

INSTITUTE OF INTERNATIONAL BANKERS

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LAWRENCE R. UHLICK
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October 4, 2006

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, DC 20551

Re: Request for Early Correction of the Disparity in
Treatment of International Banks Under Existing Overdraft Policy

Dear Chairman Bernanke:

We are writing to draw your attention to a longstanding concern we have raised regarding a competitively-significant disparity in the treatment of international banks in comparison to their domestic counterparts embedded in the formula used for calculating permissible caps and deductibles for daylight overdrafts under the Federal Reserve's Policy Statement on Payments System Risk. The formula derives the cap for each institution based on its allowable capital, but recognizes not more than 35 percent of an international bank's capital in comparison to 100 percent of a domestic bank's capital. The deductible is based on 10 percent of allowable capital, and thus amounts to 10 percent of capital for a domestic bank, but not more than 3.5 percent for an international bank. As a result of these calculations, a domestic bank with a comparable capital size and credit rating as an international bank receives nearly triple the amount of fee-free credit and permissible overdrafts. This disparity results in a markedly unequal playing field and real cost difference between the international and domestic banks that are major participants in the U.S. dollar clearing business. Of equal importance to these competitive considerations, the disparity leads to chronic delays in payments and increased operational and systemic risk for the payments system generally.

As we discuss below, eliminating the inequality in the deductible determination is a matter of simple fairness and, as such, merits prompt remedial action. We appreciate the considerations underlying the disparity in the overdraft cap, but we believe that such unequal treatment of international banks is not justified and also deserves early correction.

The Institute's mission is to help resolve the many special legislative, regulatory and tax issues confronting **internationally headquartered** financial institutions that engage in banking, securities and/or insurance activities in the United States.

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BACKGROUND

We recognize that the Federal Reserve has published a Consultation Paper on intraday liquidity policy issues requesting comments on or before December 15, 2006 and are planning to participate in that process. However, the disparity in capital recognition is a fundamental preliminary concern that affects any analysis of the various issues and alternatives reviewed in the Consultation Paper. Indeed, in the absence of a correction, certain possible policy changes such as introducing time of day pricing would in fact exacerbate the existing competitive cost disadvantage of international banks that must defer payments of certain items during the day to avoid exceeding their limited deductible. We are therefore seeking a separate and expedited track for correcting this longstanding difference in treatment.

Based on information obtained and reported in the Institute's Global Survey (copy attached), we believe the United States is the only country that differentiates between international and domestic banks in the treatment of intra-day liquidity. Some countries have decided not to permit such credit or to permit it only if collateralized, but no other country to our knowledge has treated domestic and foreign banks unequally.

During the past two years, we have addressed our concerns regarding this material disparity in written materials and in meetings with senior staff members of the Federal Reserve in Washington and New York. We have presented illustrative comparative cost data and explained the negative effects of the cost disparity on the ability of international banks to remain competitive in the narrow-margin business of clearing U.S. dollar payment transactions. At the invitation of several of our member banks, the Federal Reserve staff has visited their payments operations for a first-hand view of how the disparity is causing deferrals of payments and contributing to operational and systemic risk in the system.

Over the period that we have been discussing these issues with staff, there have been several developments that have made our concerns more pressing and exacerbated the problem, both for international banks and for the payments system as a whole. These developments include expanded hedge fund payment needs, restricted timing windows for CLS, DTC and CHIPS payments, and, most recently, the removal of intra-day free liquidity for GSEs. The combination of these circumstances artificially distorts optimum payment flows and adversely affects liquidity in U.S. markets. In particular, the "queue management" international banks must implement to respond to unnecessarily low deductibles adds an element of risk to the payments system without any comparable protection to the Federal Reserve, whether as a credit matter or otherwise.

ANALYSIS

We believe there is no justification for discounting the capital of the best rated international banks by 65 percent or more in comparison to their domestic counterparts. Indeed, if any differentiation were to be justifiable it should be based on and reflect any difference in risk to the system from participation by international banks in comparison to domestic banks. As discussed below, we believe such a risk analysis fully supports our perspective and the need for correction. We also believe that our oral and written presentations have laid a solid foundation for moving expeditiously to address these concerns.

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1. Deductible. As regards the intra-day deductible from overdraft fees, the issue is one of fairness and uniformity of treatment in the terms under which a fee would or would not be charged. There is no element of risk to the payments system raised by ensuring that international banks receive a deductible credit for daylight overdraft fees on the same terms as do domestic banks of a comparable capital size and credit standing, and the deductible (unlike the cap) has nothing to do with a perception of, or reaction to, credit risk. Prompt action to provide equality of treatment in the deductible accorded to domestic and international banks would address this regulatory cost disparity, and eliminate the negative impact on international banks engaged in the U.S. dollar clearing business, without any adverse impact on the Federal Reserve. We have heard no suggestion by anyone that there is any justification for maintaining fee-free credit for domestic banks that is nearly triple the amount permitted for comparable international banks.

