

# RESCINDED

Office of Thrift Supervision  
Federal Reserve System

March 11, 2008

**Transmittal**  
**TR-409**

This rescission does not change the applicability of the conveyed document. To determine the applicability of the conveyed document, refer to the original issuer of the document.



Federal Register, Vol. 73, No. 46, pp. 12417-12443

Number TR-409

On March 7, 2008 the Board of Governors of the Federal Reserve System issued a request for comment on proposed changes to its Payments System Risk policy that would adopt a new strategy for providing intraday balances and credit to depository institutions and encourages such institutions to collateralize their daylight overdrafts.

i

would help loosen liquidity constraints and reduce operational risk. Specifically, the Board proposes to adopt a policy of supplying intraday balances to healthy depository institutions predominantly through *explicitly* collateralized daylight overdrafts provided at a zero fee. The Board would allow depository institutions to pledge collateral *voluntarily* to secure daylight overdrafts but would encourage the voluntary pledging of collateral to cover daylight overdrafts by raising the fee for uncollateralized daylight overdrafts to 50 basis points (annual rate) from the current 36 basis points. The Board also proposes to increase the biweekly daylight overdraft fee waiver to \$150 from \$25 to minimize the effect of the proposed policy changes on institutions that use small amounts of daylight overdrafts (small users). In addition, the proposed policy would involve changes to other elements of the PSR policy dealing with daylight overdrafts, including adjusting net debit caps, streamlining maximum daylight overdraft capacity (max cap) procedures for certain foreign banking organizations (FBOs), eliminating the current deductible for daylight overdraft fees, and increasing the penalty daylight overdraft fee for ineligible institutions to 150 basis points (annual rate) from the current 136 basis points.

**DATES:** Comments must be received on or before June 4, 2008.

**ADDRESSES:** You may submit comments, identified by Docket No. OP-1309, by any of the following methods:

- *Agency Web Site:* <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.
- *E-mail:* [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include the docket number in the subject line of the message.
- *Fax:* (202) 452-3819 or (202) 452-3102.
- *Mail:* Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments will be made available on the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed

---

## FEDERAL RESERVE SYSTEM

[Docket No. OP-1309]

### Policy on Payments System Risk

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Policy statement; request for comment.

**SUMMARY:** The Board of Governors of the Federal Reserve System (Board) requests comment on proposed changes to its Payments System Risk (PSR) policy that would adopt a new strategy for providing intraday balances and credit to depository institutions and encourage such institutions to collateralize their daylight overdrafts. The Board believes changes to the Federal Reserve's current strategy for providing intraday balances and credit to the banking industry

electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

**FOR FURTHER INFORMATION CONTACT:**

Jeffrey Marquardt, Deputy Director (202-452-2360) or Susan Foley, Assistant Director (202-452-3596), Division of Reserve Bank Operations and Payment Systems, Board of Governors of the Federal Reserve System; for users of Telecommunications Device for the Deaf ("TDD") only, contact (202) 263-4869.

**SUPPLEMENTARY INFORMATION:**

**I. Background**

The Federal Reserve's Payments System Risk (PSR) policy sets out the general public policy objectives of *safety and efficiency* for payments and settlement systems. Over the past few years, the Federal Reserve has been reviewing the long-term effects of market, operational, and policy changes by the financial industry and the Federal Reserve on intraday liquidity, operational, and associated credit risks in financial markets and the payments system, including account overdrafts (daylight overdrafts) at the Federal Reserve Banks (Reserve Banks). On June 21, 2006, the Board published for public comment the *Consultation Paper on Intraday Liquidity Management and the Payments System Risk Policy* (consultation paper) that sought information from financial institutions and other interested parties on their experience in managing liquidity, operational, and credit risks related to Fedwire funds transfers, especially late-day transfers.<sup>1</sup> The paper included a list of detailed objectives relating to safety and efficiency that the Board has previously used to conduct payments system risk analysis. An important goal of the consultation process was to identify opportunities to improve the safety/efficiency trade-offs in the payments system over the long run.

Significant changes to U.S. payments and settlement systems over the past twenty-five years have helped reduce systemic risk. In accord with U.S. and international risk policies and standards, several of these changes have relied increasingly on the use of central bank money—in this context, balances that financial institutions and private clearing and settlement organizations hold in accounts at Reserve Banks—to strengthen the management of credit and liquidity risk in private-sector clearing and settlement arrangements. Such changes have had the effect of

increasing significantly the intraday demand for central bank money and hence the demand for daylight overdrafts at the Reserve Banks, which are a major source of these funds.

In addition, the combined effect of depository institutions' intraday liquidity management strategies, changes at clearing and settlement organizations, and late-day market activity has been to shift the sending of larger Fedwire funds transfers to later in the day. From an operational risk perspective, delaying the sending of large payments until late in the day increases the potential magnitude of liquidity dislocation and risk in the financial industry if late-in-the-day operational disruptions should occur. An increase in such risk is particularly troublesome in an era of heightened concern about operational disruptions generally.

Given the growing demand for intraday central bank money and accompanying daylight overdrafts, as well as the shift of larger Fedwire payments to later in the day, the Board believes that significant further steps are appropriate to mitigate the growing credit exposures of the Reserve Banks, while also improving intraday liquidity management for the banking system and augmenting liquidity provided. The consultation paper requested views on potential changes in market practices, operations, and the Federal Reserve's PSR policy that could reduce liquidity, operational, and credit risks. These proposed changes would not affect the provisions of part I of the PSR policy, which deal with risk management in private-sector systems.

**II. Comments and Analysis**

The Board received twenty-three public comment letters in response to its consultation paper.<sup>2</sup> The majority of these letters were from commercial banking organizations and from several private-sector clearing and settlement systems, industry groups, and trade organizations. In addition, the Board received comments from one Reserve Bank and one individual. Almost all commenters explicitly expressed concern about the operational risk associated with the increasing concentration of late-day payments. Most commenters identified payment queuing at depository institutions, particularly the queuing of payments to settle large money market transactions, as a liquidity conservation strategy that

contributes to institutions sending payments late in the day.<sup>3</sup> A majority of commenters also agreed that some private-sector clearing and settlement systems absorb a considerable amount of intraday liquidity in connection with their risk-management processes. Further, some commenters identified market constraints, such as the late-day settlements of tri-party repo transactions, and the processes and settlement procedures of The Depository Trust Company (DTC) and The Clearing House Interbank Payment System (CHIPS) as important contributors to the concentration of late-day payments.<sup>4</sup>

The comments also addressed the specific market, operational, and PSR policy options set forth in the consultation paper. The majority of commenters strongly supported greater use of collateral and two-tiered pricing of daylight overdrafts by the Federal Reserve under the PSR policy.<sup>5</sup> Several institutions expressed strong support for a zero fee for collateralized daylight overdrafts, similar to policies followed by other central banks. Most commenters also stressed that they should have the ability to use unencumbered collateral already pledged to the discount window to support their daylight overdrafts.

Several commenters also strongly supported continued work on potential opportunities to conserve liquidity within DTC and CHIPS. These comments endorsed the work performed by the Federal Reserve Bank of New

<sup>3</sup> Payment queuing is a tool used by some depository institutions to hold a payment internally until sufficient funds—available balances or credit line—become available to send the payment to the Fedwire funds transfer system or another system. Some payments are held in queues because a customer has insufficient balances or credit to fund the payments. Other payments may be held to manage the level of account daylight overdrafts at the Reserve Bank or the associated fees.

<sup>4</sup> CHIPS is a real-time final payments system operated by The Clearing House Payments Company. In January 2001, The Clearing House implemented operational and rule changes to allow all transactions settled in CHIPS to be final upon release from a central queuing system. DTC is a subsidiary of the Depository Trust and Clearing Corporation, which operates six subsidiaries that provide clearance, settlement, and information services for many financial instruments, including equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments, and over-the-counter derivatives. DTC provides custody and settlement services for corporate and municipal securities and money market instruments. DTC is a member of the Federal Reserve System and a clearing agency registered with the Securities and Exchange Commission.

<sup>5</sup> In 2001, the Board requested comment on two-tier pricing as a long-term PSR policy direction and, based on comments, agreed to continue evaluating the benefits and drawbacks of implementing such a regime. See 66 FR 30208, June 5, 2001 and 67 FR 54424, August 22, 2002.

<sup>2</sup> Copies of all public comments on the consultation paper can be found on the Board's website at [http://www.federalreserve.gov/generalinfo/foia/index.cfm?doc\\_id=OP%2D1257&doc\\_ver=1](http://www.federalreserve.gov/generalinfo/foia/index.cfm?doc_id=OP%2D1257&doc_ver=1).

<sup>1</sup> See 71 FR 35679, June 21, 2006.

York's Payment Risk Committee (PRC) and Wholesale Customer Advisory Group (WCAG) during the consultation period. The PRC and WCAG conducted a liquidity survey to understand better the determinants of late-day payments.<sup>6</sup> The results of the survey prompted the formation of four workgroups to evaluate liquidity improvement opportunities for CHIPS, DTC, tri-party repo payments, and broker-dealer payments.

The workgroup focused on CHIPS processing found that the CHIPS algorithm can leave a number of large-value payments unresolved in the system for significant periods of time, resulting in some institutions redirecting payments to the Fedwire funds transfer system at the end of the day; these payments are in addition to the daily Fedwire funds transfers that are part of the CHIPS' end-of-day funding procedures around 5:15 p.m. The workgroup and CHIPS identified possible opportunities to release unresolved payments for settlement earlier, including changing some of the system controls. The workgroup that focused on DTC largely examined the money market instrument clearing and settlement processes and the reasons a substantial amount of liquidity is transferred to and remains at DTC, especially between 1 and 3 p.m. This liquidity is then released as part of settlement around 4:30 p.m. The workgroup and DTC tried to identify ways to reduce the length of time of the settlement process, to encourage institutions to manage better liquidity at DTC, and to enhance operations and certain controls. The other two workgroups on broker-dealer payments and on tri-party payments largely focused on documenting processes and procedures to educate the PRC and WCAG members so they could better understand why these payments are key determinants of late-in-the-day payments. The results from each of the workgroups were shared as part of the

<sup>6</sup> The Payment Risk Committee (PRC) is sponsored by the Federal Reserve Bank of New York and works to identify and analyze issues of mutual interest related to risk in payments and settlement. The institutions represented on the PRC include Bank of America, Bank of New York, Bank of Tokyo-Mitsubishi UFJ, Citibank, Deutsche Bank, HSBC, JPMorgan Chase, State Street, UBS, Wachovia, and Wells Fargo. The Wholesale Customer Advisory Group (WCAG) advises the Wholesale Product Office on business issues and is composed of depository institutions that are major users of Fedwire. Institutions represented on this group include ABN AMRO, Bank of America, Bank of New York, Citibank, Deutsche Bank, HSBC, JPMorgan Chase, Key Bank, Mellon Financial, State Street, SunTrust, UBS, U.S. Bank, U.S. Central Credit Union, Wachovia, and Wells Fargo.

comment process and were cited for continued work by commenters.

Commenters were split in terms of support for developing a liquidity-saving mechanism for the Fedwire funds transfer system.<sup>7</sup> Eight of the thirteen respondents that commented on the possible introduction of a liquidity-saving mechanism encouraged further exploration of this idea, while the remaining five expressed some concerns. Those respondents that were supportive noted that a liquidity-saving mechanism could help reduce the length of time that large-value payments sit in internal queues at depository institutions. One commenter specifically suggested that the Federal Reserve focus on a liquidity-saving system for the exchange of broker-dealer and tri-party repo payments, which are typically large-value payments. Other supporters strongly favored a centralized queuing system for all Fedwire funds transfer payments and mentioned systems used or under development in other countries.<sup>8</sup> Concerns about developing a liquidity-saving mechanism included the possibility that it could undermine the real-time gross settlement attribute of the Fedwire funds transfer system, create a competitive disadvantage for a private-sector payments system, or significantly increase the cost of making Fedwire funds transfer payments.

Commenters had different views on the idea of time-of-day pricing, which would vary the fee charged for daylight overdrafts through the day so that overdrafts incurred earlier in the day would incur a lower fee than overdrafts incurred late in the day. While some commenters supported time-of-day pricing as an incentive to send funds transfers earlier in the day, others requested additional information about the idea. Still other commenters pointed

<sup>7</sup> The creation of a liquidity-saving mechanism could involve adding new features to the Fedwire funds transfer system that depository institutions could use to coordinate better the timing and settlement of their payments as well as to economize on the use of intraday central bank money, daylight overdrafts, and collateral. The existing real-time gross settlement functionality of Fedwire would be retained. In particular, a depository institution could still designate that a Fedwire funds transfer settle immediately as it does today. The new features, for example, could allow depository institutions to designate certain types of payments, possibly including payments generated by certain types of transactions, to be placed into a central queuing system and settled using algorithms that allow the liquidity provided by incoming payments to a depository institution to be used as far as possible to settle that institution's outgoing payments.

<sup>8</sup> Versions of liquidity-saving mechanisms are used by CHIPS and Target 2 in the European Union. Such features will also be included in the new wire transfer systems in Japan and other countries.

out that the effectiveness of time-of-day pricing would be constrained by the reality of late afternoon trade settlements, such as tri-party repo payments and Fed funds loans.

Commenters expressed limited or no support for the creation of an intraday market to exchange liquidity, an expansion of the market for early return of Fed funds loans, or throughput requirements for the Fedwire funds transfer system. Most respondents thought that an intraday market would not be helpful in addressing the late-day concentration of payments and would be costly and complex to establish. In terms of expanding the market for early return of Fed funds loans, several commenters were uncertain about the effects of such a change on late-day payments. In addition, a majority of respondents did not support the introduction of throughput requirements for the Fedwire funds transfer system, primarily because of the potential difficulty of administering and enforcing such requirements. Throughput requirements are used by some systems around the world to encourage certain percentages of payments volume to be submitted by predetermined times. Three commenters, however, were somewhat supportive provided the throughput requirements were voluntary, implemented jointly with a central queue, or in conjunction with brief, intermittent periods when institutions could coordinate sending Fedwire funds transfers.

The Board received several comment letters raising concerns about the policy's treatment of the daylight overdrafts of foreign banking organizations (FBOs). The commenters stated that the U.S. capital equivalency measure used to determine FBO net debit caps and deductibles in the calculation of daylight overdraft limits and fees is discriminatory and results in a competitive disadvantage for these organizations and in their delaying payments. This assertion is based on the fact that U.S.-chartered depository institutions receive a net debit cap and deductible based on their worldwide capital, while FBOs receive a net debit cap based on no more than 35 percent of their worldwide capital (referred to as the U.S. capital equivalency) and a deductible based on their U.S. capital equivalency.<sup>9</sup> As a result, FBOs are

<sup>9</sup> In 2001, the Board modified the criteria to determine eligible capital and raised the percent of capital used in calculating net debit caps and the deductible. The percent of capital used increased from as much as 10 percent to up to 35 percent. See also 66 FR 30205, June 5, 2001.

eligible for considerably lower daylight overdraft capacity and free intraday credit than are U.S.-chartered depository institutions with equivalent worldwide capital. The commenters asked the Board to calculate FBO deductibles using 100 percent of their worldwide capital, as is done for U.S.-chartered institutions. The commenters also asserted that the existing formula used to determine the net debit cap cannot be justified, particularly in the case of FBOs which are considered to be both “well capitalized” and “well managed” for U.S. regulatory (FHC) purposes or which have received the highest rated “strength-of-support assessment” (SOSA 1).<sup>10</sup>

Finally, the Board received a few other comments. One responder suggested changing the posting rules for automated clearinghouse (ACH) debit transfers so that settlements from credit and debit transfers are posted simultaneously with only the net amount of funds increasing or decreasing the balances of depository institutions held at Reserve Banks.<sup>11</sup> The Board has issued a separate **Federal Register** notice requesting comment on shifting from 11 a.m. to 8:30 a.m., eastern time, the posting time for commercial and government ACH debit transfers that are processed by the Reserve Banks’ FedACH service.<sup>12</sup> The earlier posting time would make the postings of commercial and government ACH debit and credit transfers simultaneous.

Some commenters raised ideas for changes other than those suggested in the consultation paper, including lowering fees for securities-related daylight overdrafts, allowing individual banks to coordinate informally the sending of Fedwire funds transfers, and reducing the maximum payment size allowed through the Fedwire funds transfer system. Finally, several commenters addressed a question in the consultation paper about the payment of interest on reserves and the possible effect on depository institutions’ intraday liquidity management. Most responders believed that the Federal

Reserve’s payment of interest on reserve balances would not affect intraday liquidity management or stated that its effect on liquidity was unknown without further information.

Overall, the public comment letters and the extensive PRC and WCAG investigations into intraday liquidity and late-day payments issues validate a number of concerns raised in the consultation paper. It has also become clear that no single policy or operational change would address all of the intraday liquidity, risk, and payments issues that the Board and the industry have identified. However, a series of steps by both the private sector and the Federal Reserve could help.

To address the combination of intraday liquidity, operational, and credit risks in the wholesale payments system, the Board believes that the Federal Reserve and industry should pursue a four-pronged strategy. The Board should review its PSR policy and consider adjusting the terms and pricing of daylight overdrafts. The Reserve Banks should work with the industry and investigate options for developing a liquidity-saving mechanism for the Fedwire funds transfer system. Additionally, working with the PRC, CHIPS and The Depository Trust and Clearing Corporation should explore opportunities for improving payments processing and liquidity use in their systems and processes relating to large-value funds and securities settlement, respectively. This request for comment focuses on the Board’s PSR policy and recommends changes in strategy, terms, and pricing for the provision of intraday credit by the Reserve Banks.

