iib

INSTITUTE OF INTERNATIONAL BANKERS

299 Park Avenue, 17th Floor
New York, N.Y. 10171
Telephone: (212) 421-1611
Facsimile:(212) 421-1119
www.iib.org

LAWRENCE R. UHLICK
Chief Executive Officer
E-mail: luhlick@iib.org

June 4, 2008

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551
regs.comments@federalreserve.gov

Re: Proposed Revisions To the Policy on Payments System Risk (Docket No. OP-1309)

Dear Ms. Johnson:

The Institute of International Bankers welcomes the opportunity to comment on the revisions to the Payments System Risk Policy (the "PSR Policy") proposed by the Board of Governors of the Federal Reserve System (the "Board") whereby the Federal Reserve would supply intraday balances to healthy depository institutions predominantly through explicitly collateralized daylight overdrafts provided at a zero fee and without any deductible (the "Proposal").[1] The Institute's members are internationally headquartered banking organizations that in the aggregate have more than $5.6 trillion of assets booked in their U.S. banking, securities and other financial operations, employ more than 250,000 individuals in the United States and have total annual expenditures in the United States of approximately $60 billion. Many of our member banks are subject to the PSR Policy by virtue of their dollar clearing activities in the United States and thus would be directly affected by the Proposal.

The Institute appreciates the efforts by the Federal Reserve to address the longstanding concerns we have raised regarding the disparity of treatment of international banks relative to domestic banks with respect to intraday overdrafts under the existing PSR Policy. The Institute strongly supports the Proposal insofar as it seeks to resolve this disparity by creating significant incentives for domestically and internationally headquartered banks alike to collateralize the entirety of their intraday overdrafts on equal terms, but we are concerned that the Proposal would preserve the status quo with

[1] *See* 73 Fed. Reg. 12417 (March 7, 2008).

respect to the amount of *unsecured* intraday overdraft credit that would be available to international banks vis-à-vis their domestic competitors.

Specifically, an international bank that might choose not to collateralize the entirety of its daylight overdraft exposures – because it determines that an overdraft fee calculated at an annual rate of 50 basis points would be less than the cost of the required collateral – would remain at a disadvantage vis-à-vis a domestic bank of comparable capital size and credit standing since under the Proposal the amount of unsecured credit available to the international bank would remain a function of its net debit cap, which would still be limited to an amount calculated on the basis of not more than 35 percent of its worldwide capital. In contrast, the amount of unsecured credit available to a domestic bank under its net debit cap would be calculated on the basis of 100 percent of its risk-based capital. Consequently, under the Proposal international banks would be significantly more restricted than domestic banks of comparable capital size and credit standing in exercising the choice provided between incurring unsecured and collateralized intraday overdraft exposures.

We continue to believe that the application of lower net debit caps to international banks vis-à-vis domestic banks is unjustified, and we urge the Board to incorporate equal treatment of international banks into its daylight overdraft policy by eliminating this disparity, which, as discussed below, discounts an international bank's Basel-based capital by 65 percent or more. In addition, to address the continuing disparity of treatment of international banks that would exist with respect to the intraday deductible pending the proposed revisions to the PSR Policy taking effect, we believe it would be appropriate to provide international banks interim relief in this regard during the transition period (see the discussion below at pages 4-5).

<u>Increasing the Net Debit Cap</u>. We believe the case for increasing international banks' net debit caps is especially compelling with respect to determining the amount of unsecured daylight overdraft credit that is made available to those international banks with self-assessed net debit caps 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). We recognize and applaud the Board's proposal to streamline the procedure enabling such international banks to expand their maximum daylight overdraft capacity to an amount based on 100 percent of worldwide capital, but this procedure would facilitate only *collateralized* overdrafts and would leave in place the significantly lower limits applicable to *unsecured* overdrafts.[2]

The existing disparity of treatment of international banks vis-à-vis domestic banks with respect to daylight overdrafts is embedded directly in the formula used under the existing PSR Policy to calculate permissible caps and deductibles. This formula derives

[2] *See* 73 Fed. Reg. at 12441, note 92.

the cap for each institution based on its allowable capital, but recognizes no 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 no more than 3.5 percent of capital for an international bank. Thus, under existing PSR Policy, a domestic bank with a capital size and credit standing comparable to an international bank competitor receives nearly triple the amount of fee-free credit and permissible overdrafts. This disparity results in cost differences that are competitively significant and result in a markedly unequal playing field for international banks as compared to domestic banks that are major participants in the U.S. dollar clearing business.

