STATE STREET.

March 14th, 2007

Via email: regs.comments@federalreserve.gov

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

RE: Docket Number OP-1257

<u>Consultation Paper on Intra-day Liquidity Management and Payment System Risk Policy</u>

Dear Ms. Johnson:

State Street Corporation ("<u>State Street</u>") appreciates the opportunity to comment on the consultation paper issued by the Board of Governors of the Federal Reserve System ("<u>Board</u>") relative to the management of intra-day liquidity within the Federal Reserve ("Fed") payment system, including potential changes to its Payment System Risk ("<u>PSR</u>") policy. Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With $11.9 trillion in assets under custody and $1.7 trillion in assets under management as of December 31st, 2006, State Street operates in 26 countries and more than 100 markets worldwide.

State Street would like to commend the Board for its decision to begin a dialogue with the financial industry on a matter of growing importance. As emphasized within the Board's consultation paper and as validated in a recent analysis of payment activity undertaken by the joint Payments Risk Committee – Wholesale Customer Advisory Group ("PRC-WCAG") Task Force (of which State Street is a member), there is an increasing demand for intra-day credit within the Fed payment system, as well as a heavy concentration of late in the day high value payments. This is especially true in the last two hours of the processing day, with the largest value of payments stemming from tri-party repurchase and broker-dealer activity. It is as a result prudent for the Board to consider measures, with the assistance of the financial services industry, which might help to enhance the efficiency and risk profile of the Fed payment system. In so doing, we would urge the Board to be sensitive to the cost-benefit implications of any proposed solution.

While many of the proposals put forth by the Board in its consultation paper have merit, we believe that two are worthy of particular consideration; the introduction of liquidity savings mechanisms within the Fedwire funds transfer system and the enhanced ability to make use on a voluntary basis of collateral to manage intra-day exposure. In addition, since we believe that a narrow approach is unlikely to sufficiently address the current challenges faced by the Fed payment system, we would also recommend that these core proposals be combined with other promising measures, notably the establishment of time of day pricing for daylight overdrafts and the possible creation of a Fed sponsored market for intra-day liquidity.

In order to facilitate our assessment of this important document, we have structured our comments around the six core questions posed in Section V of the consultation paper.

Question #1 – Liquidity Conservation Strategies

State Street's liquidity management strategy is predicated upon the efficient use of available intra-day credit capacity. Although sensitive to the costs of daylight overdrafts, our primary concern is the effective servicing of our clients business needs. As such, funds transfers which meet all established criteria, including relevant credit controls, are processed on a straight through basis.

Question #2 – Impact of Private Sector Systems on Intra-day Liquidity

The previously noted analysis of payment activity undertaken by the joint PRC-WCAG Task Force reveals that the demand for intra-day central bank funds is materially impacted by the operations of private sector systems. This includes both the Depository Trust Company ("DTC") and the Clearing House Interbank Payments System ("CHIPS") where final settlement deadlines and the mechanics of their individual processes have a direct impact upon the compression of late in the day payments. In the case of DTC, progress payments generally reduce the amount of liquidity available for use in making Fedwire payments until completion of the entire settlement cycle at 4:30 p.m. Although participants do have the ability up until 3:00 p.m. to draw down progress payments made (as well as principal and income allocations), this is not necessarily an effective liquidity enhancing process given debit cap constraints at DTC which may require the institution to almost immediately wire funds back to cover trading obligations. In the case of CHIPS, the PRC-WCAG Task Force's analysis reveals that considerable liquidity is not made available until the close of the CHIPS business day, with payments averaging $23 billion actually removed from the CHIPS system near the close only to settle via Fedwire shortly thereafter. On the other hand, Continuous Link Settlement ("CLS") requirements for intra-day liquidity appear to have minimal effect upon the late in the day compression of funds, since those payments are made much earlier in the day and are not of the same magnitude as those initiated via DTC and CHIPS. State Street therefore believes that the Board has correctly identified the main sources of private sector system demand for intra-day central bank funds.

Question #3 – Late in the Day Payments

State Street views the late in the day concentration of payments within the Fedwire funds transfer system as an area of substantial and growing concern. We would emphasize in this regard the operational risk inherent in such a broad concentration of payment activity, with the clear potential for even a moderate end of day disruption to cascade throughout the US financial system. Simply put, the current concentration of payment activity so late in the day means that there is less room or tolerance for error. In addition, the late in the day receipt of funds transfers has complicated the timely and accurate forecasting of end-of-day cash positions throughout the industry, thereby leading to enhanced volatility relative to final Fed funding requirements for member institutions.