### III. New Strategy for PSR Policy

The current policy of providing uncollateralized daylight overdrafts at an administered fee grew out of a Board study in the late 1980s that reviewed options for reducing the volume of intraday credit provided by the Reserve Banks. A fundamental premise of this work was that intraday credit is a necessary but undesirable aspect of the payments system and should be reduced whenever possible. This premise is expressed in the introduction to the current PSR policy as follows:

[T]he Board expects depository institutions to manage their Federal Reserve accounts effectively and minimize their use of Federal Reserve daylight credit. Although some intraday credit may be necessary, the Board expects that, as a result of this policy, relatively few institutions will consistently

rely on intraday credit supplied by the Federal Reserve to conduct their business.<sup>13</sup>

In reviewing the current PSR policy, the Board identified five major concerns related to risk and efficiency that together suggest that a change in the Federal Reserve’s approach to the provision of daylight overdrafts is warranted at this time.<sup>14</sup> First, the data indicate a long-term trend of declining end-of-day balances held in Federal Reserve accounts which, in turn, implies an increasing need by institutions for daylight credit from the Reserve Banks to fund payments-system transactions. Second, the Board notes that some financial utilities can absorb large amounts of intraday funding from participants to meet their risk management requirements. These funding requirements result in large transfers of balances from participants’ Federal Reserve accounts that often are not reversed until the late afternoon. Third, data, as well as comments on the consultation paper, make clear that many large depository institutions hold a significant number of large-value payments in “liquidity queues” primarily to avoid daylight overdraft fees; such queuing can delay payments across the financial markets. Fourth, data show that Reserve Banks’ credit exposure has increased over time in real terms despite Reserve Banks charging fees. On certain days, the peak overdraft of the banking system can exceed \$210 billion. In 2007, the average daily overdraft of the banking system as a whole was approximately \$60 billion and the *average* daily peak overdraft was approximately \$160 billion. Finally, daylight overdraft fees paid by the banking system have continued to rise, increasing the cost burden of the PSR policy on the industry. Daylight overdraft fees for 2007 totaled approximately \$65 million, compared with \$32.2 million in 2003. Because there are systemic reasons for the increased demand for intraday balances and credit as well as evidence that the current pricing approach is creating liquidity queues and increasing late-day operational risk, the Board concluded that its current strategy of seeking to minimize daylight overdrafts should be reassessed.

The Board also notes that thinking about the role of central banks in providing intraday balances to the payments system has evolved significantly over the past twenty years.

<sup>13</sup> See the Policy on Payment System Risk <http://www.federalreserve.gov/paymentsystems/psr/policy07.pdf>, pg. 2.

<sup>14</sup> Please see appendix I for a full discussion of these issues.

<sup>10</sup> For an FBO, the policy incorporates the SOSA rankings and FHC status in determining U.S. capital equivalency. The SOSA ranking is composed of four factors, including the FBO’s financial condition and prospects, the system of supervision in the FBO’s home country, the record of the home country’s government in support of the banking system or other sources of support for the FBO; and transfer risk concerns. The SOSA ranking is based on a scale of 1 through 3, with 1 representing the lowest level of supervisory concern.

<sup>11</sup> Currently FedACH credit transfer and debit transfer transactions post at 8:30 a.m. and 11 a.m. eastern time, respectively.

<sup>12</sup> All times referenced are eastern time.

A 2003 study by the G-10 Committee on Payments and Settlements Systems summarized this change in perspective and explicitly recognized that central banks have an important role in providing intraday (central bank money) balances to foster the smooth operation and settlement of payments systems.<sup>15</sup> In essence, this view is an extension to the intraday market of the traditional role of central banks in supplying overnight balances to the banking industry to meet financial market demand for liquidity and operating balances. While some of the demand of the banking industry for intraday balances can be met by overnight balances, when the level of those balances is inadequate, a central bank will need to supply additional funds through the temporary provision of intraday funds, which could include using mechanisms such as daylight overdraft facilities.

The Board believes that a new strategy would enhance intraday liquidity management while controlling risk to the Reserve Banks and would build on the Board's 2001 proposal to consider two-tiered pricing for daylight overdrafts.<sup>16</sup> This strategy would

(1) Explicitly recognize that the Federal Reserve has an important role in providing intraday balances to foster the smooth operation of the payments system.

(2) Provide temporary, intraday balances to healthy depository institutions predominantly through collateralized intraday overdrafts.

<sup>15</sup> "Because the settlement of each payment involves a direct transfer of the settlement asset, [real time gross settlement] systems require substantially more of the asset to ensure smooth payment flows. To enable this, most central banks provide intraday credit to banks participating in these systems in quantities which in some cases dwarf the banks' overnight balances or their overnight borrowing from the central bank." See "The Role of Central Bank Money in the Payment System," Committee on Payment and Settlement Systems, August 2003 at <http://www.bis.org/publ/cpss55.pdf>.

<sup>16</sup> The strategy is consistent with the public policy objectives in the current PSR policy to foster the *safety and efficiency* of payments and settlement systems as well as the version of these objectives used in developing the Board's original pricing proposals in 1988. At that time, the safety objectives were stated as low direct credit risk to the Federal Reserve, low direct credit risk to the private sector, low systemic risk, and rapid final payments. The efficiency objectives were stated as a low operating expense of making payments, equitable treatment of all service providers and users in the payments system, effective tools for implementing monetary policy, and low transaction costs in the Treasury market. See "Controlling Risk in the Payment System," Report of the Task Force on Controlling Payments System Risk to the Payments System Policy Committee of the Federal Reserve System, Board of Governors of the Federal Reserve System, August 1988.

(3) Reduce over time the reliance of the banking industry on uncollateralized daylight credit if this can be done without significantly disrupting the operation of the payments system or causing other unintended adverse consequences.

In brief, the rationale for the new strategy is that modern payments and settlement systems, including Fedwire, CHIPS, CLS, and DTC, require significant amounts of intraday balances or liquidity for smooth operations and that the role of a central bank is to meet reasonable market needs of participants in these systems for this liquidity.<sup>17</sup> In addition, under current policies, overnight balances are not sufficient to address these needs and, as a result, temporary, intraday balances through intraday credit must be provided by daylight overdrafts.<sup>18</sup> Intraday credit is now widely and explicitly provided by central banks to support the operation of payments and settlement systems, including by the Eurosystem, Bank of Japan, and Bank of England. Typically this daylight credit is collateralized, but no fee is charged.

The proposed new strategy would explicitly use collateral augmented by the framework of net debit caps to control credit risk to the Reserve Banks in providing daylight overdrafts and would link the fees charged for daylight overdrafts to the amount of collateral provided. The same collateral eligibility criteria and haircuts would be used for both overnight and intraday credit. Unencumbered collateral pledged for discount window or PSR purposes could be used to support intraday credit provided at the reduced daylight overdraft fee. The benefits of encouraging the pledge of collateral would extend beyond the reduced intraday credit exposure of the Reserve Banks and would include enhanced emergency preparedness. Under the proposed policy, eligible institutions would have an additional incentive to sign borrowing documents with the Reserve Banks and pledge collateral, which would enable such institutions to borrow from the discount window, if needed.

Controlling credit risk by taking collateral is a time-honored risk-management technique. It is used

<sup>17</sup> See *The Role of Central Bank Money in the Payment System*, Committee on Payment and Settlement Systems, August 2003. (<http://www.bis.org/publ/cpss55.pdf>).

<sup>18</sup> Policy decisions that will be made to exercise the Federal Reserve's new statutory authority to pay interest on reserves beginning in October 2011 could increase the level of overnight balances held at the Reserve Banks and consequently reduce the demand for daylight overdrafts to provide intraday balances.

explicitly in some cases today by the Reserve Banks in the daylight overdraft program.<sup>19</sup> Moreover, under Operating Circular 10, depository institutions grant Reserve Banks a lien on collateral pledged to the Reserve Bank as well as any other property in the possession or control of, or maintained with, any Reserve Bank, to secure discount window loans and any other obligations, such as daylight overdrafts, owing to any Reserve Bank.<sup>20</sup>

The new strategy would retain a net debit cap regime for all depository institutions.<sup>21</sup> The net debit cap would focus on addressing low-probability risks and not unduly constraining normal demands for balances and credit. Industry best practices and supervisory guidance support the use of borrowing limits, or caps, even for collateralized risk exposures as a prudent credit risk management tool. Caps also serve as a useful mechanism for both Reserve Banks and institutions in terms of setting benchmarks for the maximum expected usage of daylight credit and supporting collateral.

The new strategy also reflects the Board's sensitivity to avoiding sudden and disruptive changes in policy that would not be in the public interest and would not advance efforts to improve payments system efficiency and safety. Hence, an element of the new strategy is to move toward a greater use of collateral in a way that minimizes the cost and administrative burden of the policy on most users of daylight overdrafts. As a general matter, the Board believes that *requiring* depository institutions to pledge collateral to support daylight overdrafts would be consistent with reducing Reserve Bank credit risk, with existing discount window practices, and with the policies

<sup>19</sup> Pledging collateral is generally limited to securing maximum capacity (overdraft capacity above the net debit cap) or protecting Reserve Banks against risk from problem depository institutions.

<sup>20</sup> Under Operating Circular 1, depository institutions also grant Reserve Banks a lien on certain assets to secure any obligation owing to any Reserve Bank: "To secure any overdraft in the master account, as well as any other obligation, now existing or arising in the future, of the account holder to any Reserve Bank, the account holder grants to the Reserve Bank all the account holder's right, title, and interest in property, whether now owned or hereafter acquired, in the possession or control of, or maintained with, any Reserve Bank."

<sup>21</sup> The current cap is a function of qualifying capital, which varies based on the entity type. The qualifying capital is multiplied by the cap multiplier for cap categories to determine each institution's limit. One limit applies for single-day use and another for two-week average use, but these limits generally are not binding. If an institution exceeds its cap, the Reserve Bank will counsel the institution *ex post*. For additional information, see the Guide to the Federal Reserve's Payments System Risk Policy at <http://www.federalreserve.gov/paymentsystems/psr/guide.pdf>.

of other central banks. The Board is concerned, however, about the potential implications of moving to a mandatory collateral regime at this time, because of the uncertain effects such a move might have on intraday liquidity and operational risk, as well as the burden on the banking industry.<sup>22</sup> The Board will continue to monitor developments over time and to evaluate the costs and benefits of moving further toward a collateralized structure.

**IV. Discussion of Proposed PSR Policy Changes**

To implement this new strategy, the Federal Reserve System will need to adjust its current terms and fees for providing daylight overdrafts. The Board believes that the following points summarize in broad terms the elements of a new PSR policy that would be consistent with such a change in strategy:

- Explicitly encourage the pledging of collateral to support intraday credit and apply unencumbered discount window collateral to intraday credit.

- Eliminate the fee for collateralized intraday credit.
- Increase the fee for uncollateralized intraday credit.
- Retain a modified version of the single-day daylight overdraft cap to limit the ultimate size of Reserve Bank risk exposures.
- Adopt measures to limit the impact of policy changes on depository institutions that are relatively small users of intraday credit.

Table 1 summarizes the specific elements of the current and proposed PSR policy.

TABLE 1.—SUMMARY OF KEY ELEMENTS OF THE CURRENT AND PROPOSED PSR POLICY<sup>23</sup>

	Current policy	Proposed policy
Collateral .....	Required for problem institutions <sup>24</sup> and institutions with max caps. Collateral eligibility and margins same as discount window.	Additional provision that explicitly applies collateral pledged by healthy institutions to daylight overdrafts in their Reserve Bank accounts.
Fee for collateralized daylight overdrafts.	36 basis points .....	Zero fee.
Fee for uncollateralized daylight overdrafts.	36 basis points .....	Increase to 50 basis points.
Deductible .....	10 percent of an institution's capital measure .....	Replaced by zero fee for collateralized daylight overdrafts and increased fee waiver.
Fee waiver .....	Up to \$25 biweekly .....	\$150 biweekly. <sup>25</sup>
Net debit cap .....	Two-week average limit and higher single-day limit .....	Two-week average limit is eliminated; adjusted policy for single-day limit.
Max cap .....	Additional collateralized capacity above net debit cap for self-assessed institutions.	Streamlined process for certain FBOs up to a limit; minor changes for all institutions.
Penalty fee for ineligible institutions.	136 bps .....	Increase to 150 bps.

To assist institutions in understanding the effect of the proposed policy on their daylight overdraft fees, the Board has developed a simplified fee calculator. The calculator enables institutions to provide daylight overdraft and collateral data to estimate their daylight overdraft fees under the proposed policy. The calculator is located on the Board's Web site at <https://www.federalreserve.gov/apps/RPFCalc/>.

*A. Collateral.* To help meet institutions' demand for intraday balances while mitigating Reserve Bank credit risk, the Board would adopt a policy of supplying intraday balances predominately through explicitly collateralized daylight overdrafts provided by Reserve Banks to healthy depository institutions at a zero fee. To avoid disrupting the operation of the

payments system and increasing the cost burden on a large number of smaller users of daylight overdrafts, the Board would allow the use of collateral to be *voluntary*, but a system of two-tiered fees would be adopted to encourage the industry to make greater use of collateral. Unencumbered discount window collateral would explicitly collateralize daylight overdrafts, and collateralized overdrafts would be charged a zero fee. Collateral eligibility and margins would remain the same for PSR policy purposes as for the discount window.<sup>26</sup> In addition, the pledging of in-transit securities would remain an eligible collateral option for PSR purposes at Reserve Banks' discretion.<sup>27</sup>

Of the twenty-three responses to the consultation paper, fourteen commenters addressed the question

regarding greater use of collateral to cover daylight overdrafts. All fourteen commenters supported greater use of collateral (particularly to obtain a lower daylight overdraft fee). A number of the respondents specifically argued for voluntary or partial collateralization of intraday credit. Several respondents also commented that collateralized overdrafts should be free of charge or subject to an adjusted daylight overdraft fee. Most commenters stated that their support for greater use of collateral was contingent upon being able to use unencumbered discount window collateral to support intraday credit.

The Board considered whether it should *require* collateralization of all daylight overdrafts at this time. The Board generally believes that requiring depository institutions to pledge collateral to support daylight overdrafts

<sup>22</sup> Historically, the Board has sought to minimize the cost and administrative burden of the PSR policy on institutions that do not rely significantly on the use of daylight overdrafts to make payments.

<sup>23</sup> Access to daylight credit would continue to be available only to institutions with regular access to the discount window as is the case today.

<sup>24</sup> Problem institutions are institutions that are in weak financial condition and should refrain from incurring daylight overdrafts and institutions that

chronically incur daylight overdrafts in excess of their net debit caps in violation of the PSR policy.

<sup>25</sup> The proposed \$150 waiver would be subtracted from the gross fees (in a two-week reserve-maintenance period) assessed on any depository institution eligible to incur daylight overdrafts. This procedure differs from the current policy in which the waiver only eliminates gross fees of institutions that have charges less than or equal to \$25 in a two-week period.

<sup>26</sup> See <http://www.frbdiscountwindow.org/> for information on the discount window and PSR collateral acceptance policy and collateral margins.

<sup>27</sup> In-transit securities are book-entry securities transferred over the Fedwire securities system that have been purchased by a depository institution but not yet paid for or owned by the institution's customers.

would be consistent with reducing Reserve Bank credit risk, existing discount window practices, and the policies of other central banks. However, the potential effect on intraday liquidity and operational risk, along with the burden on the banking industry of a move to mandatory collateral, suggests caution. For example, requiring collateral could result in institutions being subject to rejected payments or high "penalty" fees if they exceed the amount of pledged collateral, could increase payment queuing by institutions without sufficient collateral to pledge, and could add significant compliance costs to the banking industry. Indeed, one respondent specifically stated in its comment letter that it was not supportive of moving to a mandatory collateral regime for daylight overdrafts even at a zero fee. For all these reasons, at this time, the Board is proposing a voluntary collateral regime for daylight overdrafts.

The Board has long recognized that accepting collateral from institutions

would help control intraday credit risk to Reserve Banks. Moving towards greater collateralization of daylight overdrafts was hampered in the past by concerns about administration costs to depository institutions, incentive effects, and other unintended consequences. Most of these concerns have been addressed over time.

In the early 1980s, the aggregate amount of collateral pledged to the discount window was quite low relative to intraday credit extended, and many depository institutions had not signed the necessary legal agreements with their Reserve Banks. During early PSR policy consultations, there was also concern about the administrative costs of pledging and monitoring additional collateral and about the possibility that Fedwire or other payments could be disrupted if a depository institution did not have sufficient collateral at a particular point during the day. Since the 1980s, however, the quantity of collateral pledged to the discount window has increased dramatically. In particular, pledges to the discount

window began to increase as a result of industry and Federal Reserve actions to address contingencies prior to the century date change and following September 11th.<sup>28</sup> As of year-end 2007, more than \$980 billion in assets were pledged for discount window and PSR purposes, most of which was unencumbered by outstanding discount window loans.<sup>29</sup>

Most of the largest users of daylight overdrafts have sufficient unencumbered collateral pledged to the Reserve Banks to cover their average level of daylight overdrafts. In addition, as table 1 indicates, during the fourth quarter of 2007, fifteen of the twenty largest users of intraday credit would have been able to cover the average peak amount of daylight overdrafts using existing pledged collateral. In particular, the maximum peak overdrafts of eight of these institutions would have been covered by their current collateral pledges. It is highly likely that additional collateral would be pledged to cover intraday credit if appropriate incentives existed.

TABLE 2.—THE NUMBER OF TOP DAYLIGHT OVERDRAFTERS ABLE TO COLLATERALIZE BORROWINGS WITH EXISTING COLLATERAL PLEDGES  
[Q4 2007]

	Cumulative percent of average daylight overdrafts	Number of institutions that have existing collateral to cover:		
		Average daylight overdrafts *	Average peak of daylight overdrafts *	Maximum daily peak of daylight overdrafts
Top 10 .....	75	8	7	3
Top 20 .....	84	18	15	8
Top 50 .....	94	46	40	28
Top 100 .....	97	91	68	47
Top 200 .....	98	174	119	80

\* The data are quarterly averages of daily data.

One issue that has not changed since the 1980s is that a substantial number of depository institutions, mainly smaller institutions, use intraday credit but have not signed borrowing agreements with their Reserve Banks (about 1,500 of 4,400 institutions that make some use of intraday credit). In addition, another 1,700 institutions that use intraday credit have borrowing agreements, but have not pledged any collateral to the Reserve Banks. Thus, the Board recognizes that the policy needs to avoid imposing an undue burden on small users of daylight credit

or on the Reserve Banks. The new fee waiver is intended to minimize the burden on small users of the proposed policy changes.

Another historical administrative concern has been the cost and practicality of Reserve Banks' perfecting their security interests in collateral and monitoring that collateral to manage their credit risk. Today, it is a routine matter for a Reserve Bank to file a Uniform Commercial Code financing statement with state authorities to perfect its security interest in any and all bank assets that are pledged. The

Reserve Banks have implemented automated systems to track collateral held at the Reserve Banks, by third-party custodians, and by the borrowers themselves. In addition, the Reserve Banks monitor borrower eligibility to participate in a borrower-in-custody program. On balance, although improvements can always be made in procedures and systems, significant improvements have been made over time that address the earlier administrative concerns about explicitly collateralizing the daylight overdrafts of

<sup>28</sup> In the early 1990s, the Reserve Banks began standardizing policies regarding eligible asset types, acceptance criteria, and valuation. By the mid 1990s, the Reserve Banks allowed multiparty pledges through DTC. In the late 1990s, the Reserve Banks began using market pricing for securities valuation, started allowing for nonbank custodian

and foreign custodian (Clearstream and Euroclear) arrangements, and began accepting a broader array of asset types of collateral. New types of eligible assets since that time have included non-AAA ABS, AAA collateralized debt obligations, commercial mortgage-backed securities, trust preferred securities, credit union mutual funds, GSE stock,

STRIPS, German jumbo Pfandbriefe, and certain other foreign currency-denominated assets.