The Proposal would eliminate the deductible for both domestically and internationally headquartered banks. The Institute supports this "headquarters neutral" aspect of the Proposal. Further, by increasing the fee charged for unsecured intraday overdrafts and not charging any fee for collateralized intraday overdrafts, the Proposal would create significant incentives for all banks, international and domestic alike, to collateralize their intraday exposures. As stated in the Proposal, the Board believes it is "highly likely that additional collateral would be pledged to cover intraday credit if appropriate incentives existed."[3] If implemented as intended, and all daylight overdrafts were fully collateralized, regardless of where the bank incurring the overdraft is headquartered, the Proposal as a practical matter would eliminate the disparity of treatment of international banks and place them on a level playing field with their domestic counterparts. As stated above, the Institute strongly supports the Proposal insofar as it achieves this result.

Nevertheless, the Proposal would retain the lower net debit cap for international banks, so that even the best-rated international banks would be significantly limited in the amount of *unsecured* intraday overdrafts they could incur compared to domestic banks of comparable capital size and credit standing. While the Proposal provides banks significant incentives to collateralize their intraday exposures and thereby avoid overdraft fees, the decision whether to post collateral or pay the fee will depend on the amount of the fee, which is prorated for the period of time during the day that the intraday credit is needed, relative to the cost of maintaining collateral at the discount window. Depending on its circumstances, a bank reasonably might conclude that it is advantageous for it to incur the overdraft fee rather than allocate collateral and therefore might decide not to collateralize its intraday overdraft exposures. In making this decision, domestic banks would be permitted under the Proposal to incur unsecured intraday overdrafts in an amount based on 100 percent of their capital, whereas similarly situated international banks would have no choice but to collateralize any intraday overdraft in excess of an amount based on not more than 35 percent of their capital.

[3] 73 Fed. Reg. at 12423.

The Institute continues to believe there are compelling reasons for eliminating the disparity with respect to net debit caps, especially as they apply to international banks that are either FHCs or have a "SOSA 1" rating. 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 any insolvency losses whatsoever, and the expectations resulting from this record are especially justified for large, well-rated international banks that 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 unsecured intraday credit to domestic banks as to international banks of a comparable capital size and credit standing, as is the case under the existing PSR Policy and would be possible under the Proposal.

Intraday Deductibles. The Proposal contemplates that the intraday deductible would be eliminated once the changes to the PSR Policy become effective. Until that time, however, the existing system would remain in effect and international banks therefore would remain at a disadvantage vis-à-vis domestic banks with regard to calculation of the deductible. As discussed in our earlier correspondence on this subject, the disparity with respect to deductibles acts as a "throttle" on international banks' payment processing operations and results in their deferring payments of certain items during the day to avoid exceeding their limited deductible.[4]

We respectfully continue to believe that the issue with respect to the intraday deductible is one of simple fairness. 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 net debit 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 or the payments system. 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 with which they compete.

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[4] In its discussion of the Proposal, the Board states that "[a] few FBOs may approach their cap limits on certain liquidity-intensive payment days, but it doe not appear that FBOs are generally are constrained by current cap levels." 73 Fed. Reg. at 12429. This statement does not sufficiently take into account the impact the cap level has on the size of the intraday deductible available to international banks and the resulting limitations on their processing of payments during the day.

Fixing a uniform deductible at 10 percent of capital pending the outright elimination of the deductible for both international and domestic banks would 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, equalizing the intraday deductible for domestic and international banks would resolve the current unfair economic differentiation, could only be helpful to the payments process, and would 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 believe it would be appropriate to place international banks on an equal footing vis-à-vis domestic banks with respect to the intraday deductible prior to the proposed revisions to the PSR Policy taking effect, and we respectfully request the Board to take such action in connection with finalizing the Proposal.

Collateral Management. Given the significant incentives under the Proposal for banks to collateralize their intraday exposures to the Federal Reserve, it is essential to ensure that there are effective systems and procedures in place regarding the receipt and return of discount window collateral in support of those exposures. For example, attention should be given to ensuring that collateral pledged to secure intraday overdraft credit will be available to an institution at day's end to support any overnight borrowing once its intraday overdrafts are eliminated. We applaud the efforts by the Federal Reserve to work with industry to address the operational aspects of the Proposal.

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Please contact the undersigned or the Institute's General Counsel Richard Coffman (212-421-1611; rcoffman@iib.org) if we can provide further information or assistance.

Very truly yours,

Lawrence R. Uhlick

Lawrence R. Uhlick
Chief Executive Officer