JPMorganChase

David A. Weisbrod
Senior Vice President
Treasury & Securities Services - Risk Management

May 30, 2008

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Docket No. OP-1309
<u>Proposed Changes to Policy on Payments System Risk</u>

Governors:

JPMorgan Chase Bank, N.A. ("JPMorgan") is pleased to provide comments to the Board of Governors of the Federal Reserve System (the "Board") on its proposed changes to the Policy on Payments System Risk (PSR) under Docket no. OP-1309. As the nation's largest clearer of U.S. dollar payments, JPMorgan supports the Board's efforts to improve the efficiency of, and reduce the risks in, the payments system. To that end, JPMorgan was an active participant in the extensive investigation conducted by the Payments Risk Committee (PRC) and Wholesale Customer Advisory Group (WCAG) of factors that contribute to the concentration of late day payments. JPMorgan commends the Board's diligence in assessing shifts in payment industry trends and its efforts to loosen intraday liquidity constraints in response to the changing financial markets. We compliment the Board for its continued efforts to solicit feedback from the institutions impacted by its policy, and its willingness to adopt recommendations from the industry.

JPMorgan is supportive of the strategy for providing intraday credit to depository institutions through collateralized daylight overdrafts at a zero fee. Below we provide comments to the Board's proposed changes to the PSR policy. In particular we address: 1) the potential impact of the elimination of daylight overdraft charges for collateralized overdrafts; 2) the need for the Federal Reserve to monitor and encourage bilateral flow of liquidity; and 3) the timeline for implementation of the proposed policy changes. In addition, we append to this letter our responses to the specific questions posed by the Board under Docket OP-1309.

JPMorgan has long shared the Federal Reserve's concerns over the increasing number of large-value Fedwire payments effected late in the day. The growing trend in late day concentration of payments presents increased risk to the financial markets. The greater the

JPMorgan Chase & Co. • One Chase Manhattan Plaza, Floor 6, New York, NY 10005-1401
Telephone: 212 552 7714 • Facsimile: 212 552 0391
david.a.weisbrod@chase.com

number and value of late day payments, the higher the risk that payments will not settle in a timely manner in periods of financial turmoil or if operational disruptions were to occur late in the day. The potential gridlock of late day payments is due, at least in part, to depository institutions' incentive to hold payments in queues in an effort to reduce daylight overdraft cost and preserve liquidity for time-sensitive payments. JPMorgan expects that the introduction of a zero fee for collaterized daylight overdrafts would significantly lessen (although not eradicate) banks' tactical behavior of releasing large value payments late in the day.

As we proposed in our comments to the Board's Consultation Paper on Intraday Liquidity Management and the Payments System Risk Policy ("Consultation Paper – Docket OP-1257"), banks should be allowed to utilize their available collaterized overdrafts before being charged for overdrafts. We are pleased that the Board has incorporated this recommendation into its proposed revisions to the PSR policy. Banks' unencumbered use of discount window collateral to cover daylight overdrafts at a zero fee will facilitate earlier release of payments and thus should improve liquidity flow. While banks may generate a larger daylight overdraft position earlier in the day, the collateral would be available to offset the total amount of the banks' indebtedness to the Federal Reserve, thereby mitigating the Federal Reserve's credit exposure. This strategy reduces the credit risk to the Reserve Banks in the incurrence of larger overdrafts while at the same time incenting the early release of payments.

We note that although the proposed policy change will lead to the earlier release of some payments, it will not necessarily eliminate certain banks' strategic practice of holding payments in queues. Many banks will assess the relative benefits of pledging collateral versus paying daylight overdraft fees or holding payments in queues. Based on the relative costs, some institutions may continue to hold on to liquidity and elect not to collateralize, choosing instead to wait for other institutions to release funds. A consequence of this practice would be sustained imbalance of liquidity flows in the industry. JPMorgan believes that unless there are changes to the underlying market practices and behavior, certain institutions could function, or might continue to function, as "funding agents" to the market, thereby impeding the potential benefits of the Board's proposed changes.

JPMorgan believes that in order for the industry to realize the full benefits of the proposed changes to the PSR, the earnest and active participation of major payment institutions is crucial. To that end, JPMorgan encourages the Board to monitor and analyze developments in the industry's collective behavior over time, and to adopt mechanics to encourage and promote bilateral flow of payments between institutions. We expect that the implementation of such strategies will require further collaboration and input from the industry.

