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Federal Reserve System
Board of Governors
Ms. Jennifer J. Johnson
Secretary
20th Street & Constitution Avenue, NW
Washington, DC 20551

June 2, 2008

Re: Policy on Payments System Risk
(Docket No. OP-1309)

Dear Ms. Johnson:

UBS appreciates the opportunity to respond to the proposed changes to the Payment Systems Risk (PSR) policy under Docket No. OP-1309. We are encouraged by the approach to augment the current net debit cap concept with the use of unencumbered discount window collateral at a zero fee. As a major participant in the payment system, UBS would be directly impacted by the proposed revisions and welcomes the ability to comment.

In general, UBS supports the measure and views the changes as a positive change to the existing PSR policy. Our responses on the attached questionnaire represent the collective views of the various stakeholders within the UBS organization and also address certain aspects of the proposal where we believe further analysis is required such as the discount window pledging process and late day payments drivers not addressed by these revisions.

With regard to the pledging process we commented on the need for more transparency to collateral level reporting, a streamlined pledging process, enhanced collateral movement deadlines, and an expansion in the eligible types of discount window collateral. The current reporting mechanism requires streamlining in that it lacks a real time view of the collateral pledge. In the future state a more dynamic intra-day pledging mechanism would be a requirement along with the ability for intraday collateral movements. Additionally we are of the opinion that the deadline to pledge collateral should be aligned with the two major daily liquidity milestones. (DTC and CHIPS finality)

Although the proposal addresses maximum debit cap and daylight overdraft fee considerations that lead to late day payments risk, we think that the DTC and CHIPS PRC working groups have to continue their work to further mitigate this risk by developing a financial incentive for early payments. In our view these are areas of equal importance to address the current late day payment patterns.

In our response we also address the role of credit market conditions with regard to the decisions in the discount window pledging process. The overall consensus was that the availability and opportunity cost of collateral as well as the higher uncollateralized overdraft fee will be key factors in future pledge considerations. Furthermore, we comment on the potential impact these changes may have on the CHIPS clearing channel with regard to a potential decrease in flows (impacting the algorithm) or conversely, lead to an increase in supplemental funding given the potential for larger Fed maximum debit caps.

Finally, although the proposal would allow Foreign Banking Organizations (FBO's) with a SOSA-1 rating to collateralize intra-day overdraft balances at a zero fee for up to 100% of worldwide capital times the self-assessment multiple, we would like to address the unchanged recognition of 35% of worldwide capital times the cap multiple for unsecured intraday overdrafts. We echo the Institute of International Bankers' (IIB) concern regarding the disparity in treatment of international banks.

Overall, we are supportive of the changes and view these as a positive step toward a more equitable and level playing field for foreign institutions, and encourage the Federal Reserve to perform a tiered implementation so that some of the benefits may be realized ahead of the two-year implementation timeframe. We also recognize that these changes adopt a global approach to liquidity and payments management and look forward to working in cooperation on the adoption of these changes.

Yours sincerely,

UBS AG

Barry Tebbutt,

Executive Director

Region Head of
Payments & Cross Product Services

UBS AG

Anneliese Schwyter

Managing Director

Head of Regional Treasury NA

Enclosure

UBS

FEDERAL RESERVE SYSTEM

Docket No. OP 1309

UBS AG (ABA #:026007993)

Policy on Payments System Risk

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

   Our liquidity risk will be reduced by the introduction of a zero fee for collateralized daylight overdrafts due to increased access to liquidity, should it be required. We also believe that Operations risk will be reduced as more access to liquidity would allow payments to be released more frequently. It is likely that as an institution, we would increase our daylight overdraft usage however we think that the proposed changes should include an incentive for all banks to release payments early in the day. The proposed change from uncollateralized to collateralized day light overdrafts may not address this issue and a similar late payment pattern may remain or develop again in the future.

   The credit risk practices of UBS will not change as a result of this policy. UBS would experience reduced counterparty credit risk if counterparties release payments quicker intra-day as there would be less overall payment throttling and a potential reduction in pending inbound receipts to our institution. Additionally it is our belief that the use of collateral for daylight overdraft purposes would reduce central bank counterparty risk. Finally any risk reductions are dependent on the participation and the collective behavior of other institutions with regard to intraday payment flow management in response to these policy changes. Intra-day payments flows should increase if depository institutions utilize collateral, and as a result, throttle their payments less. If this is the case, the benefit would be realized by all payment system participants.

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

   From a systems perspective, a change to the liquidity management system would be needed to track pledged collateral. From a procedural standpoint, Our Cash Management Function would no longer manage daylight overdrafts to the deductible amount but rather to an internally specified limit e.g. based on historical usage and amount of collateral the institution is willing to set aside to clear payments. Our internal pledging process would be augmented to accommodate any changes the Fed intends to implement as a result of this policy change.