<sup>29</sup> This collateral value reflects lendable value based on the Reserve Banks' margins and does not include pledges of in-transit securities.



depository institutions that routinely use large amounts of intraday credit.

In the past, the Board also had concerns that accepting collateral to address Reserve Bank credit risk for daylight overdrafts would not provide strong incentives to reduce the level of intraday credit. In particular, there was concern that because of the wide range of collateral accepted by the Reserve Banks, depository institutions would have weak incentives to reduce their use of intraday credit. Under the new strategy, the purpose of Reserve Banks accepting collateral is not to control the *level* of overdrafts per se, but to mitigate credit risk to the Reserve Banks when they provide intraday balances and credit needed for the smooth operation of the payments system.

Additionally, there was concern that reliance on collateral alone might result in Reserve Banks providing excessive amounts of credit to particular depository institutions and present the Reserve Banks with reputational and residual credit risks. Although the Board proposes to relax some aspects of the net debit cap program, caps on total intraday credit extensions would remain in place to help address these risks. Eliminating the two-week average net debit cap and retaining the higher single-day cap for healthy depository institutions has the effect of raising caps approximately 50 percent from the current policy. This increase coupled with the incentive to collateralize daylight overdrafts is consistent with the strategy of providing additional balances and credit for the payments system. Other central banks that provide collateralized intraday credit at a zero price have not reported problems with excessive growth in the level of intraday credit.

The Board's main concern about unintended consequences has been that by taking collateral, the Reserve Banks could be inadvertently shifting credit risk to unsecured and uninsured creditors of an institution or to the Federal Deposit Insurance Corporation's (FDIC) deposit insurance fund. With regard to unsecured creditors of a depository institution, the concern is whether these creditors would know about the institution's pledge to a Reserve Bank and have an opportunity to reduce their exposure to the depository institution, increase compensation for increased risk, or take other appropriate action. The public filing of financing statements by Reserve Banks and the existence of automated services for searching for liens mitigates this concern.

The Board's concerns about the implications for the FDIC's insurance

fund predate changes in Reserve Bank collateral administration practices and the FDIC's adoption of "least cost" resolution policies pursuant to the FDIC Improvement Act of 1991. The Board believes that the evolution of the PSR policy and related procedures have helped to address its concerns. Under the current PSR policy, an "institution must be financially healthy and have regular access to the discount window" in order to qualify to receive daylight credit from its Reserve Bank.<sup>30</sup> Under the implementation scheme for net debit caps, a financially healthy institution is essentially defined as at least an adequately capitalized depository institution that has a supervisory rating of CAMELS-3 or higher.<sup>31</sup> Moreover, a Reserve Bank may "limit or prohibit an institution's use of Federal Reserve intraday credit if \* \* \* the institution's use of daylight credit is deemed by the institution's supervisor to be unsafe or unsound."<sup>32</sup> Thus, if supervisory issues arise with an institution, supervisors, including the OCC and FDIC, would be and have been consulted about the financial condition of an institution that is using or seeking to use intraday credit. In some circumstances, Reserve Banks impose real-time controls to reject outgoing Fedwire funds transfers that would cause a depository institution's account to exceed a limit, including a limit of zero.<sup>33</sup> While residual risks may exist, PSR policies and procedures as well as FDIC legislation have been significantly enhanced in ways that help control both risk to the Reserve Banks and to the FDIC insurance fund.

On balance, the Board believes that explicitly accepting collateral for daylight overdrafts on a voluntary basis offers important improvements in

policy. In particular, collateralized daylight overdrafts will support liquidity and operational risk reduction for the payments system, long-term credit risk reduction for the Reserve Banks, and a more-reasonable cost burden on the industry.

*B. Fees for collateralized daylight overdrafts.* The Board proposes lowering the fee to zero for collateralized daylight overdrafts to encourage institutions to pledge collateral and to reduce payments held in liquidity-management queues. The value of unencumbered collateral pledged at the Reserve Banks for PSR or discount window purposes would be applied in the determination of daylight overdraft fees assessed to institutions.

Of the twelve commenters that addressed two-tier pricing with a lower fee for collateralized overdrafts, most were highly supportive, particularly if the fee on collateralized daylight credit were zero. The other commenters raised questions or issues for the Board's consideration. For instance, one commenter that supported two-tier pricing expressed some concern about the potential cost and complexity of implementing a two-tier pricing system. Another mentioned the likelihood that two-tier pricing would increase the level of daylight overdrafts. In addition, several institutions specifically collateral pledged to the Reserve Bank for discount window or PSR purposes be considered in calculating an institution's fees.

The Board has previously raised the possibility of a two-tier pricing system for collateralized and uncollateralized daylight overdrafts. In 2001, the Board requested comment on two-tier pricing as a long-term PSR policy direction.<sup>34</sup> Then, as now, most commenters were supportive of such a regime. In August 2002, the Board stated that it would continue to study two-tier pricing for collateralized and uncollateralized overdrafts.<sup>35</sup> The Board also specified that the Reserve Banks would charge the collateralized rate on daylight overdrafts up to the value of collateral pledged and then apply the uncollateralized rate to the remaining daylight overdrafts.

To determine a collateralized fee, the Board has reviewed historical papers and discussions of overdraft pricing, industry comments and discussions surrounding the consultation paper, and the practices of other major central banks. There is no definitive economic literature on whether there is a nonzero intraday rate of interest that should be

<sup>30</sup> See the Payment System Risk Policy at <http://www.federalreserve.gov/paymentsystems/psr/policy07.pdf>, p. 22.

<sup>31</sup> The CAMELS ratings apply to commercial banks, savings and loan associations, natural person credit unions, and bankers' banks. Other supervisory rating structures apply for FBOs and corporate credit unions. The Reserve Banks use these supervisory ratings and other factors to determine credit risk and whether they will extend daylight overdraft capacity.

<sup>32</sup> See the Policy on Payment System Risk at <http://www.federalreserve.gov/paymentsystems/psr/policy07.pdf>, p.23.

<sup>33</sup> The Reserve Banks use real-time monitoring to prevent selected institutions from effecting certain transactions—outgoing Fedwire funds transfers, National Settlement Services transactions, or automated clearing house (ACH) credit originations—if their accounts lack sufficient funds to cover the payments. Generally, a Reserve Bank will apply real-time monitoring to an institution's position when the Reserve Bank believes that it faces a greater level of risk exposure, for example from problem institutions or institutions with chronic overdrafts in excess of what the Reserve Bank determines is prudent.

<sup>34</sup> 66 FR 30208, June 5, 2001.

<sup>35</sup> 67 FR 54424, August 22, 2002.

used in calculating fees for collateralized intraday central bank credit. There are different views. One view argues that it would be anomalous if the general term structure of interest rates contained a major discontinuity between the overnight rate and the intraday rate but without showing how to determine the existence and level of an intraday rate. Another view essentially holds that intraday balances provided by central banks should be priced at the marginal social cost of production, which is approximately zero for central banks. This view is reinforced by recent academic work suggesting that the role of central bank intraday balances and credit is to help coordinate the settlement of payments and not ultimately to finance underlying real economic activity.

From the economic literature, a reasonable perspective is that central banks should target a rate for providing collateralized daylight balances and credit that advances the policy objectives of the central bank. Further, because there is no evidence from other countries that intraday rates affect central bank macroeconomic goals, such as inflation or unemployment, a central bank has the flexibility to set an intraday rate to advance its payments system objectives of safety and efficiency. This is the intraday credit pricing strategy generally followed by other major central banks, and there have not been any reported effects on the central banks' ability to achieve their monetary policy objectives.

The Board's view is that setting the collateralized daylight overdraft fee at zero would improve tradeoffs among liquidity, operational, and credit risks in the payments system. Although the amount of intraday credit provided could well increase, credit risk to the Reserve Banks would be controlled by traditional banking tools used in providing credit (eligibility requirements, collateral, caps, and monitoring). The Board also believes that credit risk to depository institutions could decrease somewhat because greater liquidity would imply faster payments and settlements and a correspondingly shorter duration of intraday risk on customer accounts and counterparty settlements. Similarly, liquidity would likely circulate more quickly with the faster flow of payments as the incentive for depository institutions to queue payments for liquidity purposes declines. Operational risk from late-day payments would also likely decline somewhat if depository institutions release payments generated earlier in the day from their internal afternoon liquidity queues.

In addition, some theoretical literature and discussions with bankers suggest that setting the collateralized fee at even a low rate above zero might continue to provide incentives to queue and delay payments. For example, small incentives can lead to strategic behavior by depository institutions in which each waits for the other to send payments that essentially provide the liquidity to avoid (priced) daylight overdrafts, which in turn leads to a generalized delay of payments until late in the day. Discussions with depository institutions tend to confirm that, if a payment is not time-sensitive, they may very well hold that payment to reduce overdraft charges that affect their budgets. Thus, the Board believes that the industry may continue to hold back payments at any positive fee for collateralized intraday credit.

The Board recognizes that a zero fee for collateralized intraday credit is unlikely to reduce the share of late-day payments back to pre-2000 levels. As validated by the PRC and WCAG survey, a number of late-day payments are not originated until late in the day, and many of these are unlikely to be affected by changes to daylight overdraft fees. For example, late-day money market investments will of necessity generate late-day payments.

In weighing the reasons for charging a zero fee for collateralized daylight overdrafts, the Board identified at least two potential unintended consequences. First, the Board is concerned that a zero fee for collateralized overdrafts could eliminate incentives for depository institutions and their customers to return securities used in repurchase agreements early in the morning. The practice of early return grew out of a coordinated effort by the clearing banks and the market to respond to the implementation of overdraft fees in 1994 by delivering government and agency securities held under certain types of repurchase agreements back to borrowers of funds and their banks early in the morning.<sup>36</sup> The concern is that removing the overdraft fee could remove

<sup>36</sup> These deliveries take place over the Fedwire securities (delivery-versus-payment) system, with the account of the depository institution delivering securities credited with the accompanying funds and the depository institution receiving the security debited for those funds. The depository institutions and their large customers delivering securities control the delivery process. Fees provide a significant incentive for institutions to return (deliver) securities early in the day and obtain the corresponding funds credits in order to limit daylight overdrafts at a Reserve Bank. These early deliveries have the corresponding effect of generating priced daylight overdrafts in the accounts of institutions receiving securities, which, in turn, provides incentives to settle new trades or initiate new deliveries quickly.

the incentive for the early returns of securities, which has been viewed as an important operational success in the securities industry. Initial discussions with some depository institutions suggest that the early return of securities has become an entrenched practice in the market and it would not be reversed if there were a zero fee for collateralized daylight overdrafts.

Second, the Board is concerned that a collateralized overdraft fee of zero would reduce the incentives of depository institutions to invest in a new liquidity-saving mechanism for the Fedwire funds transfer system or to improve practices in using CHIPS or DTC.<sup>37</sup> This is a clear risk to the overall four-prong strategy for addressing liquidity, operational, and credit risk. Other countries, such as Germany, have seen a demand for liquidity-saving mechanisms even with zero overdraft fees, but those demands may have been motivated by depository institutions' desire to save collateral capacity in a regime of mandatory collateralization of intraday credit.

While the Board is concerned about these possible unintended consequences, it must balance these concerns with its goal of reducing liquidity, operational, and credit risks. On balance, the Board believes that charging a zero fee for collateralized overdrafts will contribute to overall risk reduction.

*C. Fees for uncollateralized daylight overdrafts.* In a regime in which the Board expects the pledging of collateral to become the norm, but remain voluntary to avoid the disruptions of rejecting payments that could occur under mandatory collateralization, the fee for uncollateralized overdrafts takes on a new role of providing a significant incentive to collateralize overdrafts. In the past, the Board has suggested assessing a "risk premium" for uncollateralized overdrafts by estimating the spread between the overnight Federal funds rate and the Treasury general collateral repo rate.<sup>38</sup> In 2001, the Board cited a risk premium of 12 to 15 basis points.<sup>39</sup> Although the

<sup>37</sup> Work with the industry on models for a liquidity-saving mechanism for the Fedwire funds transfer system began in August 2007.

<sup>38</sup> The spread between the *overnight* Federal funds rate and the Treasury general collateral repo rate can be used as a proxy or measure of credit risk. The spread can be volatile over short periods, reflecting changes in the availability of Treasury collateral. The average spread since 1991 is 7 basis points, with a standard deviation of 17 basis points. From 2000 to 2007, the average spread was between 6 and 10 basis points, while from mid-1980 to 2000, the spread was closer to 12 to 15 basis points.

<sup>39</sup> See 66 FR 30208, June, 5, 2001.

current fee of 36 basis points is higher than this risk premium if a zero fee is charged for collateralized daylight overdrafts, the fee arguably reflects allowances for variation in the risk premium across time and across borrowers.<sup>40</sup> Under the proposed strategy to encourage the voluntary pledging of collateral, the Board proposes a more-significant spread between collateralized and uncollateralized daylight overdrafts that exceeds previous estimates of the risk premium. Specifically, the Board proposes raising the fee to 50 from 36 basis points (annual rate) for uncollateralized daylight overdrafts to encourage the collateralization of daylight overdrafts.<sup>41</sup> The Board notes that the proposed 50 basis point fee for uncollateralized credit would be less than the final fee of 60 basis points for daylight credit originally announced by the Board in 1994 but never implemented.<sup>42</sup>

The 50 basis point fee for uncollateralized overdrafts would provide a strong incentive for a depository institution to pledge collateral to its Reserve Bank in an amount sufficient to reduce or eliminate the depository institution's charges for its use of daylight credit. In addition, the fee for uncollateralized credit would discourage the use of uncollateralized daylight credit by those depository institutions that have not pledged sufficient collateral to support their payments activity. If uncollateralized credit increases, however, the fee for uncollateralized credit could be raised at a future date to limit further the use of such credit. At this time, the 50 basis point spread between collateralized and uncollateralized daylight overdrafts

sufficiently underscores the Board's new strategy about the importance of pledging collateral to obtain intraday balances *and* to reduce the Reserve Banks' credit risk.

*D. Deductible.* The Board has long sought to minimize the burden of the PSR policy on institutions that use small amounts of daylight overdrafts by adopting a series of special provisions in the administration of daylight overdraft pricing and net debit caps. These provisions reflect the highly concentrated incidence of overdrafts at twenty depository institutions, which incur about 80 percent of daylight overdrafts. Two important components of the current PSR policy are the deductible from daylight overdraft fees based on an institution's capital and a \$25 biweekly fee waiver.<sup>43</sup> In essence, an amount of free uncollateralized intraday credit is provided through these provisions. The Board proposes to eliminate the deductible but also proposes to increase the fee waiver (discussed in the next section) to minimize the burden of the policy changes on small users of daylight overdrafts.

Continuing to provide significant amounts of free uncollateralized credit to large institutions through the deductible would be inconsistent with the strategy of emphasizing the provision of intraday credit through *collateralized* overdrafts at a zero fee. Retaining the deductible would weaken the incentives for depository institutions to pledge collateral to cover overdrafts and would not decrease risk to the Reserve Banks. In particular, the largest users of daylight credit would be able to use collateral to cover a significant portion of their overdrafts and then use their deductible to avoid fees on a significant amount of uncollateralized credit, undermining the incentive effects of fees on uncollateralized daylight overdrafts. Further, to the extent the deductible historically provided a source of free liquidity to depository institutions, it would no longer be needed because collateralized credit would provide an alternative source of free intraday

liquidity. In addition, eliminating the deductible and increasing the fee waiver would provide a simpler and more-uniform way to provide a *de minimis* amount of free uncollateralized credit and would help limit the cost burden of the policy on small users of daylight overdrafts.

Further, the Board believes that by eliminating the deductible for *all* depository institutions and providing free *collateralized* intraday credit to eligible depository institutions, including FBOs, the proposed policy changes would address the negative incentive effects of the deductible calculations on FBOs that the commenters identified. FBOs would be assessed the same fees as U.S.-chartered depository institutions, which, under the proposal, would be zero for collateralized daylight overdrafts and 50 basis points for uncollateralized overdrafts.

*E. Fee waiver and treatment of small users of daylight overdrafts.* The Board continues to believe that it is important to reduce the burden of the PSR policy on institutions that use small amounts of daylight overdrafts. In setting the fee waiver amount, the Board sought to balance the risk faced by Reserve Banks from uncollateralized overdraft exposures against the administration costs to Reserve Banks and depository institutions from fee assessments and collateral arrangements. The Board proposes to limit the burden for institutions that use small amounts of daylight overdrafts by increasing the fee waiver to \$150 from \$25. The waiver would be subtracted from the gross fees (in a two-week reserve-maintenance period) assessed on any user of daylight overdrafts.<sup>44</sup> This procedure differs from the current policy in which the waiver only eliminates gross fees of institutions that have charges less than or equal to \$25 in a two-week period. This approach would avoid a discontinuity in applying the waiver, which may create incentives for delaying payments to prevent a large marginal increase in fees.

An institution is defined as a small user of daylight credit if the institution has an exempt cap, which is the smallest positive cap under the policy, or if the institution averages less than \$1 million a day in daylight overdrafts. The Board has historically considered exempt-cap institutions to be small users of daylight overdrafts.<sup>45</sup> In

<sup>40</sup> Another possible proxy of credit risk is the rate associated with credit default swaps for major depository institutions. Between January 2001 and December 2007, the median spread for an index of one-year credit default swaps on major depository institutions was 10 basis points (standard deviation of 10 basis points). The minimum and maximum for the index were 1 and 63 basis points, respectively.

<sup>41</sup> In calculating an institution's fees, the value of collateral pledged to the Reserve Banks will be subtracted from negative account balances at the end of each minute. All minutes where the negative account balance exceeds the value of collateral pledged will be summed and divided by the number of minutes in the Fedwire operating day to arrive at a daily uncollateralized daylight overdraft, which would be assessed the 50 basis point (annual) fee. The value of collateral pledged is the same for PSR and discount window purposes.

