to the Board's payments system risk (PSR) policy, including lowering self-assessed net debit caps, eliminating the two-week average caps, implementing a two-tiered pricing system for collateralized and uncollateralized daylight overdrafts, and rejecting payments with settlement-day finality that would cause an institution to exceed its daylight overdraft capacity level (Docket No. R-1111). The Board is also issuing today an interim policy statement and requesting comment on the broader use of collateral for daylight overdraft purposes (Docket No. R-1107). Furthermore, to reduce burden associated with the PSR policy, the Board recently rescinded the interaffiliate transfer (Docket No. R-1106) and third-party access policies (Docket No. R-1100).

The Board requests that in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each. This will facilitate the Board's analysis of all comments received.

I. Background

Beginning in 1985, the Board adopted and subsequently modified a policy to reduce the risks that payment systems present to the Federal Reserve Banks, to the banking system, and to other sectors of the economy. An integral component of the PSR policy was to control depository institutions' use of intraday Federal Reserve credit, commonly referred to as "daylight credit" or "daylight overdrafts." The Board's intention was to address the Federal Reserve's risk as well as risks on various types of private-sector networks, primarily large-dollar payments systems.

As part of modifications to the PSR policy in 1988, the Board imposed a $50 million limit on the par value of individual book-entry securities transfers on the Fedwire system (52 FR 29255, August 6, 1987).[1] The purpose of the $50 million limit was to encourage government securities dealers to split large trades into multiple partial deliveries and, thereby, reduce subsequent book-entry securities-related daylight overdrafts. The Board anticipated that government securities dealers' practice of building securities inventories to meet large trade obligations would diminish and book-entry securities transfer volume would be distributed more evenly throughout the day. The Board recognized, however, that the effectiveness of the $50 million limit depended on dealers accepting multiple deliveries for the completion of a single trade obligation. As a result, Federal Reserve staff worked with the Public Securities Association (PSA) to develop delivery guidelines that incorporated necessary changes related to the $50 million limit.[2]

Prior to the implementation of the $50 million limit, the PSA's delivery guidelines required trade obligations to be delivered in full. As a result, dealers often had to accumulate securities in the full amount of the trade before they could deliver them. Partial deliveries, those for less than the full amount of the trade obligation, were typically returned to the sending institution. The incentives to minimize fail-to-deliver costs and maximize fail-to-receive benefits strongly influenced dealers' decisions regarding their settlement of government securities trades.[3] Because fail costs are proportional to the size of unfulfilled obligations,

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[1] The $50 million limit does not apply to original issue deliveries of book-entry securities from a Reserve Bank to a depository institution or transactions sent to or by a Reserve Bank in its capacity as fiscal agent for the United States or international organizations.

[2] The PSA is now known as the Bond Market Association.

[3] Fail costs are the costs dealers incur if they fail to deliver securities to a counterparty on the agreed settlement day. These costs can be significant because a dealer that fails to deliver securities may have to obtain overnight financing as well as forego any interest that the security accrues between the agreed and actual settlement days. The purchasing counterparty that does not receive its securities on the agreed settlement day benefits because that party typically receives the accrued interest on those securities, yet postpones financing the securities until they are actually delivered.

dealers typically organized their deliveries to fulfill their largest obligations first. In addition, in order to maximize fail benefits, a dealer selling and buying the same type of security could strategically delay its deliveries of that security until the end of the day, hoping that counterparties trying to deliver the same securities would be unable to settle their obligations before the close of the securities transfer system.[4] These incentives often led dealers to stockpile large amounts of securities until very near the end of the day.

To stockpile large amounts of securities until very near the end of the day in a delivery-versus-payment environment, dealers often used daylight credit at their clearing banks. The clearing banks, in turn, had to hold positive balances in their Federal Reserve accounts or use Federal Reserve daylight credit. As a dealer accumulates securities and holds them during the day to deliver on its largest obligations first, its overdraft becomes larger and lasts longer. In the absence of charges for daylight credit, however, the dealers' had no incentive to economize on daylight credit but had a strong incentive to avoid the substantial costs associated with failing to deliver on large obligations. In addition, because securities deliveries were often delayed until near the close of the Fedwire book-entry security transfer system, the Federal Reserve frequently extended the system's operating hours.

Although the Board intended the $50 million limit to promote the acceptance of partial deliveries, dealers had limited incentive to change their delivery practices. Under the PSA good delivery guidelines, dealers no longer needed to stockpile securities. As soon as an inventory of $50 million in a particular security was obtained, dealers could immediately deliver that $50 million to a different counterparty, receiving funds to cover any overdraft associated with the original receipt of that security. In effect, the transfer limit and the PSA's modified delivery guidelines allowed dealers to accept partial deliveries and effectively reduced the maximum size of any required position to $50 million. Nonetheless, without fees on daylight overdrafts, dealers could continue to stockpile securities without incurring any explicit costs. Most dealers, therefore, did not change their behavior significantly, and the limit had very little impact on the clearing banks' use of daylight credit.