Although there are many interrelated factors which account for the current concentration of high value payments, we believe that three are predominant:

- The timing of same day trade instructions which are in turn driven by late in the day short term trading activity
- The timing of the return of maturity proceeds, notably in the tri-party repurchase and commercial paper markets
- The late in the day determination of funding requirements by money market funds

In our role as an institutional service provider, State Street has sought to manage the demands related to the late in the day concentration of high value payments by the implementation of systems enhancements designed to facilitate straight through processing, including the automated receipt of same day cash and securities transactions.

Question #4 – Potential Market, Operational and PSR Policy Changes

Intra-day Liquidity Market – If properly structured, State Street believes that the establishment of a Fed sponsored intra-day liquidity market would help to improve the balance of funds within the Fed payment system. It is unlikely, however, that such an approach would have a substantial impact upon the late in the day concentration of payments. This is because late in the day payments are largely the result of the current operational structure of the US short term cash market, including the timing of same day high value trade instructions, the timing of maturity payments and the funding requirements of money market funds. Among the factors which would need to be incorporated within any intra-day liquidity market, would be an equitable pricing structure designed to offer an attractive alternative to Fed intra-day overdraft charges, while nonetheless properly compensating those institutions capable and willing to lend. Similarly, it would also be essential to have a mechanism in place which would ensure that a lending institution was able to retrieve funds on loan without delay so as not to impact the integrity of its own liquidity management process. In our view, this would require the direct involvement of the Fed, most likely via the creation of a liquidity distribution mechanism within the existing Fedwire funds transfer system.

Market for the Early Return of Funds – As in the case of an intra-day liquidity market, State Street believes that a Fed sponsored market for the early return of funds would have some value in improving the balance of funds within the Fed payment system. However, in light of the US short term cash market constraints emphasized in our prior response, it is unlikely that such an approach would have a material impact upon the concentration of high value payments late in the business day. As for the structure of such an early return of funds market, we would re-emphasize the points made in our prior response relative to fair and competitive pricing, the existence of a mechanism for the prompt return of funds and the need for likely modifications to the existing Fedwire funds transfer system. It is relevant to note in this regard that the costs of the two proposed market derived alternatives may very well outweigh the potential benefits obtained. State Street would therefore strongly encourage the undertaking of a robust feasibility study as a prelude to any substantial work by the Fed on either of these alternatives.

Private Settlement System Enhancements – Depending upon the specific enhancements proposed, changes to the operational processes of core private sector settlement systems could improve the liquidity posture of the Fed payment system. As an example, it would be extremely advantageous to explore with DTC the feasibility of a second early settlement cycle for non money market instruments or even the potential advent of a real time gross settlement system. Similarly, State Street would also encourage the further review of many of the practical systems enhancements recommended by the joint PRC-WCAG Task Force, including the movement by DTC of end of day credits to the Fed's Net Settlement System as well as enhancements to CHIPS designed to facilitate the resolution/release of payments from queue within a specified timeframe. State Street would nonetheless caution that the value of these approaches is heavily dependent upon their specifics and that gaining consensus with outside parties may prove more complex and time consuming than other proposed liquidity enhancement solutions. As such, private sector settlement system enhancements may best be viewed as a longer term component of a comprehensive strategy to improve the overall intra-day liquidity posture of the Fed payment system.

Liquidity Savings Mechanisms – In our estimation, the introduction of liquidity savings mechanisms within the existing Fedwire funds transfer system is an attractive alternative. This could include either a queuing system as described within the Board consultation paper, or an internal net settlement mechanism for bank to bank obligations. In order to protect confidential client and proprietary trading information, such an approach would have to include a broad level of participant anonymity. Similarly, should either of these alternatives be implemented, State Street would recommend the promulgation of clear operational guidelines, specifying the roles and responsibilities of all parties involved. This would include the Fed itself, since in this alternative, control over the release of payments would transition from the private to the public sector, thereby necessitating a high degree of certainty as to exactly how such a system would operate. This should also include provisions relative to the legal finality of payments.

Throughput Requirements – In light of the nature and current operational structure of the US short term cash market, State Street does not view throughput requirements as a viable alternative for enhancing liquidity within the Fed payment system. We would re-emphasize in this regard the current timing of trade instructions and maturity proceeds, as well as the funding requirements of money market funds, all of which occur very late in the day. As such, the bulk of current activity within the Fed payment system cannot settle outside of a fairly narrow two hour window, thereby negating the usefulness of any requirements relative to the timing of intra-day Fed payment obligations.