<sup>42</sup> As a result of the sizeable reductions in daylight overdrafts achieved by the introduction of fees, as well as concerns about the possible effects of further rapid fee increases, the Board announced in March 1995 that it would increase the fee to 36 basis points rather than the planned 48 basis points. Originally, the Board planned to phase in over three years a fee of 60 basis points in steps of 24, 48, and 60 basis points.

<sup>43</sup> Daylight overdraft charges are reduced by a deductible, which is calculated using 10 percent of eligible capital. The deductible was created with the introduction of pricing to provide some amount of free liquidity to the payments system, to compensate depository institutions for periodic outages of Reserve Bank computer systems, and to enhance operational simplicity by exempting small users of intraday credit. The Reserve Banks also waive fees of up to \$25 or less in any two-week reserve-maintenance period. The waiver reduces administrative burden on Reserve Banks and a large number of depository institutions that incur small fees.

<sup>44</sup> The proposed waiver would not result in refunds or credits to an institution. The waiver would not apply to institutions subject to the penalty fee.

<sup>45</sup> See 51 FR 45054, December 16, 1986, and 52 FR 29255, August 6, 1987.

addition, a number of institutions with higher cap levels regularly incur similar small amounts of daylight overdrafts. The level of \$1 million, in 2007 dollars, is based on levels historically considered small.<sup>46</sup> Through the waiver, the Board intends to limit the burden for virtually all exempt-cap institutions and to cover the routine overdraft activity of institutions that average less than \$1 million a day in daylight overdrafts.

The Board considered a range of waiver amounts from \$100 to \$250. At the \$150 waiver, the amount of free credit provided limits the burden for virtually all exempt-cap institutions and covers the routine overdraft activity of small users. Beyond a \$150 waiver, the number of small users that would be paying higher fees diminishes only marginally, and mid-to-large users of

daylight overdrafts benefit increasingly. On balance, the Board determined that the associated increase in uncollateralized Reserve Bank exposure per day of increasing the waiver amount outweighed the marginal decrease in the number of small users paying higher fees. In addition, a higher waiver amount would decrease the incentive to pledge collateral for those mid-to-large users of daylight overdrafts benefiting from the waiver increase.

Based on fourth-quarter 2007 daylight overdraft and collateral values, table 3 shows that the proposed \$150 waiver would eliminate or reduce fees for 99.2 percent of small users of daylight overdrafts. The vast majority of these institutions do not pay fees under the current policy. The waiver, however, would not eliminate or reduce fees paid

for *all* small users because some of these institutions incur relatively high daylight overdrafts on peak days, which could result in fees. In particular, the \$150 waiver generally covers routine daylight overdraft activity for small users but may not cover the highest one or two business days in the quarter. Because of this peak overdraft activity, an estimated thirty-five small users could pay higher fees based on fourth-quarter data if they did not pledge (additional) collateral. The actual number of depository institutions that could incur higher fees will vary over time based on daylight overdrafts incurred and collateral pledged. In practice, there are few institutions, especially small users, that would pay fees across all two-week periods in which fees are assessed in a given year.

**Table 3**

**Depository institutions (DIs) paying higher or lower fees after applying the \$150 waiver  
(Q4 2007)**

	Number of DIs	Percent of DIs	Percent with collateral pledged	Percent with borrowing documents submitted	Average annual increase in fees <sup>47</sup>
<b>Small users</b>					
Paying lower or no fees	4,100	99.2%			
Paying higher fees	35	0.8%	14.3%	65.7%	\$180
Total	4,135	100%			
<b>Mid-to-large users</b>					
Paying lower or no fees	135	51.9%			
Paying higher fees	125	48.1%	57.6%	92.8%	\$18,350
Total	260	100%			
<b>All users</b>					
Paying lower or no fees	4,235	96.4%			
Paying higher fees	160	3.6%	48.1%	86.9%	\$14,300
Total	4,395	100%			

The average annual increase in fees for each of the thirty-five institutions is approximately \$180. Of the thirty-five institutions, a small number could incur an increase in average fees between \$500 and \$1,000 in a year, while the other institutions could incur increases of less than \$500 in a year (or less than

\$20 in a two-week period). The higher fees are associated with peak levels of daylight overdraft activity relative to the amounts of collateral pledged. Each small user could eliminate increases in fees by pledging \$8 million, on average, in (additional) collateral. As of the fourth-quarter 2007, only about 14

percent of these small users had collateral pledged, although two-thirds had signed borrowing documents with their administrative Reserve Banks.

Table 3 also shows that over half (52 percent) of institutions that incur mid-to-high levels of daylight overdrafts (mid-to-large users) would have

<sup>46</sup> See 51 FR 45054, December 16, 1986.

<sup>47</sup> The fee data for mid-to-large users and all users exclude one institution that is an outlier in comparison to the other institutions that could be

paying higher fees. The annual average increase in fees more than doubles for mid-to-large institutions and all users with the inclusion of this institution. This institution would incur a fee increase of

almost \$3 million per year. The next highest increases in fees are \$475,000 and \$260,000 per year.

sufficient collateral to eliminate or reduce their fees paid, while slightly less than half (48 percent) of mid-to-large users could face higher fees or would need to pledge collateral. Much of their overdraft activity was excluded from fees under the deductible of the current policy.

The average annual increase in fees across the 125 mid-to-large users paying higher fees is approximately \$18,350 (or \$690 per two-week period). The large majority of these institutions (about 75 percent) would incur an increase in average fees of less than \$10,000 per year (less than \$375 in a two-week period). Many of the mid-to-large users have pledged collateral and have signed borrowing documents. Pledging (additional) collateral of \$90 million on average per institution would avoid any increase in fees.

The Board recognizes that institutions will be interested in the effect of the proposed changes on their daylight overdraft fees. To assist institutions, the Board has developed a simple fee calculator. The calculator enables institutions to provide daylight overdraft and collateral data to estimate their daylight overdraft fees under the proposed policy. The calculator is located on the Board's Web site at <https://www.federalreserve.gov/apps/RPFCalc/>.

*F. Net debit caps.* Based, in part, on the expectation of some additional collateralization of daylight overdrafts and the potential need to provide more credit to the industry, the Board proposes to eliminate the current two-week average cap on daylight overdrafts for healthy depository institutions and retain the higher single-day cap. The effect is to increase the routine daylight overdraft capacity of healthy institutions with self-assessed caps approximately 50 percent from the current policy. The single-day cap will apply to the total of collateralized and uncollateralized daylight overdrafts.

The Board also proposes to provide additional flexibility in the administration of net debit caps for fully collateralized daylight overdrafts. If an institution incurs an overdraft above its single-day cap, the Board proposes the following new ex post monitoring and counseling procedures.

(1) If any part of the overdraft is *uncollateralized*, the current ex post counseling regime would be used.<sup>48</sup>

<sup>48</sup> The ex post counseling regime includes a series of actions by the Reserve Bank that are aimed at deterring an institution from violating the PSR policy by exceeding its net debit cap. These actions depend on the institution's history of daylight overdrafts and financial condition. Initial actions taken by the Reserve Bank may include an

Counseling may include a discussion of ways the institution could manage more effectively its account as well as other possible Reserve Bank actions, such as reducing the net debit cap and rejecting certain payment transactions, that would enable the Reserve Bank to protect its risk exposure from the institution.

(2) If the overdraft is *fully collateralized*, the Reserve Bank would generally consider the condition an "overlimit" situation and would be able to "waive counseling" for two incidents of overlimit, fully collateralized overdrafts per two consecutive reserve-maintenance periods (four weeks). Incidents of overlimit, fully collateralized overdrafts beyond the two waivable incidents would be subject to ex post counseling.

The overlimit flexibility would apply to institutions that have *de minimis* or self-assessed net debit caps or max caps.<sup>49</sup> Exempt-cap institutions are already allowed under the policy to incur up to two cap breaches in two consecutive reserve-maintenance periods. Zero cap institutions would not be eligible. The overlimit flexibility would also be in addition to other permissible waivers, such as waivers due to Reserve Banks' errors.

The overlimit flexibility allows a depository institution to obtain additional fully collateralized credit beyond the established single-day cap on an infrequent basis if the depository institution has *fully collateralized all of its daylight overdrafts—both those above and those below its cap—when the event occurs*. The proposed waiver of counseling for overlimit overdrafts, if they are fully collateralized, reflects their lower risk to a Reserve Bank relative to an overlimit condition for

assessment of the causes of the overdrafts, a counseling letter to the institution, and a review of the institution's account-management practices. If policy violations continue to occur, the Reserve Bank may take additional actions, which may include encouraging the institution to file a cap resolution or perform a self-assessment to obtain a higher net debit cap or to apply for maximum daylight overdraft capacity. In situations in which an institution continues to violate the PSR policy, and counseling and other Reserve Bank actions have been ineffective, the Reserve Bank may assign the institution a zero cap. The Reserve Bank may also impose other account controls that it deems prudent, such as requiring the institution to pledge collateral, imposing clearing balance requirements; rejecting Fedwire funds transfers, ACH credit originations, or National Settlement Service transactions that would cause or increase an institution's daylight overdraft; or requiring the institution to prefund certain transactions.

<sup>49</sup> FBOs will continue to be monitored at their cap level in real time. If an institution's account is monitored in real time, any outgoing Fedwire funds transfer, National Settlement Service transaction, or ACH credit origination that exceeds available funds is rejected.

uncollateralized credit. The Board recognizes that the Reserve Banks may need to be flexible in granting fully collateralized credit to carry out the intent of the new policy. The additional flexibility also reinforces the new explicit policy emphasis on collateralized intraday credit. The limited number of waivers, however, reflects the fact that collateral may not fully protect a Reserve Bank and that frequent breaches of agreed caps may reflect other concerns about a depository institution, including an inability to manage its account at a Reserve Bank or to manage its customers' activity. In addition, max caps would continue to be available at a Reserve Bank's discretion to deal with cases in which routine additional capacity is needed by healthy institutions.

The overlimit flexibility also recognizes that from a supervisory perspective counterparty credit risk management systems allow for bank management to approve exceptions to those limits under appropriate conditions, assuming the proper degree of management attention is focused on such decisions. A waiver of what is currently called a "breach" of a daylight overdraft cap can be likened to an "approval" of an overlimit condition vis-à-vis a counterparty credit risk exposure limit.

The Board examined the need to retain the net debit cap structure for institutions that fully collateralize overdrafts and concluded that it is still appropriate and prudent to have limits on intraday credit even when the credit is fully collateralized. First, prudent banking practice and current supervisory guidance support placing limits on counterparty credit exposures even when other tools such as collateral (with haircuts) are used to control risk. The basis for this guidance is that collateral alone should not be regarded as sufficient protection against counterparty credit risk but that a range of tools should be used to manage risk, including credit limits. Haircuts on collateral help mitigate the risk that counterparty credit exposure that is intended to be collateralized will remain collateralized when the value of the collateral declines. Haircuts themselves, however, may change more slowly than the value of collateral for a variety of operational, market, and policy reasons. Limits or caps complement the use of collateral in risk mitigation. Among other things, they aim to constrain the size of exposures in the first place rather than to mitigate the risk of loss on exposures of a given size. Moreover, limits may be used to limit

exposure to extreme risks and take some pressure off the use of haircuts to address such risks.

Second, daylight overdrafts operate more like drawings on lines of credit than discrete loans. Limits help the Reserve Banks set expectations about the quantity of their potential exposures and help depository institutions to keep their use of credit within prudent and agreed-upon bounds. Further, credit limits serve as standardized benchmarks for analyzing and comparing credit usage across depository institutions and over time.

Third, the net debit caps, in particular, are based on customer account and operational management policies at a depository institution in addition to factors such as credit risk. Specifically, depository institutions are required under the PSR policy to take four factors into account when determining self-assessed caps, including their creditworthiness; intraday funds management and related controls; customer credit policies and related controls; and operating controls and contingency procedures. These factors figure prominently in supervisory guidance on managing risk in wholesale payments systems and are also based on recommendations provided to the Board by the banking industry in the 1980s.<sup>50</sup> The issue of reputational risk is also a factor in current supervisory guidance. The process of establishing and renewing caps compels a depository institution and its management to focus on a range of interrelated aspects of risk in controlling credit and operational exposures both to a depository institution and to Reserve Banks.

Overall, there is a reasonable and prudent basis for placing caps on collateralized overdrafts. Hence there is also a reasonable and prudent basis for placing caps on overdrafts that are collateralized voluntarily or not collateralized at all.<sup>51</sup> The Board

<sup>50</sup> See Association of Reserve City Bankers, *The Final Report of the Risk Control Task Force*, prepared with the assistance of the Bank Administration Institute and Robert Morris Associates (October 1984).

<sup>51</sup> Limits on daylight overdrafts also address the possibility of "adverse selection" in a system of voluntary collateralization. In essence, depository institutions in weaker operational or financial condition might be quicker to pledge collateral to obtain larger amounts of intraday credit than stronger banks, for example, to ensure that critical payments are made on time. In the theoretical literature, caps or limits are frequently characterized as helping to deal with adverse selection issues in credit markets. Although Reserve Banks typically have access to supervisory information about their borrowers, including their history and management, the Reserve Banks may have imperfect information, which may be another

recognizes that other central banks have not employed net debit caps in addition to collateral in managing risk from intraday credit. Most central banks seem to have viewed the provision of intraday credit as a simple extension of practices with respect to overnight credit policy. These central banks, however, have adopted *mandatory* collateral policies and typically accept a much smaller range of collateral than the Reserve Banks. Further, some major central banks have not had the technical capability to conduct the comprehensive centralized tracking of intraday credit extensions that has been developed by the Federal Reserve over the past twenty years.

Lastly, the Board considered the FBOs' request to increase the fractions used to calculate the U.S. capital equivalency in determining net debit caps. Under the current policy, the most-highly rated FBOs receive 35 percent (instead of 100 percent) of their worldwide capital for the U.S. capital equivalency. FBOs with weaker ratings receive lower measures of U.S. capital equivalency. In 2007, FBOs as a group incurred average peak overdrafts that were less than 50 percent of their single-day capacity. A few FBOs may approach their cap limits on certain liquidity-intensive payment days, but it does not appear that FBOs are generally constrained by current cap levels. The Board recognizes, however, that the behavioral changes of individual FBOs and other depository institutions following a change in daylight overdraft policy are somewhat uncertain. For example, some institutions may prefer to release payments more quickly, incurring periods of increased daylight overdrafts, if they have the capacity to do so. To facilitate the earlier release of payments, the Board is proposing to streamline the process for the maximum daylight overdraft capacity (max cap) program, which provides additional capacity on a fully collateralized basis, for certain FBOs (discussed in the next section).

*G. Maximum daylight overdraft capacity.* Currently, depository institutions with self-assessed net debit caps are eligible to pledge additional collateral to their Reserve Banks to secure intraday credit in excess of their net debit cap under the max cap program.<sup>52</sup> As part of the consultation

argument for caps as a useful tool in limiting residual risk from such problems.

<sup>52</sup> Current procedures associated with max caps can be found in the *Guide to the Federal Reserve's Payments System Risk*, which is available at <http://www.federalreserve.gov/paymentsystems/psr/mainguide.pdf>.

process, the Board received two comments on the max cap program. The commenters indicated preferences for greater flexibility and consistency across Reserve Banks in the implementation of the program.

Under the new strategy, the max cap would continue to act as a tool to provide healthy institutions with flexibility in addressing their intraday liquidity needs. In particular, the Board proposes to take a more-favorable view of extending collateralized credit to financially sound institutions demonstrating a business need for additional daylight overdraft capacity. The current policy states:

An institution with a self-assessed net debit cap that wishes to expand its daylight overdraft capacity by pledging collateral should consult with its administrative Reserve Bank. Institutions that request daylight overdraft capacity beyond the net debit cap must have already explored other alternatives to address their increased liquidity needs. The Reserve Banks will work with an institution that requests additional daylight overdraft capacity to determine the appropriate maximum daylight overdraft capacity level. In considering the institution's request, the Reserve Bank will evaluate the institution's rationale for requesting additional daylight overdraft capacity as well as its financial and supervisory information.

The Board proposes to remove the requirement that institutions must have already explored other alternatives to address their increased liquidity needs. This statement is inconsistent with the proposed strategic direction of the new policy. A depository institution interested in obtaining a max cap would still need to contact its administrative Reserve Bank, which would work with the institution to determine an appropriate capacity level and would assess relevant financial and supervisory information in making such a credit decision.

In addition, the Board proposes allowing an FBO that is a financial holding company or SOSA 1-rated institution to request from its administrative Reserve Bank a max cap without documenting a specific business need for additional capacity or providing a max cap board of directors resolution.<sup>53</sup> The streamlined max cap would enable these FBOs to acquire additional capacity that in total would provide up to 100 percent of worldwide capital times the self-assessed cap multiple. A financial holding company is currently eligible for uncollateralized capacity of 35 percent of worldwide

<sup>53</sup> The FBO would still be required to complete a self-assessment and provide a board of directors resolution for the self-assessed cap.

capital times the cap multiple. The streamlined max cap would provide additional *collateralized* capacity of 65 percent of worldwide capital times the cap multiple.<sup>54</sup> While streamlined, the Reserve Bank would retain the right to assess the ability of eligible FBOs to manage the intraday capacity permitted by the max cap as part of reviewing financial and supervisory information. Specifically, the Reserve Bank, in consultation with the home country supervisor, would engage in initial as well as periodic dialogue with the institution that is analogous to the periodic review of liquidity plans performed with U.S. institutions to ensure the institution's intraday liquidity risk is managed appropriately.

The Board believes the streamlined max cap is appropriate for the group of FBOs with which the Reserve Banks have lower supervisory concerns. If an FBO requests capacity in excess of 100 percent of worldwide capital times the self-assessed cap multiple, however, it would be subject to the full max cap process applicable to all institutions.

*H. Foreign Banking Organizations.* The fractional allowance for worldwide capital of FBOs used in calculating net debit caps and deductibles historically has been based on risk differences between FBOs and U.S.-chartered depository institutions. The Federal Reserve's access to supervisory information on FBOs is generally not as timely or complete as the information about U.S.-chartered institutions. In addition, the Federal Reserve incurs legal risk with respect to the application of foreign insolvency laws to FBOs. The existing cap limit and daylight overdraft fee have helped to control credit risk from FBOs to the Reserve Banks.