When the Board began charging a fee for daylight overdrafts in 1994, most clearing banks decided to pass on these charges to their government securities dealers. Because government securities dealers generally relied heavily on intraday credit to conduct their transactions, the fee provided a strong incentive for most major dealers to send securities earlier in the day while the limit and the PSA delivery guidelines allowed dealers to send and required their counterparties to accept partial deliveries in $50 million increments. As dealers began to send securities earlier in the day, Federal Reserve daylight overdrafts decreased substantially.[5]

[4] Because many government securities dealers take long and short positions in the same security among a relatively small group of counterparties, a dealer could be expected to deliver a security to one counterparty and receive the same security from another counterparty.

[5] Because the limit forced receiving dealers to accept multiple deliveries for the settlement of one trade, the receiver could not force the sender to stockpile securities. For example, if a dealer had an obligation to deliver $100 million of a certain security, expected to receive $90 million of the same issue, and already held $10 million of that security in its account, delivery of its obligation would be dependent upon first receiving the expected $90 million, if a limit were not present. With the limit in place, the dealer could immediately forward $50 million of that security as soon as it was received, rather than waiting for the entire $90 million. To the extent that a dealer buys securities from many counterparties and that deliveries from these counterparties are dependent on receipt of their own purchases,

II. Effectiveness of the $50 Million Limit

As part of a broad review of the Federal Reserve's daylight credit policies, the Board considered the effectiveness of the $50 million limit policy, with a focus on whether the limit imposes an undue regulatory burden. To understand better the industry's view of the limit, Federal Reserve staff met with representatives of primary dealers, clearing banks, and industry utilities. Federal Reserve staff learned that many government securities dealers and their clearing banks support retaining the $50 million limit. These representatives believe that removing the limit could increase position building and securities-related overdrafts despite the existence of daylight overdraft fees. In addition, the representatives stated that removing the limit would likely require costly system changes throughout the industry. Given that the industry bears a significant portion of the costs and benefits of the limit, both in terms of transaction fees and reduced overdraft fees, the support of the limit voiced by industry representatives reflects their perception that the limit has a positive net effect on the government securities settlement system.

Industry representatives indicated that removal of the limit would likely lead the industry to demand that securities trades be settled in full and to reject partial deliveries. While current delivery guidelines encourage acceptance of partial deliveries, industry representatives expressed concern that there would be no technical mechanism to enforce these guidelines. The Board believes the $50 million limit on book-entry securities transfers in combination with daylight overdraft fees has been effective in reducing daylight overdrafts. Because the limit appears to have a net positive effect, the Board is disposed to retaining the limit. The Board, however, would like to ensure that it considers the perspectives of all parties before making a final determination regarding the retention of this limit.

III. Request for Comment

The Board is proposing to maintain its current policy limiting the size of individual book-entry security transfers on Fedwire to $50 million in par value. The Board is requesting comment on all aspects of the $50 million limit as well as on the following questions:

1. Should the limit be retained?

   If yes, is $50 million a reasonable level for the limit? Do the benefits of the limit support a reduction of the limit to $25 million? Or, would a higher limit reduce transaction costs but maintain the existing benefits of the limit? Would changing the limit require costly system changes?

   If no, what would be the effect of eliminating the $50 million limit on delivery fails, daylight overdrafts, and dealer costs? In particular, would eliminating the limit require costly system changes?

2. Does the limit impose any significant costs on dealers or clearing banks, net of any benefits from reduced overdrafts?

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the limit allows deliveries to occur earlier than otherwise possible, reducing the liquidity required to settle the total amount of transactions.

3. Does the limit promote specific benefits in the government securities market other than reduced overdrafts?

IV. Competitive Impact Analysis

Under its competitive equity policy, the Board assesses the competitive impact of changes that have a substantial effect of payments system participants.[6] The Board believes that retention of the $50 million securities transfer limit will have no adverse effect on the ability of other service providers to compete effectively with the Federal Reserve Banks in providing similar transfer services.

V. 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 the request for comments under the authority delegated to the Board by the Office of Management and Budget. The collection of information pursuant to the Paperwork Reduction Act contained in the policy statement will not unduly burden depository institutions.

By order of the Board of Governors of the Federal Reserve System, May 30, 2001.

(Signed) Jennifer J. Johnson

Jennifer J. Johnson,

Secretary of the Board.

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