To enable institutions to efficiently manage their intraday collateral, the Federal Reserve must provide banks with capabilities to monitor and measure collateral requirements. In this regard, we request that the Federal Reserve provide institutions with frequent updates of their collateralized position to support daylight overdraft (as frequently as every fifteen (15) minutes), in addition to daily reports setting forth total charges for uncollateralized amounts. We request that the Board provide additional details to enable banks to better understand the mechanics of how the Federal Reserve will provide banks with the necessary data to effectively manage and monitor collateral.

JPMorgan understands that the Federal Reserve will need to modify its systems to accommodate the proposed PSR policy changes, and that such adjustments will affect its credit risk management and accounting applications. While JPMorgan expects that we may need to adjust our systems to accommodate the revisions to the PSR policy, we do not anticipate significant changes to our technology infrastructure. We are mindful that the extent of necessary adjustments will depend on the components of the final rule and the level of systems integration that will be required. Nonetheless, we expect to be able to implement the proposed changes, as currently defined, within a year of the announcement of a final rule. Accordingly, we strongly support implementation of the revised PSR policy sooner than the Board's two year proposed timeframe.

We thank the Board for the opportunity to comment upon the proposed changes to the PSR policy and hope our comments have been helpful.

Very truly yours,

David A. Weisbrod

JPMorgan is pleased to submit the following responses to the Board's questions posed in OP-1309:

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?**

   The Federal Reserve's proposal may help reduce liquidity, operational and credit risks in the payments system. In any event, the proposal is not likely to increase these risks. To the extent that payments are released throughout the processing day and there are a greater number of payments completed earlier in the day, there could be an improvement in liquidity flows. This may lead to some earlier credit decisions at paying banks and reduced operational risk during the late day period.

   Would it reduce these risks for depository institutions, their customers, or financial utilities?

   The proposed change would in theory reduce the risks provided all participants create and utilize a sufficient critical mass of collateral for the common benefit of all market participants. There is the potential to release more payments from liquidity queues in the afternoon as the incremental use of collateralized debit cap bears no incremental cost. It is in the best interest of the participants and the market to maximize this usage.

   Larger depository institutions may find that they are generating a larger daylight overdraft position in the early morning hours and carrying a larger portion of that position into the afternoon to the extent liquidity is not returned.

   Certain large bilateral credit exposures between settlement members, such as the cash leg of tri-party settlements, might not necessarily be reduced in the afternoon without the benefit of further discussions around this process or a Liquidity Saving Mechanism (LSM).

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

   The procedural or systems changes that JPMorgan would make as a result of the proposed policy change will depend on the extent of changes, if any, in the current practice of posting collateral at the discount window. We expect minimal procedural or systems changes if there are only minor changes to the current practice. JPMorgan will review the current outgoing payment queues and determine what changes would be appropriate as the industry adapts to the policy changes. We will educate both our cash clearing and securities clearance clients on the changes and potential impacts.

The Federal Reserve should consider additional changes to support the posting and return of eligible securities as collateral on an intra-day basis, to the extent that it is demonstrated to be an economical option. The ability to return the securities before end of day, while they are still eligible to be re-invested overnight, would be key. JPMorgan would need to understand the mechanism for intra-day management of this collateral. For example, whether the securities might be delivered through a sub-account to our ABA and/or posted to a segmented sub-account to our master account at the discount window, and how these securities would later be retrieved or returned. While such changes would require further due diligence on our part, we do not anticipate that they would require significantly more procedural or systems changes for JPMorgan. We would also look to develop a model that monitors the use and values the availability of our collateral.

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?**

   Yes, JPMorgan regularly uses daylight credit. JPMorgan has unencumbered eligible collateral.

   By your estimate, what proportion of your expected average and peak overdraft would you intend to collateralize?

   In foreseeable circumstances, JPMorgan estimates that it would collaterize its entire average overdraft position and most of its peak overdraft position.

4. **Would your institution's intraday credit use increase or decrease from current levels?**

   We expect our institution's daylight overdraft use to increase from current levels, absent any change in counterparty behavior. Higher daylight overdraft levels may be offset by an increase in incoming payments from banks that use their collateralized positions to release payments earlier in the day.

   Do you expect the intraday credit usage of depository institutions as a group to increase or decrease from current levels?