The Board, however, is proposing several changes to the treatment of FBOs under the PSR policy that would address the concerns of the FBOs while managing the risk to the Reserve Banks. The Board believes that by eliminating the deductible for *all* depository institutions and providing free *collateralized* intraday credit to eligible depository institutions, including FBOs, the proposed policy changes would address the negative incentive effects of the deductible calculations that the commenters have identified. In addition, as discussed in the previous section, the Board proposes to streamline the max cap process for certain FBOs. Today, if an FBO is

constrained by the cap limit on a frequent basis or on specific days, it may apply to its Reserve Bank for a max cap. While the Board believes this program has provided sufficient flexibility for FBOs to obtain additional capacity, the Board recognizes that the business case and board of directors resolution required to obtain a max cap could be slow or cumbersome. This procedure may not be warranted for financial holding companies and SOSA-1-rated FBOs to acquire additional capacity that in total provides up to 100 percent of worldwide capital times the self-assessed cap multiple.

*I. Penalty fees.* Institutions that do not have regular access to the discount window are not eligible under the PSR policy to incur daylight overdrafts. In 1994, the Board announced that it would apply a penalty fee to these institutions if they did incur daylight overdrafts.<sup>55</sup> The Board believed that the penalty rate would provide incentives to these institutions to avoid situations that could cause a daylight overdraft. The penalty rate adopted by the Board was equal to the regular daylight overdraft fee plus 100 basis points. Thus, given the proposed increase in the fee for uncollateralized daylight overdrafts, the Board proposes to increase the penalty fee correspondingly from 136 to 150 basis points.

*J. Timing considerations and issues for Reserve Bank and depository institution implementation.* The Reserve Banks will need a significant lead time to adjust internal processes and systems to the proposed PSR policy changes. These changes will affect the Reserve Banks' credit risk management and accounting software applications. The Board anticipates that institutions' systems could also require some adjustments. The Board expects that a revised PSR policy could be implemented in approximately two years from the announcement of a final rule. The Board, however, could implement the proposed changes to the max cap program for FBOs on an earlier date.

## V. Questions

The Board requests comments on all aspects of the proposed PSR policy changes, including the new strategy, collateral, fees for collateralized daylight overdrafts, fees for uncollateralized daylight overdrafts, net debit caps, max caps, deductibles, fee waivers, penalty fees, and implementation timeline.

In addition to comments on all aspects of the proposed PSR policy changes, the Board would appreciate responses to the following questions.

### General

(1) Does your institution believe that the introduction of a zero fee for collateralized daylight overdrafts will contribute to an overall reduction in liquidity, operational, and credit risks in the payments system? Would it reduce these risks for depository institutions, their customers, or financial utilities?

(2) What procedural or systems changes do you expect to make as a result of this proposed policy change?

### Collateral

(3) Does your institution regularly use Federal Reserve daylight credit, and does your institution currently have sufficient unencumbered eligible collateral to pledge to the Reserve Banks to take advantage of a zero fee for collateralized overdrafts? By your estimate, what proportion of your expected average and peak overdraft would you intend to collateralize?

(4) Would your institution's intraday credit use increase or decrease from current levels? Do you expect the intraday credit usage of depository institutions as a group to increase or decrease from current levels?

(5) While the proposal envisages no fee for collateralized overdrafts, institutions will face an opportunity cost to pledge collateral. How difficult or costly would it be to collateralize daylight overdrafts? What opportunity costs would your institution face in pledging (additional) eligible assets to the Reserve Bank to collateralize daylight overdrafts? What are the costs of entering into the Reserve Banks' borrowing documents?

(6) How would the adoption of this new PSR strategy, which explicitly links collateral to daylight overdrafts and pricing of daylight overdrafts, affect the availability of collateral for other financial market activity? How might it affect other creditors and other payments system participants?

(7) What (additional) collateral management capabilities would your institution expect of its Reserve Bank (such as changes to the frequency or means of obtaining collateral reports, the ability to move directly and quickly collateral in and out of pledge accounts, and so on)?

(8) If you do not currently have a borrowing agreement or pledge any collateral, would you expect to do so? If so, would the rationale rest on the use of daylight overdrafts or overnight extensions of credit?

<sup>54</sup> A SOSA-1 rated institution is eligible for uncollateralized capacity of 25 percent of worldwide capital times the cap multiple. The streamlined max cap would provide additional *collateralized* capacity of 75 percent of worldwide capital times the cap multiple.

<sup>55</sup> See 59 CFR 8979, February 24, 1994.

## Pricing

(9) To what extent would your institution make payments earlier in the day as a result of the proposed pricing changes? If your institution holds payments in a liquidity queue, would your institution continue to hold payments, particularly large-value payments, in a liquidity queue under the proposed policy changes? If so, under what circumstances would your institution continue to queue payments? What further steps would encourage queue reductions?

(10) Does your institution believe that the introduction of a zero fee for collateralized daylight overdrafts could lead to changes in practices for returning early securities used in repurchase agreements? What changes might institutions expect?

(11) Does your institution believe that the introduction of a zero fee for collateralized daylight overdrafts and the higher (50 basis point) fee for uncollateralized daylight overdrafts could lead to changes in practices for the early return of fed funds loans? What changes might institutions expect?

(12) If your institution would face potentially higher fees on its daylight overdrafts, how will your institution adjust its collateral position or payments activities in response to the Board's proposed fees?

## VI. Competitive Impact Analysis

The Board has established procedures for assessing the competitive impact of a rule or policy change that has a substantial effect on payments systems participants.<sup>56</sup> Under these procedures, the Board assesses whether a change would have had a direct and material

<sup>56</sup> 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).

adverse effect on the ability of other service providers to compete 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 modification would 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.

Intraday balances of central bank money help ensure the smooth flow of payments systems whether operated by the Reserve Banks or private-sector clearing and settlement systems. The demand for intraday balances at the Reserve Banks for processing payments for private-sector clearing and settlement systems can substantially exceed the supply of overnight balances in Federal Reserve accounts, making intraday credit from the Reserve Banks the key marginal source of intraday funding for the market and for making payments, particularly over the Reserve Banks' payments systems. For some large users of intraday credit, the proposed PSR policy changes may result in a reduction in daylight overdraft fees and thus lower explicit costs of using central bank money to fund payments activity. The lower explicit cost of using intraday balances of central bank money will lower the implicit cost of using the Reserve Banks' payments services. The Board, however, does not believe this lower cost will have an adverse material effect on the ability of other service providers to compete with the Reserve Banks because private-sector clearing and settlement systems will gain from the lower explicit cost of funding net debit caps and other risk and operational controls employed by those systems. Generally, the Board expects

that both the Reserve Banks and private-sector clearing and settlement systems will benefit to some extent from the reduced costs for daylight overdrafts.

## VII. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the proposed PSR policy under the authority delegated to the Board by the Office of Management and Budget. No collection of information pursuant to the Paperwork Reduction Act is contained in the policy statement.

## VIII. Appendix I

The Board has identified five major concerns related to risk or efficiency that together suggest a change in the Federal Reserve's approach to the provision of intraday credit and the PSR policy is warranted at this time. These concerns include the declining level of overnight balances, the intraday funding needs of financial utilities, payments delays, continued growth in Reserve Bank credit exposure, and cost burden on the payments system.

*A. Level of overnight balances.* First, the current level of overnight reserve and clearing balances is not sufficient to meet the *intraday* liquidity needs of the banking industry and the payments system. In 1988, overnight balances held at the Reserve Banks were approximately \$39 billion. Since that time, changes in market practices (especially the introduction of retail sweep programs) and reserve requirements have reduced overnight balances to an average of approximately \$16 billion in 2007; average daylight overdraft and (average) peak daylight overdrafts in 2007 were four and ten times overnight (closing) balances, respectively.

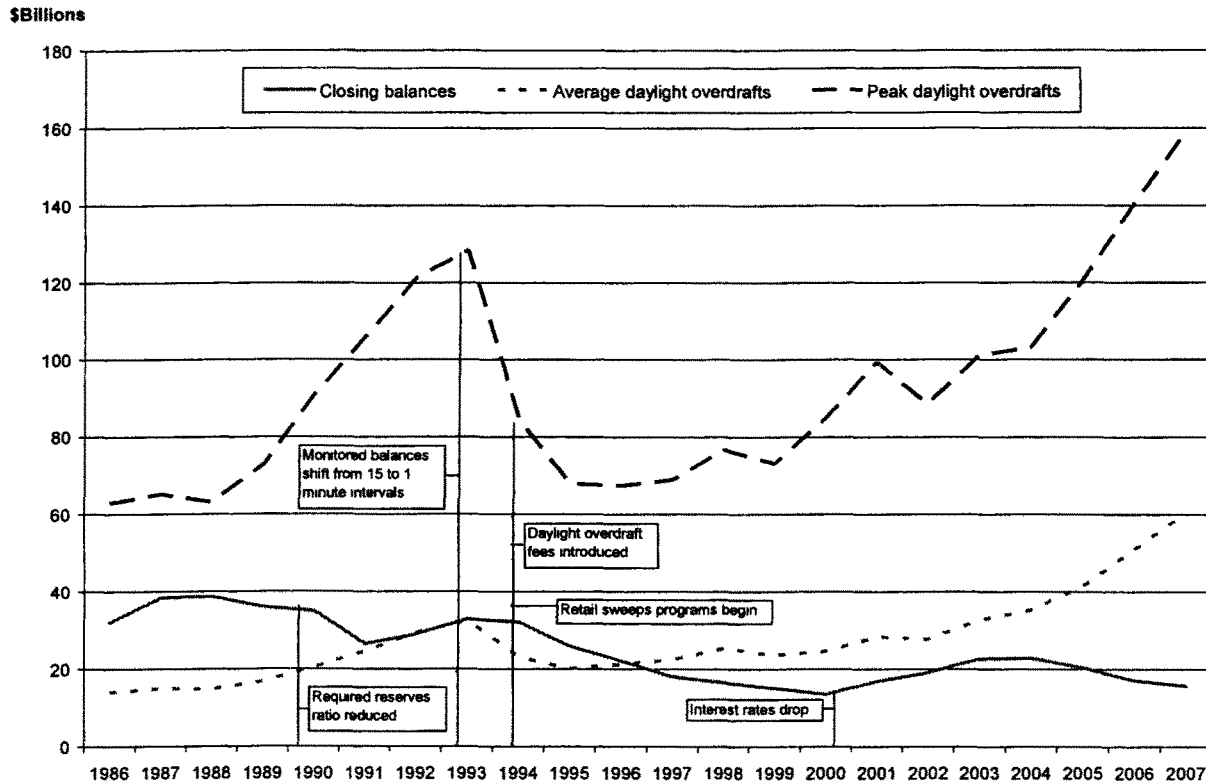


## Chart 1

## Trends in closing balances and daylight overdrafts

1986-2007

(unadjusted for inflation)



*B. Intraday funding of financial utilities.* Second, with the encouragement of the Federal Reserve and the industry, virtually all commercial paper is now held at DTC in book-entry form and issued and paid through that organization. In addition, trades of most publicly listed stocks and corporate bonds are also settled through DTC. As a result, DTC's members transfer substantial sums over the Fedwire funds transfer system to DTC's clearing account at the Federal Reserve Bank of New York beginning in the early afternoon to help meet DTC's risk-management requirements.<sup>57</sup> Most of

<sup>57</sup> The use of intraday balances of central bank money to manage risk is explicitly endorsed by international risk standards applicable to securities settlement systems such as DTC and incorporated in the Board's PSR policy. See also "Recommendations for securities settlement systems," Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, Bank for International Settlements, November 2001.

these funds are not released by DTC back to the market until final DTC settlement occurs around 4:30 p.m.<sup>58</sup> As a result, for most of the afternoon, the demand for intraday balances at the Reserve Banks for processing other payments far exceeds the supply of overnight balances in Federal Reserve accounts, making intraday credit from the Reserve Banks the key marginal source of intraday funding for the market and for making payments, particularly over the Federal Reserve's payments systems. Under these circumstances, the provision of substantial amounts of daylight balances and credit by the Reserve Banks is necessary for the smooth functioning of Fedwire and the payments system more broadly. Private-sector payments systems have created a structural demand for daylight central bank credit averaging about \$50 billion per day to

<sup>58</sup> DTC is not permitted to incur daylight overdrafts. It ends each day with a positive balance close to zero in its clearing account.

support their settlement and risk management activities. On peak days, this demand can exceed \$150 billion. The large magnitude of these amounts is inconsistent with the premise of the current PSR policy that relatively few institutions should rely on daylight credit from the Federal Reserve and use should be minimal.

*C. Payments delays.* Third, the policy of pricing daylight overdrafts and the implied quantity of intraday credit supplied to the market has encouraged depository institutions to delay sending Fedwire payments until later in the operating day, creating added operational risk for the markets. The concern that pricing would cause payments delays has been a long-standing concern associated with the PSR policy. Although delays were not observed in the early years of the policy, in recent years depository institutions have sent an increasing share of the value of payments made over the Fedwire funds transfer system later in

the day. In the period 1985 to 1990, data indicate that about 14 percent of the value of daily Fedwire payments were sent after 5 p.m.<sup>59</sup> The data in chart 2, however, indicate that the share of the

value of Fedwire payments sent after 5 p.m. has grown steadily, averaging about 22 percent by 1998 and increasing to about 32 percent by 2007. The chart illustrates that this growth is driven

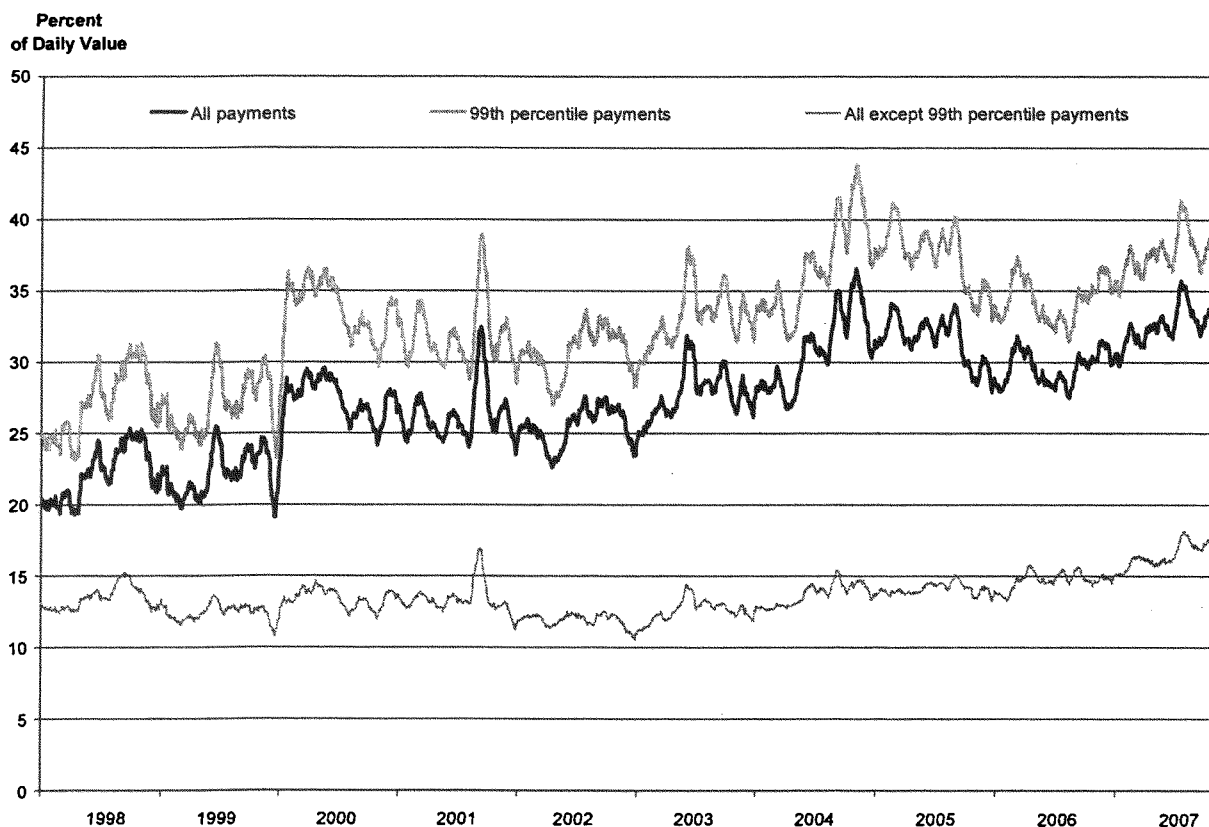
largely by the largest-valued payments (the 99th percentile), which averaged almost \$1 billion in 2007.

## Chart 2

### Timing of Fedwire funds transfer payments<sup>60</sup>

Percentage of value sent after 5:00 p.m.

(21-day moving averages, 1998-2007)



The PRC and WCAG study make clear that key depository institutions hold back (large-value) Fedwire funds transfers in so-called “liquidity queues” during the afternoon in order to manage their daylight overdraft levels and avoid fees.<sup>61</sup> Additional funds transfers, which may be designated for CHIPS, Fedwire funds, or book transfers, are

held in customer credit queues generally awaiting sufficient funds to be transferred to an account to release the payments. Modifications to the policy for providing intraday liquidity, coupled with more-efficient use of liquidity, could ease some of these problems. Daylight overdraft fees alone, however, are not responsible for the

late-day concentration of payments. PRC/WCAG members report that an increasing number of large-value payments are now originated later in the day because of later investment activities in the financial market and late closing times for major settlement systems.

<sup>59</sup>In 1995, the value of Fedwire funds transfers after 5 p.m. was approximately 16 percent. See Richards, Heidi Willmann, Daylight overdraft fees and the Federal Reserve’s Payment System Risk Policy, Federal Reserve Bulletin, December 1995.

The Fedwire funds transfer system closes at 6:30 p.m.

<sup>60</sup>Data are for funds transfers only and exclude transactions sent or received by CHIPS, DTC, or CLS Bank International (CLS). CLS, which is an

Edge Corporation supervised by the Federal Reserve, offers payment-versus-payment settlement of foreign exchange trades.

<sup>61</sup>Payments may be held in several types of queues once the depository institution receives an instruction from a customer to make a Fedwire funds transfer. If a customer instructs the depository institution to make a payment and the customer does not have sufficient balances or intraday credit with the institution, it may hold the payment in a “credit queue” until funds become

available. Once the payment is cleared from the credit queue, the depository institution may send the payment or may move the payment to another queue in its process, such as the liquidity queue. A depository institution may use the liquidity queue to manage its daylight overdraft position with the Reserve Bank. The liquidity queue can help the institution manage daylight overdraft fees, avoid cap breaches, manage bilateral exposures, and so on.

