Re Docket No. OP-1257

The following observations have been prepared by William DuMond MBA/CPA
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I am available to discuss any of the aspects of these observations. A brief autobiography is appended at the end of the formal observations I comment as a member of the business faculty of Metropolitan College of New York and as an Industry Consultant to Electra Information Systems et al.

William DuMond 3/10/2007

Re: Docket No. OP-1257

OBSERVATIONS RE: REDUCTIONS IN INTRADAY OVERDRAFT RISK

AN ANALYSIS OF CURRENT GENERIC SYSTEM PRACTICES
The observations that follow are made from the perspective of the impacts on the Federal payments system intraday by securities transactions settlement and clearance.

Before identifying ideas to mitigate payment systems intraday risk, we must first identify the underlying generic processes for all securities related transactions that give or may give rise to intraday overdrafts in the Fed payments systems. Ideally if we could accomplish the three steps cited below within a shorter span of time we would reduce most risks including intraday payments risk:

All economic exchanges of securities involving material financial value go through a three- step process:

Step 1-Transaction Initiation and documented "Meeting of the Minds."
Do the parties agree as to what is to be exchanged and the values agreed to for the exchange? Transaction details must be agreed upon or there is no transaction. The buyers and sellers version of the transaction must be "compared", confirmed, contractually agreed upon or signaled by real time request for payment which are accepted (processing of same day trades in US Treasury securities and money market instruments.) Any material reconciling items between the parties to the trade must be identified and corrected as soon as possible. Immaterial cash differences may be absorbed..

Step 2-Exchange (Clearance) of Value for Value

The exchange of value for value should be simultaneous and should occur as soon as possible after the meeting of the mind that occurs in Step 1. The most serious risk problems that may threaten the system arise in the period between the step one agreement of details and the actual exchange of value for value. The T+3 business day settlement delay problem is just one of the examples of the delays rooted in operational and industry practice problems.

Delays in the securitization process and delays in the home mortgage market from initial sales agreement through the lengthy home closing cycle are examples of "delayed settlement risk". The too lengthy meeting of the minds on mortgages through to initial closing and then on through to securitization opens the possibility that a precipitous drop in housing prices may result in losses on any items in the settlement pipeline that may be "walked away" from. This could lead to "lengthy litigation risk.". The industry needs to greatly reduce the time it takes to finalize the mortgage settlement cycle.

Step 3-Full, Timely Reconciliation /Agreement of All Parties Records

The records of all of the parties involved in settling the trade must all be reconciled automatically and any differences identified as soon after the exchange of value for value has occurred. Any differences should be corrected immediately. All records should be reconciled and all problems identified as close to the exchange of value for value as possible and in any case by no later than the next day's opening for business. Delays in reconcilement can lead to "perfect storm risk"- the infrequent occurrence of a large adverse event that is not discovered via reconciliation until it is too late to correct "next business day". We could have a material, late-identified difference and then enter a weekend with bank's closed for three days. Delays in identifying material error may lead to material risk.

Observation- The sooner each of these three steps in a securities transaction are accomplished, the less risk there is in the overall systems. The systems referred to are not only the Fed payment system but also all of the outlier net settlement systems including DTCC, CLN etc If the three steps could be accomplished simultaneously then operationally grounded risk could be nearly eliminated. The current intraday exposure of the Fed could be exasperated by any problems in the private sectors net settlement systems which might require Fed intervention. This later situation is an example of "out of sight/out of mind risk" with many members of the industry "forgetting" about the call that may be made on the Fed if there are any serious problems in the net settlement system or if there is a reoccurrence of "Long Term Capital Management Risk."

It should also be noted that at least some of the risks that may develop in the US mortgage market will be exacerbated by the long period between the signing of a mortgage agreement to purchase and the actual closing and subsequent securitization process. The time from the meeting of the minds to final placement in a mortgage backed security is too long and only aggravates the principal risks of lowered credit standards and terms.

There follows a number of suggestions which collectively or in part could serve to reduce operationally based system risks.

a- FOSTER AN INTRADAY FED FUNDS MARKET by structuring daylight overdraft charges so that borrowers have an economic interest that will drive earlier delivery of fed funds. The overdraft charges could be scaled to drive fed funds deliveries to desired times of the day. The system should have realtime metrics provided by Fed that carve out the Fed Funds transactions hitting a Fed contra account segregated just for fed fund transactions and show them as they happen. By highlighting the time that items hit the account the market could pay a price differential for early delivery. Transactions should be "time stamped" Feds intraday charges should be structured like the intraday charges that Electric utilities offer to their largest consumers. Higher charges during critical time bands. Inferred in this suggestion is the need to time stamp trades and collect the various times it takes for trades to process through all parties. If all of the phases of the movement of cash were time stamped and appended to the trade it would be possible to set time to completion standards on various types of trades.

b- FOSTER A NEW INTRADAY PLEDGED COLLATERAL MARKET Institutions with excess pledged discount window collateral should have the ability to "sell" the excess collateral to other members intraday in a way that is analogous to the sale of excess funds in the same day market today. Members would set up lines for this type of business just as they establish fed funds lines today. A FED designed system could be set up to allow parties in need of collateral to contract with an offering institution. It is possible that Fed could develop mutual fund type arrangement whereby institutions could place portions of their pledged assets into an intraday available collateral fund. Each bank could indicate which institution they accept as a counterparty and for what amounts. Individual "borrowings" could be spread across a number of institutions and collateralization could be immediate. In practice you could systemically spread any risk over numerous participants in the arrangement and return the excess pledged collateral several times each intraday period.