   We expect that credit usage will increase to the extent that overall usage cost declines. Smaller institutions without significant collateral to support their intra-day requirement will be incented to hold on to liquidity to avoid higher daylight overdraft charges.

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?**

   We agree with the opportunity costs estimates on collateral of between 26 & 50 bps. The cost is potentially much higher to raise incremental intra-day liquidity. For JPMorgan it is less an issue of degree of difficulty and more one of incremental cost. To the extent discount window collateral has become more scarce in the current environment, it will be allocated strategically by many firms.

What opportunity costs would your institution face in pledging (additional) eligible assets to the Reserve Bank to collateralize daylight overdrafts?

The cost of incremental collateral was addressed in the prior question. On an intra-day basis it is a function of how collateral will be created, pledged, and priced. If it is a trade-off between the opportunity cost of collateral for the day versus the cost on uncollateralized daylight overdraft, we may choose to go over the limit of the collateralized cap for several hours on peak days as opposed to pledging incremental collateral.

What are the costs of entering into the Reserve Banks' borrowing documents?

These are already sunk costs and are difficult to quantify.

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?**

   An increase in demand for collateral – to the degree that it might be underutilized today – will create an opportunity to increase collateral levels at little or no cost premium. As a consequence of the recent credit crisis however, there has been a specific shift in the range of collateral, including collateral supporting new facilities made available to the market by the Fed. This reflects a systemic increase in demand for collateral, particularly at the margin, the external impact of which is still unclear.

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)?**

   - The Federal Reserve should increase the frequency of its reporting in its Account Management Information website to show the collateral outstanding to support daylight overdraft, as frequently as possible and at least every 15 minutes.
   - There should be an end of day report which runs the collateral position against the firm's net daylight overdraft position (the latter calculated as at present), and related charges on any uncollateralized portion.
   - Given that unencumbered pledged collateral at the discount window is automatically available to support intra-day daylight overdraft exposure, no further process around this is required. This may change to the extent that there will be a mechanism to augment eligible available collateral at the discount window on an intra-day basis.

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?**

   JPMorgan has securities pledged at the discount window.

Pricing

9. **To what extent would your institution make payments earlier in the day as a result of the proposed pricing changes?**

We expect to continue to release payments in the 9:00 pm to 8:00 am timeframe provided counter-party recipients are open and actively participating in Fedwire during those hours. We expect that the management/throttling of payments from 8:00am to early afternoon should decline, provided all players reduce their throttling and/or initiate return payments during this period. There will also be the incentive to maximize collateralized debit cap usage at end of day as incremental usage late in the day will bear no incremental daylight expense at the full rate, as at present, and return funds are flowing more freely.

The extent to which the demand for early morning 'funding' payments might significantly increase is uncertain.

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?

We would continue to monitor payment flows, and if traffic is not balanced, we may elect to hold outgoing payments to certain counterparties.

If so, under what circumstances would your institution continue to queue payments?

In addition to bilateral traffic flow management, in the rare instances when we would be using uncollateralized daylight overdrafts, we may queue payments to avoid potential incidents of excessive charges at the higher fee.

What further steps would encourage queue reductions?

All participants should expedite the return of large funding payments wherever possible. For example:

- Payments to DTC will continue to be caught in a liquidity trap because DTC participants do not maximize their potential cash withdrawal capabilities currently available due to a number of technical and operational issues.
- PSR1182 created a large incremental demand for early return funds to support GSE P&I payments being disbursed by the Fed. The early return of funds that are able to be invested by the GSEs into the market on non-P&I days helps narrow this net intra-day funding gap.
- The Federal Reserve might be able to expedite the turn-around time to return funds under the Term Auction Facility (TAF).

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?

No. We expect that dealers will not change their current behavior.

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?

Because of the uncertain dynamic between banks possessing varying amounts of collateral, we cannot be certain that the proposed policy would significantly change current practice. The fed funds market under current PSR policy has usually provided 24 hours value. In our view, post PSR 1182, the true liquidity cost of an early return item has still not generally been factored into the underlying deal or the charges of the settlement agent whose liquidity is being used to fund an early return credit to an account at the Fed.

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?

In the unlikely event that JPMorgan incurs higher costs to support daylight overdrafts, JPMorgan will first consider available options to increase its collateral position per our response to question 2.