In addition, in its public comment letter the Federal Reserve Bank of Chicago identified the delay of *time-critical* funds transfers used to complete the daily cycle of collecting and disbursing margin payments in the derivatives markets as a further concern related to the general delay of large-value payments. In particular, the Federal Reserve Bank of Chicago conducted a confidential study to determine the time elapsed between the delivery of payment instructions by clearing organizations to money settlement banks and the execution of those instructions in relation to the contractual commitments of these banks to make timely payments (within one hour). The study provides evidence of

substantial delays in interbank balancing payments for the exchange-traded derivatives markets during a period when there were no major financial market disruptions. The comment letter states that “a nontrivial percentage was made exceptionally late (3 to 9½ hours). Furthermore, we find that the payments associated with the biggest delays tend to have the largest dollar value.” Overall, the delay of key time-critical payments could be a source of added systemic risk during periods of financial turbulence, and concerns could extend to other organizations. These types of concerns clearly did arise in the 1987 stock market break.<sup>62</sup>

*D. Long-term Reserve Bank intraday credit exposure.* Fourth, the long-term

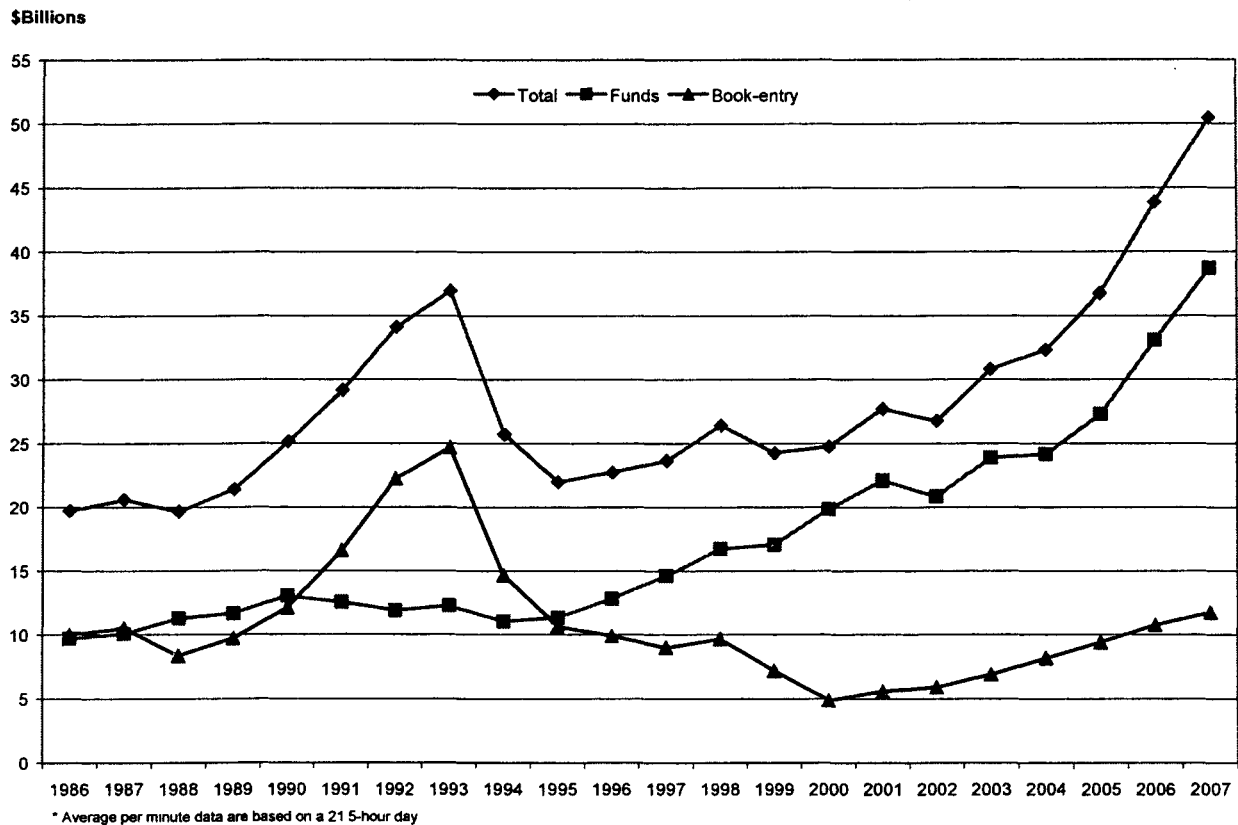
trend in daylight overdrafts indicates that they have continued to grow in both nominal and real terms despite the Reserve Banks’ charging fees. Chart 3 provides inflation-adjusted annual averages of average daylight overdraft values from 1986 to 2007. The annualized growth rate of these average daylight overdrafts for about the past ten years has been about same as the annualized growth rate of the combined value of Fedwire funds and securities transfers. Given the demand for intraday liquidity to make payments, it is not clear that a policy of continuing to rely heavily on charging fees for daylight overdrafts will be successful in limiting growth of the credit risk exposure of the Reserve Banks.

**Chart 3**

**Average daylight overdrafts**

1986-2007

(Annual average of daily data in 2000 dollars)



<sup>62</sup> See the Report of The Presidential Task Force on Market Mechanisms, January 1988, for a study of the 1987 stock market break.

*E. Cost burden on the payments system.* Fifth, the policy of charging fees has become a significant cost burden on the banking industry and the payments system. The Federal Reserve has collected over \$450 million in daylight overdraft fees from the beginning of the pricing program in 1994 through the

end of 2007. The fees collected from depository institutions, however, have increased almost 20 percent per year on a compound annualized basis since 2003, with approximately \$65 million collected in 2007. Chart 4 illustrates this substantial growth in fees, especially over the past several years.<sup>63</sup> To date, no

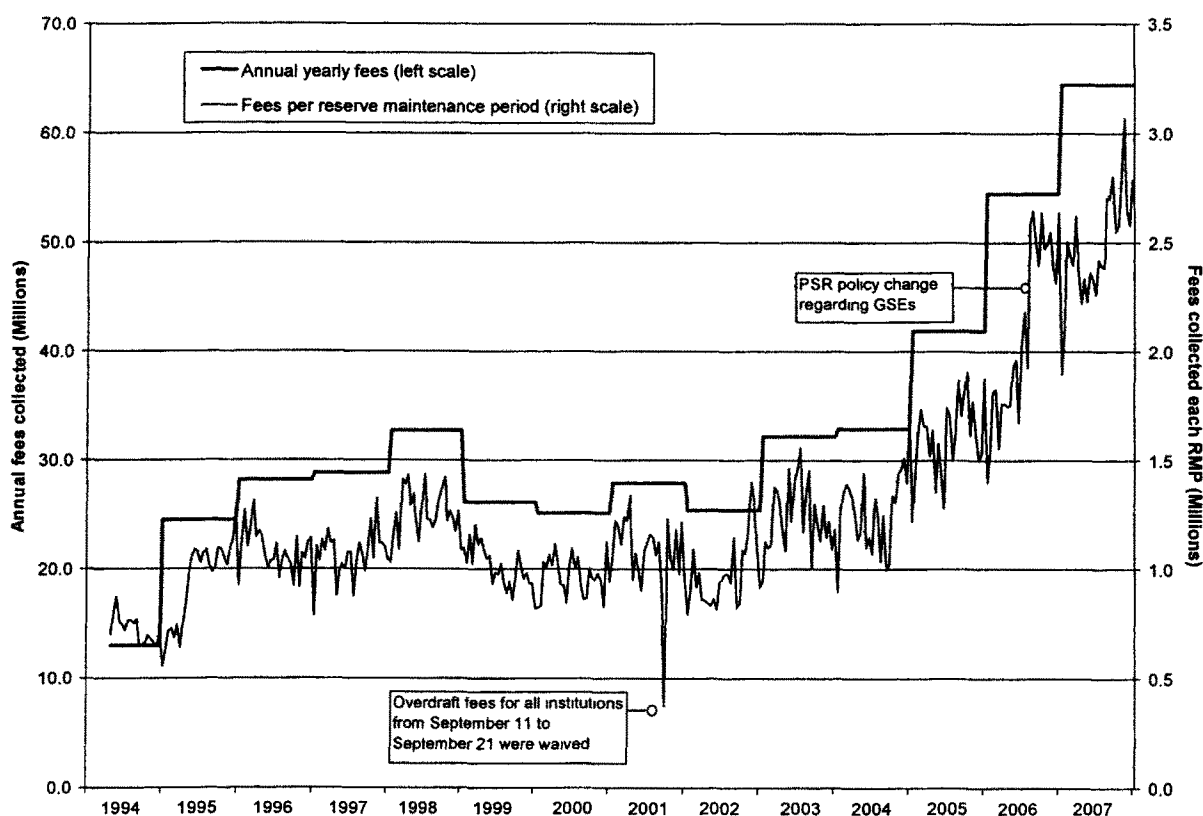
losses have been associated with the provision of daylight overdraft credit. The growing cost of the daylight overdraft fees to the industry raises the question of whether there is a less-expensive and more-effective way to manage risk.

**Chart 4**

**Daylight overdraft fees charged to depository institutions**

1994 to 2007

(unadjusted for inflation)



Overall, the challenges with the existing PSR policy suggest that significant changes are justified in order to advance its overarching risk and efficiency objectives.

**IX. Federal Reserve Policy on Payments System Risk**

If the Board adopted these proposed changes, it would amend the “Federal

Reserve Policy on Payments System Risk” Section II as follows.

Introduction [Revised]  
Risks in Payments and Settlement Systems [Revised]

I. Risk Management in Payments and Settlement Systems [No Change]

- A. Scope
- B. General policy expectations
- C. Systemically important systems

1. Principles for systemically important payments systems

2. Minimum standards for systemically important securities settlement systems and central counterparties

3. Self-assessments by systemically important systems

II. Federal Reserve Intraday Credit Policies [II and II B through II G Revised]

- A. Daylight overdraft definition and measurement [No Change]
- B. Collateral
- C. Pricing
- D. Net debit caps

<sup>63</sup> While the fees have increased substantially over the past few years, the largest increase was 35 percent on an annualized basis following the implementation of the new policy limiting overdrafts of government-sponsored enterprises in

July 2006. The fee increase is not surprising because the policy shifted the provision of intraday credit from the Reserve Banks to depository institutions. The PSR policy change for government-sponsored enterprises and certain international organizations

is available at <http://www.federalreserve.gov/boarddocs/press/other/2004/20040205/default.htm>. (See also 69 FR 57917, September 28, 2004.)

1. Definition
2. Cap categories
  - a. Self-assessed
  - b. De minimis
  - c. Exempt-from-filing
  - d. Zero
3. Capital measure
  - a. U.S.-chartered institutions
  - b. U.S. branches and agencies of foreign banks
- E. Maximum daylight overdraft capacity
  1. General procedure
  2. Streamlined procedure for certain FBOs
- F. Special situations
  1. Edge and agreement corporations
  2. Bankers' banks
  3. Limited-purpose trust companies
  4. Government-sponsored enterprises and international organizations
5. Problem institutions
- G. Monitoring
  1. Ex post
  2. Real time
  3. Multi-district institutions
- H. Transfer-size limit on book-entry securities [No Change]

### Introduction

Payments and settlement systems are critical components of the nation's financial system. The smooth functioning of these systems is vital to the financial stability of the U.S. economy. Given the importance of these systems, the Board has developed this policy to address the risks that payments and settlement activity present to the financial system and to the Federal Reserve Banks (Reserve Banks).

In adopting this policy, the Board's objectives are to foster the safety and efficiency of payments and settlement systems. These policy objectives are consistent with (1) the Board's long-standing objectives to promote the integrity, efficiency, and accessibility of the payments mechanism; (2) industry and supervisory methods for risk management; and (3) internationally accepted risk management principles and minimum standards for systemically important payments and settlement systems.<sup>64</sup>

Part I of this policy sets out the Board's views, and related principles and minimum standards, regarding the management of risks in payments and settlement systems, including those operated by the Reserve Banks. In setting out its views, the Board seeks to encourage payments and settlement systems, and their primary regulators, to take the principles and minimum standards in this policy into consideration in the design, operation,

monitoring, and assessing of these systems. The Board also will be guided by this part, in conjunction with relevant laws and other Federal Reserve policies, when exercising its authority over certain systems or their participants, when providing payments and settlement services to systems, or when providing intraday credit to Federal Reserve account holders.

Part II of this policy governs the provision of intraday credit or "daylight overdrafts" in accounts at the Reserve Banks and sets out the general methods used by the Reserve Banks to control their intraday credit exposures.<sup>65</sup> Under this part, the Board explicitly recognizes that the Federal Reserve has an important role in providing intraday balances and credit to foster the smooth operation of the payments system. The Reserve Banks provide intraday balances by way of supplying temporary, intraday credit to healthy depository institutions, predominantly through collateralized intraday overdrafts at zero price.<sup>66, 67</sup> The Board believes that such a strategy enhances intraday liquidity, while controlling risk to the Reserve Banks. Over time, the Board aims to reduce the reliance of the banking industry on uncollateralized intraday credit by providing incentives to collateralize daylight overdrafts. The Board also aims to limit the burden of the policy on healthy depository

<sup>65</sup> To assist depository institutions in implementing this part of the Board's payments system risk policy, the Federal Reserve has prepared two documents, the "Overview of the Federal Reserve's Payments System Risk Policy" and the "Guide to the Federal Reserve's Payments System Risk Policy," which are available on line at <http://www.federalreserve.gov/paymentsystems/PSR/relpol.htm>. The "Overview of the Federal Reserve's Payments System Risk Policy" summarizes the Board's policy on the provision of intraday credit, including net debit caps and daylight overdraft fees. The overview is intended for use by institutions that incur only small amounts of daylight overdrafts. The "Guide to the Federal Reserve's Payments System Risk Policy" explains in detail how these policies apply to different institutions and includes procedures for completing a self-assessment and filing a cap resolution, as well as information on other aspects of the policy.

<sup>66</sup> The term "depository institution," as used in this policy, refers not only to institutions defined as "depository institutions" in 12 U.S.C. 461(b)(1)(A), but also to U.S. branches and agencies of foreign banking organizations, Edge and agreement corporations, trust companies, and bankers' banks, unless the context indicates a different reading.

<sup>67</sup> The Board's earlier strategy expected depository institutions to manage their accounts effectively while minimizing the use of Federal Reserve's intraday credit. The rationale for the current strategy is that modern payments and settlement systems require significant amounts of intraday balances or liquidity for smooth operation. The role of the central bank is to meet reasonable market needs of participants in these systems for this liquidity.

institutions that use small amounts of intraday credit.

Through this policy, the Board expects financial system participants, including the Reserve Banks, to reduce and control settlement and systemic risks arising in payments and settlement systems, consistent with the smooth operation of the financial system. This policy is designed to provide intraday balances and credit while controlling the Reserve Bank risk by (1) making financial system participants and system operators aware of the types of basic risks that arise in the settlement process and the Board's expectations with regard to risk management, (2) setting explicit risk management expectations for systemically important systems, and (3) establishing the policy conditions governing the provision of Federal Reserve intraday credit to account holders. The Board's adoption of this policy in no way diminishes the primary responsibilities of financial system participants generally and settlement system operators, participants, and Federal Reserve account holders more specifically, to address the risks that may arise through their operation of, or participation in, payments and settlement systems.

### Risks in Payments and Settlement Systems

The basic risks in payments and settlement systems are credit risk, liquidity risk, operational risk, and legal risk. In the context of this policy, these risks are defined as follows.<sup>68</sup>

**Credit Risk.** The risk that a counterparty will not settle an obligation for full value either when due or anytime thereafter.

**Liquidity Risk.** The risk that a counterparty will not settle an obligation for full value when due.

**Operational Risk.** The risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events. This type of risk includes various physical and information security risks.

**Legal Risk.** The risk of loss because of the unexpected application of a law or regulation or because a contract cannot be enforced.

<sup>68</sup> These definitions of credit risk, liquidity risk, and legal risk are based upon those presented in the Core Principles for Systemically Important Payment Systems (Core Principles) and the Recommendations for Securities Settlement Systems (Recommendations for SSS). The definition of operational risk is based on the Basel Committee on Banking Supervision's "Sound Practices for the Management and Supervision of Operational Risk," available at <http://www.bis.org/publ/bcbs96.htm>. Each of these definitions is largely consistent with those included in the Recommendations for Central Counterparties (Recommendations for CCP).

<sup>64</sup> For the Board's long-standing objectives in the payments system, see "The Federal Reserve in the Payments System," September 2001, FRRS 9-1550, available at <http://www.federalreserve.gov/paymentsystems/pricing/frpaysys.htm>.

These risks arise between financial institutions as they settle payments and other financial transactions and must be managed by institutions, both individually and collectively.<sup>69, 70</sup> Multilateral payments and settlement systems, in particular, may increase, shift, concentrate, or otherwise transform risks in unanticipated ways. These systems also may pose systemic risk to the financial system where the inability of a system participant to meet its obligations when due may cause other participants to be unable to meet their obligations when due. The failure of one or more participants to settle their payments or other financial transactions, in turn, could create credit or liquidity problems for other participants, the system operator, or depository institutions. Systemic risk might lead ultimately to a disruption in the financial system more broadly or undermine public confidence in the nation's financial infrastructure.

These risks stem, in part, from the multilateral and time-sensitive credit and liquidity interdependencies among financial institutions. These interdependencies often create complex transaction flows that, in combination with a system's design, can lead to significant demands for intraday credit, either on a regular or extraordinary basis. The Board explicitly recognizes that the Federal Reserve has an important role in providing intraday balances and credit to foster the smooth operation of the payments system. To the extent that financial institutions or the Reserve Banks are the direct or indirect source of intraday credit, they may face a direct risk of loss if daylight overdrafts are not extinguished as planned. In addition, measures taken by Reserve Banks to limit their intraday credit exposures may shift some or all of the associated risks to private-sector systems.

The smooth functioning of payments and settlement systems is also critical to certain public policy objectives in the areas of monetary policy and banking supervision. The effective implementation of monetary policy, for

example, depends on both the orderly settlement of open market operations and the efficient distribution of reserve balances throughout the banking system via the money market and payments system. Likewise, supervisory objectives regarding the safety and soundness of depository institutions must take into account the risks payments and settlement systems pose to depository institutions that participate directly or indirectly in, or provide settlement, custody, or credit services to, such systems.

#### *I. Risk Management in Payments and Settlement Systems [No Change]*

#### *II. Federal Reserve Intraday Credit Policies [II and II B through II H Revised]*

This part outlines the methods used to provide intraday credit to ensure the smooth functioning of payments and settlement systems, while controlling credit risk to the Reserve Banks associated with such intraday credit. These methods include voluntary collateralization of intraday credit, a limit on total daylight overdrafts in institutions' Federal Reserve accounts, and a fee for uncollateralized daylight overdrafts. This part also provides a fee waiver to limit the impact of collateralization on depository institutions that use relatively small amounts of intraday credit.