It is appropriate to study various policy alternatives regarding the structure of daylight overdraft fees, including whether or not it is desirable to maintain the existing deductible or to change the incentives in such fees. However, it is essential to a fair and meaningful analysis of the effects of alternative policy choices that they be assessed in the context of a regulatory framework that accords equivalent treatment to comparable international and domestic banks. In the absence of such equivalence, the potential merits of certain policy alternatives would be obscured.

As noted earlier, adopting a fee that penalizes late-in-the-day submission of payments would exacerbate the cost penalty already applied to international banks that must delay their submissions to avoid exceeding their reduced deductible. Furthermore, fixing a uniform deductible at 10 percent of capital does not raise any credit risk issues, since the deductible is not intended to provide a surrogate for credit risk, and, in any event, a 10 percent deductible would be a comparatively small fraction of an international bank's overdraft cap. Finally, providing equality in the deductible for domestic and international banks will resolve this current unfair economic differentiation, can only be helpful to the payments process, and will remove the current artificial pressure on international banks to stagger payments to maintain their competitiveness with domestic banks which engage in a similar business.

We therefore respectfully request that this issue of fair treatment in the deductible be addressed promptly and not be delayed pending the longer term policy review anticipated by the Consultation Paper.

2. Overdraft Cap. As to the overdraft cap, we recognize that it raises certain policy questions that may require a longer period of evaluation, but we believe there nevertheless are compelling reasons why the existing formula cannot be justified in its treatment of international banks, especially those that either have been validated by the Federal Reserve to be both "well capitalized" and "well managed" for U.S. regulatory (FHC) purposes or have received the highest rated "strength-of-support assessment" (SOSA 1).

Overdraft credit is extended only intra-day, so that any comparative analysis of systemic risk from any differences regarding the availability of information concerning financial condition and insolvency protections as between international and domestic banks should, of course, be evaluated in the context of this extremely limited and current exposure period. Moreover, international banks have a long history of successful operations in the United States without producing insolvency losses, and this record is especially strong for the international banks that

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have substantial U.S. dollar clearing activities. Finally, even if it could be argued that the risk that could result from overdrafts by international banks as compared with overdrafts by domestic banks is marginally different, we do not believe it could reasonably be suggested that this difference justifies granting nearly three times as much credit to domestic banks as to international banks of a comparable capital size and credit rating.

CONCLUSION

We urge that the need for equality of treatment of international and domestic banks in the determination of the deductible for the calculation of overdraft fees be addressed promptly since this issue is simply one of fairness in fees rather than of risk to the payment system. While we recognize that the overdraft cap determination may entail some further risk review, and therefore might not be addressed on as expedited a schedule, we also believe that its existing restrictions on international banks plainly exceed what is justifiable and call for correction as early as possible.

Please contact the undersigned if we can provide further information or assistance.

Very truly yours,

Everett Schenk
Chairman

Lawrence R. Uhlick
Chief Executive Officer

Attachment

cc: Jack Jennings
Jeffrey Marquardt

**AVAILABILITY OF CENTRAL BANK
“DAYLIGHT OVERDRAFT” CREDIT**

| <p>Central Bank Daylight Overdraft Credit Is Not Available to Domestic and Non-Domestic Banks</p> | <p>Central Bank Daylight Overdraft Credit Is Available Equally to Domestic and Non-Domestic Banks But Only on a Fully Collateralized Basis</p> | <p>Central Bank Daylight Overdraft Credit Is Available to Domestic and Non-Domestic Banks on an Uncollateralized Basis But Stricter Limits Apply to Non-Domestic Banks</p> |
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| <p>Australia¹ Bahrain Cayman Islands² Hong Kong¹ Philippines¹ Romania Switzerland¹</p> | <p>Argentina Austria Belgium Czech Republic Denmark Finland Germany Ireland Israel Italy Japan Korea Latvia Luxembourg Netherlands Norway Portugal Singapore³ South Africa⁴ Spain Sweden Turkey United Kingdom</p> | <p>United States⁵</p> |

¹ Intra-day liquidity is provided through repurchase agreements with the central bank.

² There is no Central Bank equivalent in the Cayman Islands.

³ Only for banks which are Primary Dealers in Singapore government securities.

⁴ Both prudential cash and liquid assets are used to fully collateralize the real time gross settlement system intra-day.

⁵ Effective May 30, 2001, the Federal Reserve Board modified its payments system risk policy on an interim basis to permit qualifying institutions, including branches and agencies of international banks, to gain access to daylight overdraft credit in excess of the limits otherwise applicable to them by collateralizing the amount of any such excess.