Use of Voluntary Collateral – State Street views enhanced opportunities to make use of collateral on a voluntary basis to cover daylight overdrafts as an important feature in a more efficient, liquid and risk sensitive Fed payment system. As the Board itself makes clear in its consultation paper, collateral has become the norm in the day to day operations of both the private sector and other national central banks. We would as a result strongly encourage the Board to incorporate this approach in any future and presumably more detailed assessment of potential changes to its PSR policy.

Two Tier Pricing of Collateral – In light of current market practice, we question whether an approach which would involve the two tier pricing of day light overdrafts based upon a lower fee for collateralized vs. uncollateralized obligations would be effective. Instead, we would urge the Board to consider an approach which would enable participants to either voluntarily collateralize daylight overdrafts without further charge or, as is the case today, opt for no collateral with the payment of an appropriate overdraft fee. In so doing, we believe that the Board would enhance the financial incentives associated with the active and efficient management of daylight Fed obligations.

Time of Day Pricing of Daylight Overdrafts – Assuming the existence of a properly calibrated fee schedule, State Street believes that the time of day pricing of daylight overdrafts by the Fed could serve as a useful incentive for institutions to settle obligations earlier in the day, thereby enhancing the overall liquidity of the Fed payment system. This is especially true if time of day pricing were matched with our recommendations relative to the treatment of collateralized obligations (i.e. overdraft charges would only apply to uncollateralized exposure). State Street would nonetheless caution that as with several of the suggestions made within this consultation paper, the usefulness of this approach is greatly constrained by the current operational structure of the US short term cash market, notably the timing of same day high value trade instructions, the timing of maturity payments and the funding requirements of money market funds.

<u>Question #5 – Other Approaches to Manage Intra-Day Liquidity</u>

In our estimation, the Board's consultation paper accurately describes the challenges faced by the Fed payment system, as well as the solutions most likely to both reduce risk and enhance operational efficiency. State Street therefore has no other suggestions to offer relative to entities operating within the Fed payment system. We would nonetheless point out that intra-day liquidity and the concentration of late in the day payments are impacted by the operational processes of other participants within the financial industry. As such, it may be advisable to also consider broader changes to the functioning of the current US financial system. As an example, it would be extremely useful to encourage the financial system to improve the standardization and automation associated with the existing tri-party repurchase market. Ideally, this would include expanded opportunities for net settlement arrangements, whether within or outside of the Fed payment system.

<u>Question #6 – Impact of the Payment of Interest on Reserve Balances</u>

It is unlikely that banks would consider a broad increase in reserve balances without the payment of interest on deposits at competitive market rates. This is a direct result of prudent cash management policies, which aim to maximize returns without the assumption of undue risk. As such, the extent to which reserve balances can be used to enhance intra-day liquidity is at best uncertain and should not be relied upon as a central element of any reconfiguration of existing practices. This is especially true since recently enacted legislation (PL 109-351) does not allow for the payment of interest on reserve balances until October 2011.

Thank you once again for the opportunity to comment on this important conceptual document. To summarize, State Street agrees that current trends within the Fed payment system requires the consideration of broad changes to existing market practices, financial operations and the Board's PSR policy. Any such change must be based upon a careful assessment of corresponding costs. Although no one solution will resolve all of the issues faced, we believe that two proposed alternatives should stand at the core of any overarching approach; the introduction of liquidity savings mechanisms within the Fedwire funds transfer system and the enhanced ability to use collateral on a voluntary basis to manage intra-day exposure. In addition, State Street believes that there is merit in a number of other proposals put forth by the Board, notably the establishment of time of day pricing for daylight overdrafts and the possible creation of a Fed sponsored market for intra-day liquidity. Finally, State Street would also encourage the Board to actively consider a number of recommendations made by the joint PRC-WCAG Task Force relative to enhancements to core private sector settlement systems.

In light of the complex and multi-faceted issues posed by possible changes to the Board's intra-day liquidity management strategy, State Street would strongly recommend the creation of an industry advisory group to assist the Board in the further analysis of proposed solutions. As one of the largest participants within the Fed payment system, State Street would welcome the opportunity to participate in the work of such a group. Additionally, to the extent that it would be helpful, State Street is happy to discuss the details of its response with the Board.

Sincerely,

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