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

Our institution regularly uses Federal Reserve daylight credit and our intent is to maintain the same level of collateral currently pledged to the discount window. We believe that this is sufficient to cover historic peak and average overdraft needs.

4. ***Would your institution's intraday credit use increase or decrease from current levels? Do you expect the intraday credit usage of depository institutions as a group to increase or decrease from current levels?***

Based on the changes, our average intraday collateralized overdraft would be expected to increase. Our ability to improve liquidity flows is reliant on improvements to incoming flows, which may be forthcoming from institutions with insufficient discount window collateral or limited capacity to pay increased overdraft fees.

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? What opportunity costs would your institution face in pledging (additional) eligible assets to the Reserve Bank to collateralize daylight overdrafts? What are the costs of entering into the Reserve Banks' borrowing documents?***

The cost for collateral depends on the market, our various trading activities, as well as on the definition of the eligible collateral basket determined by the Fed. The larger the pool of eligible collateral, the lower the opportunity cost for collateral.

The pledging process and the cost of collateral would remain the same for those institutions that currently maintain collateral at the discount window with no daylight overdraft benefits. An expansion in the eligible types of collateral for pledging purposes would decrease the opportunity costs of that collateral and provide institutions alternatives in an environment where collateral may be required for other purposes. Furthermore the opportunity to offset these collateral costs through a reduction of daylight overdraft fees would provide incentive for institutions to increase the amount of collateral pledged to the discount window.

Increases in the amount of discount window collateral would be managed within our existing collateral framework before determining if additional collateral arrangements would be necessary.

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?***

This strategy could create further scarcity of collateral in a market that is experiencing credit tightening. Again, the larger the acceptable basket of eligible collateral that the discount window will accept, the less the impact it will have on the opportunity costs of that collateral, as well as on the increasing demand of collateral across the US market in general.

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)?

UBS would expect a real-time view of our collateral position/value with the discount window as well as the ability to move collateral to and from the discount window on an intra-day basis. We would also expect cutoff times for collateral movements for pledging purposes to be more in line with the Fed close of 6PM EST. For example, the deadline for collateral pledges over DTC is currently 3PM EST, which is prior to DTC, CHIPS, and Fed finality which are important factors of daylight overdraft usage. Additionally, we would expect the discount window to accept Triparty collateral, particularly in reference to the primary dealer facility.

Balance monitoring reports will have to include a real-time view of available collateral capacity with the discount window as the amount available could change more frequently during the day as movements occur.

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?***

Not applicable as UBS currently has collateral pledged with the Fed.

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9. ***To what extent would your institution make payments earlier in the day as a result of the proposed pricing changes? 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? If so, under what circumstances would your institution continue to queue payments? What further steps would encourage queue reductions?***

   Under the proposed mechanism it is likely that we would release payments from liquidity queues earlier in the day as we would manage to an internal limit that would be higher than the current interest free deductible.

   UBS would continue to queue payments to the extent that they would breach our internal limit, or queue high value payments (such as money market repays) in anticipation of any large CLS, DTC, or CHIPS finality settlements.

   Queue reductions could be encouraged if the Fed monitored institutions that maintained long positions over excessive periods of time throughout the day.

   Under this new concept, the Fed should devise incentives for banks to release payments from liquidity queues prior to 2pm.

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?***

    We believe that the zero fee for collateralized overdrafts would not affect the return of early securities used in repurchase agreements as the securities used in these agreements are not actively used for pledging purposes. Additionally there are multiple factors that influence the securities delivery process that will not be affected by the proposed changes.

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?***

    The introduction of the proposed changes would have an impact to fed fund early return market in that there is a potential for an increase in payment flows (as a result of the zero fee for collateralized daylight overdrafts) to the extent that there is participation by member banks. However, banks will continue to liquidity manage fed fund loan re-payments in order to ensure there is sufficient liquidity to meet obligations later in the day. (DTC & CHIPS) A premium will most likely be retained for early fed loan repayments as there is an inherent cost associated for the pledged collateral and banks would still potentially face the higher 50 bps fee for uncollateralized overdrafts.

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?***

Where UBS would face potentially higher fees on daylight overdrafts, we would increase our collateral pledge where necessary, and/or we would throttle our payments in the liquidity queues so as to avoid such fees (business permitting).

The amount of collateral pledged to the discount window is determined by several factors, including payments, daily funding profile, the current market conditions, and access to and the cost of collateral.

In the current environment, the amount of collateral pledged to the Fed today is not expected to change.