c- ENCOURAGE T+1 SETTLEMENT ENDING 2 DAY PIPELINE PROBLEM DTCC and the other netting utilities have internal controls and net debit limits that reduce their exposure to credit shocks. But their ability to handle the failure of a participant is finite and tied to their total standby lines of credit. Multiple simultaneous participant failures would pull the Fed into the equation. Currently, the settlement of US Equities is a three business day cycle which leaves the industry with three days worth of trades in the settlement pipeline. The industry must move to T+1 and eventually to T+0 perhaps with the type of same day next day settlement that is available for early government securities trades. With the recent start of the Basel regimen for capital charges for operational risks we may

have found a driver that will take us to T+1. A key missing driver in getting to T+1 settlement is training of managements who have never had to deal with this "theoretical" risk.

d-CONSIDER HAVING A 24/7 HOUR DISCOUNT WINDOW

The Fed should consider having the discount window open for 7/24 or a least have the desk manned for several hours after the close of the last outlier securities settlement system. The Fed should get a confirmatory, positive advice that each of the settlement systems is in fact done for the day. Relative to discount window operations, a review of the liquidity backup line call down procedure of the outlier net settlement systems should be done on a regular basis including periodic tests of late in the day availability. DTCC has lines in place to allow it to introduce liquidity to the system in case of the failure of a participant at the limit of the net debit cap. The banks with the liquidity lines in place would have to resort to the discount window late in the day. Collateral positions should be verified regularly to assure that the line can be accessed late in the day. The process for substituting collateral should be fully automated.

e-LTCM (1998) SECONDARY CONSOLIDATED INTRADAY RISK

In addition to the market and liquidity risks that loom in any LTCM-like situation, there is also the secondary "flying blind intraday" on consolidated counterparty risk. Intraday exposures are managed on a product by product basis intraday and the use of "best of breed" systems with siloed transaction journals prevents the rapid assembly of a consolidated counterparty intraday position. This situation could lead to product managers taking actions to neutralize their product level risk which in fact open up new risk at the consolidated exposure level. Just as CLS was a 25 year project, the retooling of the accounting journal subsystem may take as long. There is a need for a central journaling system that recorded all intraday trades and then feeds all of the parties with a role in clearing and managing the trades. Each party needing trade details would receive trade details in a format and via a communication channel that should allow for realtime reprocessing Such a central system would allow for better intraday consolidated exposure risk management. A move to such systems is underway but should be universally encouraged. This would be a long term strategic rethinking and rebuilding of the accounting infrastructure.

f-CONCENTRATION OF INTELLECTUAL CAPITAL RISK

The securities industry has outsourced it's back office operations to various industry net settlement systems. The great savings and reduced settlement costs come at the price of concentrating the intellectual capital that maintains the net settlement systems. The physical safety of this corps of specialists must be approached as a national security risk and the physical safeguarding of this resource from concentrated risk must be a topic of the highest priority.

g-INCREASED AND IMPROVED METRICS ON ALL FOCUS AREAS

The industry requires increased metrics that measure all of the areas that we are concerned about. Fail rates, failure to confirm rates, regular periodic statistics on all urgent areas are needed so that problem areas can be identified and overall progress can be tracked.

h-SPEEDIER RECONCILIATION OF DAILY CASH MOVEMENTS AND HOLDINGS

The process that finalizes the three critical steps in completing all securities transactions is the full and timely reconciliation of the cash movement and updated holdings records of the parties. Best practices in this area must be continually reviewed and improved upon moving towards timely reconciliation and rapid identification of material error. The reconciliation process should be automated to allow for scalability in case of rapid increases in volumes. The goal should be to retrieve and reconcile all data as soon as possible after the completion of each days work cycle but no later then a next day standard of 8am EST. Full, daily reconciliation of holdings should be a standard in all cases. where a daily NAV is calculated on equity portfolios in order to backstop the identification of stock splits or reverse splits.

I-CONSIDER MULTIPLE SETTLEMENT OPTIONS

US Government trades settle on either a same day or next day basis depending on the time that the trades are contracted and or the agreement of the parties. It would be very helpful to gather more metrics concerning the traffic patterns during the day. There may be classes of transactions or types of counterparties that would allow for multiple settlement periods intraday.

Conclusion of Comments

Background of the Author of the above comments.

William DuMond MBA/CPA is retired from HSBC-USA where he was SVP/MD responsible for Capital Markets Operations, custody, clearance and Trust Processing. Mr DuMond served on the Securities Committee of the NY Clearing House for 10 years and on the Board of Participants Trust Company-The GNMA Depository where he also served as Chairman. On leaving HSBC-USA, Mr DuMond served in a consulting capacity for 4 years at DTC and for one year served as a Director and Subject Matter Expert for the US securities industry for PricewaterHouseCoopers Consulting. Since 2001, Mr DuMond has served on the full time faculty of the business school of Metropolitan College of New York and as a consultant to Electra Information Systems where he has worked on reconciliation solutions. Additionally, Mr DuMond regularly presents classes to the securities industry on “Managing Operational Risk”.