To assist institutions in implementing this part of the policy, the Federal Reserve has prepared two documents: the *Overview of the Federal Reserve's Payments System Risk Policy on Intraday Credit* (Overview) and the *Guide to the Federal Reserve's Payments System Risk Policy on Intraday Credit* (Guide).<sup>71</sup> The Overview summarizes the Board's policy on the provision of intraday credit, including net debit caps, daylight overdraft fees for collateralized and uncollateralized overdrafts, and the fee waiver. It is intended for use by institutions that incur only small amounts of daylight overdrafts. The Guide explains in detail how these policies apply to different institutions and includes procedures for completing a self-assessment and filing a cap resolution, as well as information on other aspects of the policy.

#### *A. Daylight Overdraft Definition and Measurement [No change]*

#### *B. Collateral*

To help meet institutions' demand for intraday balances while mitigating Reserve Bank credit risk, the Board

supplies intraday balances predominantly through explicitly collateralized daylight overdrafts provided by Reserve Banks to healthy depository institutions at a zero fee.<sup>72</sup> The Board offers pricing incentives to encourage greater collateralization (see section II.C.). To avoid disrupting the operation of the payments system and increasing the cost burden on a large number of institutions using small amounts of daylight overdrafts, the Board allows the use of collateral to be voluntary.

Collateral eligibility and margins remain the same for PSR policy purposes as for the discount window.<sup>73</sup> Unencumbered discount window collateral can be used to collateralize daylight overdrafts. The pledge of in-transit securities remains an eligible collateral option for PSR purposes at Reserve Banks' discretion.<sup>74</sup>

#### *C. Pricing*

Under the voluntary collateralization regime, the fee for collateralized overdrafts is set at zero, while the fee for uncollateralized overdrafts is 50 basis points. The two-tiered fee for collateralized and uncollateralized overdrafts is intended to provide a strong incentive for a depository institution to pledge collateral to its Reserve Bank to reduce or eliminate the institution's *uncollateralized* daylight overdrafts and associated charges for its use of intraday credit.

Reserve Banks charge institutions for daylight overdrafts incurred in their Federal Reserve accounts. For each two-week reserve-maintenance period, the Reserve Banks calculate and assess daylight overdraft fees, which are equal to the sum of any daily uncollateralized daylight overdraft charges during the period.

Daylight overdraft fees for uncollateralized overdrafts (or the uncollateralized portion of a partially collateralized overdraft) are calculated using an annual rate of 50 basis points, quoted on the basis of a 24-hour day and a 360-day year. To obtain the effective annual rate for the standard Fedwire

<sup>69</sup>The term "financial institution," as used in this policy, includes a broad array of types of organizations that engage in financial activity, including depository institutions and securities dealers.

<sup>70</sup>Several existing regulatory and bank supervision guidelines and policies also are directed at institutions' management of the risks posed by interbank payments and settlement activity. For example, Federal Reserve Regulation F (12 CFR 206) directs insured depository institutions to establish policies and procedures to avoid excessive exposures to any other depository institutions, including exposures that may be generated through the clearing and settlement of payments.

<sup>71</sup>Available at <http://www.federalreserve.gov/paymentsystems/PSR/relpol.htm>.

<sup>72</sup>Collateral is also used to manage risk posed by daylight overdrafts of problem institutions (institutions in a weak or deteriorating financial condition), entities not eligible for Federal Reserve intraday credit (see Section II.F.) and institutions that have obtained maximum daylight overdraft capacity (see Section II.E.).

<sup>73</sup>See <http://www.frbdiscountwindow.org/> for information on the discount window and PSR collateral acceptance policy and collateral margins.

<sup>74</sup>In-transit securities are book-entry securities transferred over the Fedwire Securities Service that have been purchased by a depository institution but not yet paid for or owned by the institution's customers.

operating day, the 50-basis-point annual rate is multiplied by the fraction of a 24-hour day during which Fedwire is scheduled to operate. For example, under a 21.5-hour scheduled Fedwire operating day, the effective annual rate used to calculate daylight overdraft fees equals 44.79 basis points (50 basis points multiplied by 21.5/24).<sup>75</sup> The effective daily rate is calculated by dividing the effective annual rate by 360.<sup>76</sup> An institution's daily daylight overdraft charge is equal to the effective daily rate multiplied by the institution's average daily uncollateralized daylight overdraft.

An institution's average daily uncollateralized daylight overdraft is calculated by dividing the sum of its negative uncollateralized Federal Reserve account balances at the end of each minute of the scheduled Fedwire operating day by the total number of minutes in the scheduled Fedwire operating day. In this calculation, each positive end-of-minute balance in an institution's Federal Reserve account is set to equal zero. Fully collateralized end-of-minute negative balances are similarly set to zero.

The daily daylight overdraft charge is reduced by a fee waiver of \$150, which is primarily intended to minimize the burden of the PSR policy on institutions that use small amounts of intraday credit. The waiver is subtracted from gross fees in a two-week reserve-maintenance period.<sup>77</sup>

Certain institutions are subject to a penalty fee and modified daylight overdraft fee calculation as described in section II.F. The fee waiver is not available to these institutions.<sup>78</sup>

D. Net Debit Caps

1. Definition

In accord with sound risk management practices, to limit the amount of intraday credit that a Reserve Bank extends to an individual

<sup>75</sup> A change in the length of the scheduled Fedwire operating day should not significantly change the amount of fees charged because the effective daily rate is applied to average daylight overdrafts, whose calculation would also reflect the change in the operating day.

<sup>76</sup> Under the current 21.5-hour Fedwire operating day, the effective daily daylight-overdraft rate is truncated to 0.0000124.

<sup>77</sup> The waiver shall not result in refunds or credits to an institution.

<sup>78</sup> The fee waiver is not available to Edge and agreement corporations, bankers' banks that have not waived their exemption from reserve requirements, limited-purpose trust companies, and government-sponsored enterprises and international organizations. These types of institutions do not have regular access to the discount window and, therefore, are expected not to incur daylight overdrafts in their Federal Reserve accounts.

institution and the associated risk, each institution incurring daylight overdrafts in its Federal Reserve account must adopt a net debit cap, that is, a ceiling on the total daylight overdraft position that it can incur during any given day. If an institution's daylight overdrafts generally do not exceed the lesser of \$10 million or 20 percent of its capital measure, the institution may qualify for the exempt-from-filing cap. An institution must be financially healthy and have regular access to the discount window in order to adopt a net debit cap greater than zero or qualify for the filing exemption.

An institution's cap category and capital measure determine the size of its net debit cap. More specifically, the net debit cap is calculated as an institution's cap multiple times its capital measure:

$$\text{net debit cap} = \text{cap multiple} \times \text{capital measure}$$

Cap categories (see section II.D.2.) and their associated cap levels, set as multiples of capital measure, are listed below:

NET DEBIT CAP MULTIPLES

Cap category	Cap multiple
High .....	2.25
Above average .....	1.875
Average .....	1.125
De minimis .....	0.4
Exempt-from-filing <sup>79</sup> .....	\$10 million or 0.20
Zero .....	0

The cap is applied to the total of collateralized and uncollateralized daylight overdrafts. For the treatment of overdrafts that exceed the cap, see Section II.G.

The Board's policy on net debit caps is based on a specific set of guidelines and some degree of examiner oversight. Under the Board's policy, a Reserve Bank may further limit or prohibit an institution's use of Federal Reserve intraday credit if (1) the institution's supervisor determines that the institution is unsafe or unsound; (2) the institution does not qualify for a positive net debit cap (see section II.D.2.); or (3) the Reserve Bank determines that the institution poses excessive risk.

While capital measures differ, the net debit cap provisions of this policy apply similarly to foreign banking organizations (FBOs) as to U.S. institutions. The Reserve Banks will advise home-country supervisors of the

<sup>79</sup> The net debit cap for the exempt-from-filing category is equal to the lesser of \$10 million or 0.20 multiplied by the capital measure.

daylight overdraft capacity of U.S. branches and agencies of FBOs under their jurisdiction, as well as of other pertinent information related to the FBOs' caps. The Reserve Banks will also provide information on the daylight overdrafts in the Federal Reserve accounts of FBOs' U.S. branches and agencies in response to requests from home-country supervisors.

2. Cap Categories

The policy defines the following six cap categories, described in more detail below: high, above average, average, de minimis, exempt-from-filing, and zero. The high, above average, and average cap categories are referred to as "self-assessed" caps.

*a. Self-assessed.* In order to establish a net debit cap category of high, above average, or average, an institution must perform a self-assessment of its own creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures.<sup>80</sup> The assessment of creditworthiness is based on the institution's supervisory rating and Prompt Corrective Action (PCA) designation.<sup>81</sup> An institution may perform a full assessment of its creditworthiness in certain limited circumstances, for example, if its condition has changed significantly since its last examination or if it possesses additional substantive information regarding its financial condition. An institution performing a self-assessment must also evaluate its intraday funds-management procedures and its procedures for evaluating the financial condition of and establishing

<sup>80</sup> This assessment should be done on an individual-institution basis, treating as separate entities each commercial bank, each Edge corporation (and its branches), each thrift institution, and so on. An exception is made in the case of U.S. branches and agencies of FBOs. Because these entities have no existence separate from the FBO, all the U.S. offices of FBOs (excluding U.S.-chartered bank subsidiaries and U.S.-chartered Edge subsidiaries) should be treated as a consolidated family relying on the FBO's capital.

<sup>81</sup> An insured depository institution is (1) "well capitalized" if it significantly exceeds the required minimum level for each relevant capital measure, (2) "adequately capitalized" if it meets the required minimum level for each relevant capital measure, (3) "undercapitalized" if it fails to meet the required minimum level for any relevant capital measure, (4) "significantly undercapitalized" if it is significantly below the required minimum level for any relevant capital measure, or (5) "critically undercapitalized" if it fails to meet any leverage limit (the ratio of tangible equity to total assets) specified by the appropriate federal banking agency, in consultation with the FDIC, or any other relevant capital measure established by the agency to determine when an institution is critically undercapitalized (12 U.S.C. 1831o).

intraday credit limits for its customers. Finally, the institution must evaluate its operating controls and contingency procedures to determine if they are sufficient to prevent losses due to fraud or system failures. The Guide includes a detailed explanation of the self-assessment process.

Each institution's board of directors must review that institution's self-assessment and recommended cap category. The process of self-assessment, with board-of-directors review, should be conducted at least once in each twelve-month period. A cap determination may be reviewed and approved by the board of directors of a holding company parent of an institution, provided that (1) the self-assessment is performed by each entity incurring daylight overdrafts, (2) the entity's cap is based on the measure of the entity's own capital, and (3) each entity maintains for its primary supervisor's review its own file with supporting documents for its self-assessment and a record of the parent's board-of-directors review.<sup>82</sup>

In applying these guidelines, each institution should maintain a file for examiner review that includes (1) worksheets and supporting analysis used in its self-assessment of its own cap category, (2) copies of senior-management reports to the board of directors of the institution or its parent (as appropriate) regarding that self-assessment, and (3) copies of the minutes of the discussion at the appropriate board-of-directors meeting concerning the institution's adoption of a cap category.<sup>83</sup>

As part of its normal examination, the institution's examiners may review the contents of the self-assessment file.<sup>84</sup>

<sup>82</sup> An FBO should undergo the same self-assessment process as a domestic bank in determining a net debit cap for its U.S. branches and agencies. Many FBOs, however, do not have the same management structure as U.S. institutions, and adjustments should be made as appropriate. If an FBO's board of directors has a more limited role to play in the bank's management than a U.S. board has, the self-assessment and cap category should be reviewed by senior management at the FBO's head office that exercises authority over the FBO equivalent to the authority exercised by a board of directors over a U.S. institution. In cases in which the board of directors exercises authority equivalent to that of a U.S. board, cap determination should be made by the board of directors.

<sup>83</sup> In addition, for FBOs, the file that is made available for examiner review by the U.S. offices of an FBO should contain the report on the self-assessment that the management of U.S. operations made to the FBO's senior management and a record of the appropriate senior management's response or the minutes of the meeting of the FBO's board of directors or other appropriate management group, at which the self-assessment was discussed.

<sup>84</sup> Between examinations, examiners or Reserve Bank staff may contact an institution about its cap if there is other relevant information, such as

The objective of this review is to ensure that the institution has applied the guidelines appropriately and diligently, that the underlying analysis and method were reasonable, and that the resultant self-assessment was generally consistent with the examination findings.

Examiner comments, if any, should be forwarded to the board of directors of the institution. The examiner, however, generally would not require a modification of the self-assessed cap category, but rather would inform the appropriate Reserve Bank of any concerns. The Reserve Bank would then decide whether to modify the cap category. For example, if the institution's level of daylight overdrafts constitutes an unsafe or unsound banking practice, the Reserve Bank would likely assign the institution a zero net debit cap and impose additional risk controls.

The contents of the self-assessment file will be considered confidential by the institution's examiner. Similarly, the Federal Reserve and the institution's examiner will hold the actual cap level selected by the institution confidential. Net debit cap information should not be shared with outside parties or mentioned in any public documents; however, net debit cap information will be shared with the home-country supervisor of U.S. branches and agencies of foreign banks.

The Reserve Banks will review the status of any institution with a self-assessed net debit cap that exceeds its net debit cap during a two-week reserve-maintenance period and will decide if additional action should be taken (see section II.G.).

*b. De minimis.* Many institutions incur relatively small overdrafts and thus pose little risk to the Federal Reserve. To ease the burden on these small overdrafters of engaging in the self-assessment process and to ease the burden on the Federal Reserve of administering caps, the Board allows institutions that meet reasonable safety and soundness standards to incur de minimis amounts of daylight overdrafts without performing a self-assessment. An institution may incur daylight overdrafts of up to 40 percent of its capital measure if the institution submits a board-of-directors resolution.

An institution with a de minimis cap must submit to its Reserve Bank at least once in each 12-month period a copy of its board-of-directors resolution (or a resolution by its holding company's board) approving the institution's use of

statistical or supervisory reports, that suggests there may have been a change in the institution's financial condition.

intraday credit up to the de minimis level. The Reserve Banks will review the status of any institution with a de minimis net debit cap that exceeds its net debit cap during a two-week reserve-maintenance period and will decide if additional action should be taken (see section II.G.).

*c. Exempt-from-filing.* Institutions that only rarely incur daylight overdrafts in their Federal Reserve accounts that exceed the lesser of \$10 million or 20 percent of their capital measure are excused from performing self-assessments and filing board-of-directors resolutions with their Reserve Banks. This dual test of dollar amount and percent of capital measure is designed to limit the filing exemption to institutions that create only low-dollar risks to the Reserve Banks and that incur small overdrafts relative to their capital measure.

The Reserve Banks will review the status of an exempt institution that incurs overdrafts in its Federal Reserve account in excess of \$10 million or 20 percent of its capital measure on more than two days in any two consecutive two-week reserve-maintenance periods. The Reserve Bank will decide whether the exemption should be maintained, the institution should be required to file for a cap, or counseling should be performed (see section II.G.). Granting of the exempt-from-filing net debit cap is at the discretion of the Reserve Bank.

*d. Zero.* Some financially healthy institutions that could obtain positive net debit caps choose to have zero caps. Often these institutions have very conservative internal policies regarding the use of Federal Reserve intraday credit or simply do not want to incur daylight overdrafts and any associated daylight overdraft fees. If an institution that has adopted a zero cap incurs a daylight overdraft, the Reserve Bank counsels the institution and may monitor the institution's activity in real time and reject or delay certain transactions that would cause an overdraft. If the institution qualifies for a positive cap, the Reserve Bank may suggest that the institution adopt an exempt-from-filing cap or file for a higher cap if the institution believes that it will continue to incur daylight overdrafts.

In addition, a Reserve Bank may assign an institution a zero net debit cap. Institutions that may pose special risks to the Reserve Banks, such as those without regular access to the discount window, those incurring daylight overdrafts in violation of this policy, or those in weak financial condition, are generally assigned a zero cap (see section II.F.). Recently chartered



institutions may also be assigned a zero net debit cap.

### 3. Capital Measure

As described above, an institution's cap category and capital measure determine the size of its net debit cap. The capital measure used in calculating an institution's net debit cap depends upon its chartering authority and home-country supervisor.

*a. U.S.-chartered institutions.* For institutions chartered in the United States, net debit caps are multiples of "qualifying" or similar capital measures that consist of those capital instruments that can be used to satisfy risk-based capital standards, as set forth in the capital adequacy guidelines of the federal financial regulatory agencies. All of the federal financial regulatory agencies collect, as part of their required reports, data on the amount of capital that can be used for risk-based purposes—"risk-based" capital for commercial banks, savings banks, and savings associations and total regulatory reserves for credit unions. Other U.S.-chartered entities that incur daylight overdrafts in their Federal Reserve accounts should provide similar data to their Reserve Banks.

*b. U.S. branches and agencies of foreign banks.* For U.S. branches and agencies of foreign banks, net debit caps on daylight overdrafts in Federal Reserve accounts are calculated by applying the cap multiples for each cap category to the FBO's U.S. capital equivalency measure.<sup>85</sup> U.S. capital equivalency is equal to the following

- 35 percent of capital for FBOs that are financial holding companies (FHCs)<sup>86</sup>
- 25 percent of capital for FBOs that are not FHCs and have a strength of support assessment ranking (SOSA) of 1<sup>87</sup>

<sup>85</sup> The term "U.S. capital equivalency" is used in this context to refer to the particular capital measure used to calculate net debit caps and does not necessarily represent an appropriate capital measure for supervisory or other purposes.

<sup>86</sup> The Gramm-Leach-Bliley Act defines a financial holding company as a bank holding company that meets certain eligibility requirements. In order for a bank holding company to become a financial holding company and be eligible to engage in the new activities authorized under the Gramm-Leach-Bliley Act, the Act requires that all depository institutions controlled by the bank holding company be well capitalized and well managed (12 U.S.C. 1841(p)). With regard to a foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States, the Act requires the Board to apply comparable capital and management standards that give due regard to the principle of national treatment and equality of competitive opportunity (12 U.S.C. 1843(l)).

<sup>87</sup> The SOSA ranking is composed of four factors, including the FBO's financial condition and

- 10 percent of capital for FBOs that are not FHCs and are ranked a SOSA 2
  - 5 percent of "net due to related depository institutions" for FBOs that are not FHCs and are ranked a SOSA 3
- An FBO that is a FHC or has a SOSA rating of 1 may be eligible for a streamlined procedure (see Section II.E.) for obtaining additional collateralized intraday credit under the maximum daylight overdraft capacity provision.

Granting a net debit cap, or any extension of intraday credit, to an institution is at the discretion of the Reserve Bank. In the event a Reserve Bank grants a net debit cap or extends intraday credit to a financially healthy SOSA 3-ranked FBO, the Reserve Bank may require such credit to be fully collateralized, given the heightened supervisory concerns with SOSA 3-ranked FBOs.

### E. Maximum Daylight Overdraft Capacity

The Board recognizes that while net debit caps provide sufficient liquidity to most institutions, some institutions may still experience liquidity pressures. The Board believes it is important to provide an environment in which payments systems may function effectively and efficiently and to remove barriers, as appropriate, to foster risk-reducing payments system initiatives. Consequently, certain institutions with self-assessed net debit caps may pledge collateral to their administrative Reserve Banks to secure daylight overdraft capacity in excess of their net debit caps, subject to Reserve Bank approval.<sup>88</sup> <sup>89</sup> This policy is intended to provide extra liquidity through the pledge of collateral to the few institutions that might otherwise be constrained from participating in risk-

prospects, the system of supervision in the FBO's home country, the record of the home country's government in support of the banking system or other sources of support for the FBO; and transfer risk concerns. Transfer risk relates to the FBO's ability to access and transmit U.S. dollars, which is an essential factor in determining whether an FBO can support its U.S. operations. The SOSA ranking is based on a scale of 1 through 3, with 1 representing the lowest level of supervisory concern.

<sup>88</sup> The administrative Reserve Bank is responsible for the administration of Federal Reserve credit, reserves, and risk management policies for a given institution or other legal entity.

<sup>89</sup> Institutions have some flexibility as to the specific types of collateral they may pledge to the Reserve Banks; however, all collateral must be acceptable to the Reserve Banks. The Reserve Banks may accept securities in transit on the Fedwire book-entry securities system as collateral to support the maximum daylight overdraft capacity level. Securities in transit refer to book-entry securities transferred over the Fedwire Securities Service that have been purchased by an institution but not yet paid for and owned by the institution's customers.

reducing payments system initiatives.<sup>90</sup> The Board believes that providing extra liquidity to these few institutions should help prevent liquidity-related market disruptions.

### 1. General Procedure

An institution with a self-assessed net debit cap that wishes to expand its daylight overdraft capacity by pledging collateral should consult with its administrative Reserve Bank. The Reserve Banks will work with an institution that requests additional daylight overdraft capacity to determine the appropriate maximum daylight overdraft capacity level. In considering the institution's request, the Reserve Bank will evaluate the institution's rationale for requesting additional daylight overdraft capacity as well as its financial and supervisory information. The financial and supervisory information considered may include, but is not limited to, capital and liquidity ratios, the composition of balance sheet assets, CAMELS or other supervisory ratings and assessments, and SOSA rankings (for U.S. branches and agencies of foreign banks). An institution approved for a maximum daylight overdraft capacity level must submit at least once in each twelve-month period a board-of-directors resolution indicating its board's approval of that level.

If the Reserve Bank approves an institution's request, the Reserve Bank approves a maximum daylight overdraft capacity level. The maximum daylight overdraft capacity is defined as follows: maximum daylight overdraft capacity = net debit cap + collateralized capacity<sup>91</sup>

The Reserve Banks will review the status of any institution that exceeds its maximum daylight overdraft capacity limit during a two-week reserve-maintenance period and will decide if the maximum daylight overdraft capacity should be maintained or if additional action should be taken (see section II.G.).

Institutions with exempt-from-filing and de minimis net debit caps may *not* obtain additional daylight overdraft

<sup>90</sup> Institutions may consider applying for a maximum daylight overdraft capacity level for daylight overdrafts resulting from Fedwire funds transfers, Fedwire book-entry securities transfers, National Settlement Service entries, and ACH credit originations. Institutions incurring daylight overdrafts as a result of other payment activity may be eligible for administrative counseling flexibility (59 FR 54915-18, Nov. 2, 1994).

<sup>91</sup> Collateralized capacity, on any given day, equals the amount of collateral pledged to the Reserve Bank, not to exceed the difference between the institution's maximum daylight overdraft capacity level and its net debit cap.

capacity by pledging additional collateral without first obtaining a self-assessed net debit cap. Likewise, institutions that have voluntarily adopted zero net debit caps may *not* obtain additional daylight overdraft capacity without first obtaining a self-assessed net debit cap. Institutions that have been assigned a zero net debit cap by their administrative Reserve Bank are *not* eligible to apply for any daylight overdraft capacity.

## 2. Streamlined Procedure for Certain FBOs

An FBO that is a FHC or has a SOSA rating of 1 and has a self-assessed net debit cap may request from its Reserve Bank a streamlined procedure under the maximum daylight overdraft capacity provision. These FBOs are not required to provide documentation of the business need or obtain the board of directors' resolution for collateralized capacity in an amount that exceeds its current net debit cap (which is based on up to 35 percent worldwide capital times its cap multiple), as long as the requested additional capacity is 100 percent or less of worldwide capital times a self-assessed cap multiple.<sup>92</sup> In order to ensure that intraday liquidity risk is managed appropriately and that the FBO will be able to repay daylight overdrafts, eligible FBOs under the streamlined procedure will be subject to initial and periodic reviews of liquidity plans that are analogous to the liquidity reviews undergone by U.S. institutions.<sup>93</sup> If an eligible FBO requests capacity in excess of 100 percent of worldwide capital times the self-assessed cap multiple, it would be subject to the general procedure.

## F. Special Situations

Under the Board's policy, certain institutions warrant special treatment primarily because of their charter types. As mentioned previously, an institution must have regular access to the discount window and be in sound financial condition in order to adopt a net debit cap greater than zero. Institutions that do not have regular access to the discount window include Edge and agreement corporations, bankers' banks that are not subject to reserve requirements, limited-purpose trust companies, government-sponsored

<sup>92</sup> For example, a financial holding company is eligible for uncollateralized capacity of 35 percent of worldwide capital times the cap multiple. The streamlined max cap procedure would provide such an institution with additional *collateralized* capacity of 65 percent of worldwide capital times the cap multiple.

<sup>93</sup> The liquidity reviews will be conducted by the administrative Reserve Bank, in consultation with each FBO's home country supervisor.

enterprises (GSEs), and certain international organizations.<sup>94</sup> Institutions that have been assigned a zero cap by their Reserve Banks are also subject to special considerations under this policy based on the risks they pose. In developing its policy for these institutions, the Board has sought to balance the goal of reducing and managing risk in the payments system, including risk to the Federal Reserve, with that of minimizing the adverse effects on the payments operations of these institutions.

Regular access to the Federal Reserve discount window generally is available to institutions that are subject to reserve requirements. If an institution that is not subject to reserve requirements and thus does not have regular discount-window access were to incur a daylight overdraft, the Federal Reserve might end up extending overnight credit to that institution if the daylight overdraft were not covered by the end of the business day. Such a credit extension would be contrary to the *quid pro quo* of reserves for regular discount-window access as reflected in the Federal Reserve Act and in Board regulations. Thus, institutions that do not have regular access to the discount window should not incur daylight overdrafts in their Federal Reserve accounts.

Certain institutions are subject to a daylight-overdraft penalty fee levied against the average daily daylight overdraft incurred by the institution. These include Edge and agreement corporations, bankers' banks that are not subject to reserve requirements, and limited-purpose trust companies. The annual rate used to determine the daylight-overdraft penalty fee is equal to the annual rate applicable to the daylight overdrafts of other institutions (50 basis points) plus 100 basis points multiplied by the fraction of a 24-hour

<sup>94</sup> The Reserve Banks act as fiscal agents for certain entities, such as government-sponsored enterprises (GSEs) and international organizations, whose securities are Fedwire-eligible but are not obligations of, or fully guaranteed as to principal and interest by, the United States. The GSEs include Fannie Mae, the Federal Home Loan Mortgage Corporation (Freddie Mac), entities of the Federal Home Loan Bank System (FHLBS), the Farm Credit System, the Federal Agricultural Mortgage Corporation (Farmer Mac), the Student Loan Marketing Association (Sallie Mae), the Financing Corporation, and the Resolution Funding Corporation. The international organizations include the World Bank, the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank. The Student Loan Marketing Association Reorganization Act of 1996 requires Sallie Mae to be completely privatized by 2008; however, Sallie Mae completed privatization at the end of 2004. The Reserve Banks no longer act as fiscal agents for new issues of Sallie Mae securities, and Sallie Mae is not considered a GSE.

day during which Fedwire is scheduled to operate (currently 21.5/24). The daily daylight-overdraft penalty rate is calculated by dividing the annual penalty rate by 360.<sup>95</sup> The daylight-overdraft penalty rate applies to the institution's average daily daylight overdraft in its Federal Reserve account. The daylight-overdraft penalty rate is charged in lieu of, not in addition to, the rate used to calculate daylight overdraft fees for institutions described in section II.F.

Institutions that are subject to the daylight-overdraft penalty fee are not eligible for the \$150 fee waiver and are subject to a minimum fee of \$25 on any daylight overdrafts incurred in their Federal Reserve accounts.<sup>96</sup> While such institutions may be required to post collateral (see sections II.F.), they are not eligible for the lower fee associated with collateralized daylight overdrafts.

## 1. Edge and Agreement Corporations<sup>97</sup>

Edge and agreement corporations should refrain from incurring daylight overdrafts in their Federal Reserve accounts. In the event that any daylight overdrafts occur, the Edge or agreement corporation must post collateral to cover the overdrafts. In addition to posting collateral, the Edge or agreement corporation would be subject to the daylight-overdraft penalty rate levied against the average daily daylight overdrafts incurred by the institution, as described above.

This policy reflects the Board's concerns that these institutions lack regular access to the discount window and that the parent company may be unable or unwilling to cover its subsidiary's overdraft on a timely basis. The Board notes that the parent of an Edge or agreement corporation could fund its subsidiary during the day over Fedwire or the parent could substitute itself for its subsidiary on private systems. Such an approach by the parent could both reduce systemic risk exposure and permit the Edge or agreement corporation to continue to

<sup>95</sup> Under the current 21.5-hour Fedwire operating day, the effective daily daylight-overdraft penalty rate is truncated to 0.0000373.

<sup>96</sup> While daylight overdraft fees are calculated differently for these institutions than for institutions that have regular access to the discount window, overnight overdrafts at Edge and agreement corporations, bankers' banks that are not subject to reserve requirements, limited-purpose trust companies, GSEs, and international organizations are priced the same as overnight overdrafts at institutions that have regular access to the discount window.

<sup>97</sup> These institutions are organized under section 25A of the Federal Reserve Act (12 U.S.C. 611-631) or have an agreement or undertaking with the Board under section 25 of the Federal Reserve Act (12 U.S.C. 601-604(a)).

service its customers. Edge and agreement corporation subsidiaries of foreign banking organizations are treated in the same manner as their domestically owned counterparts.

## 2. Bankers' Banks<sup>98</sup>

Bankers' banks are exempt from reserve requirements and do not have regular access to the discount window. They do, however, have access to Federal Reserve payments services. Bankers' banks should refrain from incurring daylight overdrafts and must post collateral to cover any overdrafts they do incur. In addition to posting collateral, a bankers' bank would be subject to the daylight-overdraft penalty fee levied against the average daily daylight overdrafts incurred by the institution, as described above.

The Board's policy for bankers' banks reflects the Reserve Banks' need to protect themselves from potential losses resulting from daylight overdrafts incurred by bankers' banks. The policy also considers the fact that some bankers' banks do not incur the costs of maintaining reserves as do some other institutions and do not have regular access to the discount window.

Bankers' banks may voluntarily waive their exemption from reserve requirements, thus gaining access to the discount window. Such bankers' banks are free to establish net debit caps and would be subject to the same policy as other institutions. The policy set out in this section applies only to those bankers' banks that have not waived their exemption from reserve requirements.

## 3. Limited-Purpose Trust Companies<sup>99</sup>

The Federal Reserve Act permits the Board to grant Federal Reserve membership to limited-purpose trust companies subject to conditions the Board may prescribe pursuant to the Act. As a general matter, member limited-purpose trust companies do not accept reservable deposits and do not have regular discount-window access. Limited-purpose trust companies

<sup>98</sup> For the purposes of this policy, a bankers' bank is a depository institution that is not required to maintain reserves under the Board's Regulation D (12 CFR 204) because it is organized solely to do business with other financial institutions, is owned primarily by the financial institutions with which it does business, and does not do business with the general public. Such bankers' banks also generally are not eligible for Federal Reserve Bank credit under the Board's Regulation A (12 CFR 201.2(c)(2)).

<sup>99</sup> For the purposes of this policy, a limited-purpose trust company is a trust company that is a member of the Federal Reserve System but that does not meet the definition of "depository institution" in section 19(b)(1)(A) of the Federal Reserve Act (12 U.S.C. 461(b)(1)(A)).

should refrain from incurring daylight overdrafts and must post collateral to cover any overdrafts they do incur. In addition to posting collateral, limited-purpose trust companies would be subject to the same daylight-overdraft penalty rate as other institutions that do not have regular access to the discount window.

## 4. Government-Sponsored Enterprises and International Organizations

The Reserve Banks act as fiscal agents for certain GSEs and international organizations in accordance with federal statutes. These institutions generally have Federal Reserve accounts and issue securities over the Fedwire Securities Service. The securities of these institutions are not obligations of, or fully guaranteed as to principal and interest by, the United States. Furthermore, these institutions are not subject to reserve requirements and do not have regular access to the discount window. GSEs and international organizations should refrain from incurring daylight overdrafts and must post collateral to cover any daylight overdrafts they do incur. In addition to posting collateral, these institutions would be subject to the same daylight-overdraft penalty rate as other institutions that do not have regular access to the discount window.

## 5. Problem Institutions

For institutions that are in weak financial condition, the Reserve Banks will impose a zero cap. The Reserve Bank will also monitor the institution's activity in real time and reject or delay certain transactions that would create an overdraft. Problem institutions should refrain from incurring daylight overdrafts and must post collateral to cover any daylight overdrafts they do incur.

## G. Monitoring

### 1. Ex Post

Under the Federal Reserve's ex post monitoring procedures, an institution with a daylight overdraft in excess of its maximum daylight overdraft capacity or net debit cap may be contacted by its Reserve Bank. Overdrafts above the cap for institutions with de minimis, self-assessed and max caps may be treated differently, depending on whether the overdraft is collateralized.<sup>100</sup> If the overdraft is fully collateralized, the Reserve Bank may consider the

<sup>100</sup> There are no changes in monitoring of exempt institutions: overdrafts above the exempt cap limit, regardless of whether such overdrafts are collateralized or uncollateralized, should no more than twice in two consecutive two-week reserve-maintenance periods (the total of four weeks).

condition an overlimit situation and may waive counseling for two incidents of overlimit, fully collateralized overdrafts per two consecutive two-week reserve-maintenance periods (the total of four weeks). If instances of overlimit, fully collateralized overdrafts are beyond the approved number of overlimit incidents or if any part of the overdraft is *uncollateralized*, the Reserve Bank will apply normal counseling procedures.

Each Reserve Bank retains the right to protect its risk exposure from individual institutions by unilaterally reducing net debit caps, imposing (additional) collateralization or clearing-balance requirements, rejecting or delaying certain transactions as described below, or, in extreme cases, taking the institution off line or prohibiting it from using Fedwire.

### 2. Real Time

A Reserve Bank will, through the Account Balance Monitoring System, apply real-time monitoring to an individual institution's position when the Reserve Bank believes that it faces excessive risk exposure, for example, from problem banks or institutions with chronic overdrafts in excess of what the Reserve Bank determines is prudent. In such a case, the Reserve Bank will control its risk exposure by monitoring the institution's position in real time, rejecting or delaying certain transactions that would exceed the institution's maximum daylight overdraft capacity or net debit cap, and taking other prudential actions, including requiring (additional) collateral.<sup>101</sup>

### 3. Multi-district Institutions

Institutions, such as those maintaining merger-transition accounts and U.S. branches and agencies of a foreign bank, that access Fedwire through accounts in more than one Federal Reserve District are expected to manage their accounts so that the total daylight overdraft position across all accounts does not exceed their net debit caps. One Reserve Bank will act as the administrative Reserve Bank and will have overall risk-management responsibilities for institutions maintaining accounts in more than one Federal Reserve District. For domestic institutions that have branches in multiple Federal Reserve Districts, the administrative Reserve Bank generally

<sup>101</sup> Institutions that are monitored in real time must fund the total amount of their ACH credit originations in order for the transactions to be processed by the Federal Reserve, even if those transactions are processed one or two days before settlement.

will be the Reserve Bank where the head office of the bank is located.

In the case of families of U.S. branches and agencies of the same foreign banking organization, the administrative Reserve Bank generally is the Reserve Bank that exercises the Federal Reserve's oversight responsibilities under the International Banking Act.<sup>102</sup> The administrative Reserve Bank, in consultation with the management of the foreign bank's U.S. operations and with Reserve Banks in whose territory other U.S. agencies or branches of the same foreign bank are located, may determine that these agencies and branches will not be permitted to incur overdrafts in Federal Reserve accounts. Alternatively, the administrative Reserve Bank, after similar consultation, may allocate all or part of the foreign family's net debit cap to the Federal Reserve accounts of agencies or branches that are located outside of the administrative Reserve Bank's District; in this case, the Reserve Bank in whose Districts those agencies or branches are located will be responsible for administering all or part of the collateral requirement.<sup>103</sup>

#### H. Transfer-Size Limit on Book-Entry Securities [No change]

By order of the Board of Governors of the Federal Reserve System, February 28, 2008.

**Jennifer J. Johnson,**

*Secretary of the Board.*

[FR Doc. 08-971 Filed 3-6-08; 8:45 am]

**BILLING CODE 6210-01-P**

---

<sup>102</sup> 12 U.S.C. 3101-3108.

<sup>103</sup>As in the case of Edge and agreement corporations and their branches, with the approval of the designated administrative Reserve Bank, a second Reserve Bank may assume the responsibility of managing and monitoring the net debit cap of particular foreign branch and agency families. This would often be the case when the payments activity and national administrative office of the foreign branch and agency family is located in one District, while the oversight responsibility under the International Banking Act is in another District. If a second Reserve Bank assumes management responsibility, monitoring data will be forwarded to the designated administrator for use in the supervisory process.