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June 3, 2008

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

Re: Docket No. OP-1309- Comments on Proposed Changes to the Federal Reserve Payments System Risk (PSR) Policy

Dear Ms. Johnson,

On behalf of Citigroup, I am pleased to provide the Board of Governors of the Federal Reserve System ("Federal Reserve") with input on Proposed Changes to the Federal Reserve Payments System Risk (PSR) Policy (Docket No. OP-1309)] issued in March 2008

We understand the Board is proposing changes to its PSR policy that would adopt a new strategy for providing intraday balances and credit to depository institutions and encourage such institutions to collateralize their daylight overdrafts.

The Board proposes to adopt a policy of supplying intraday balances to healthy depository institutions predominantly through explicitly collateralized daylight overdrafts at a zero fee, and raising the fees for uncollateralized overdrafts to 50 basis points (per annum) from 36 basis points. Other changes to the PSR policy are also proposed as set out in the policy statement request for comment.

To address intraday liquidity, operational, and credit risks in the wholesale payments system, we agree that the Federal Reserve and the industry should pursue a strategy to explore improvement opportunities for CHIPS and DTC, evaluate liquidity saving arrangements for Fedwire funds transfer system, and review PSR policy, strategy, and tools to improve tradeoffs between safety and efficiency.

Our comments focus on the Board's PSR policy and recommended changes in strategy, terms and pricing for the provision of intraday credit by the Reserve Banks.

We appreciate the opportunity to share our institution's views on the proposed changes in PSR Policy in order to reduce risks, while maintaining or improving the efficiency of the U.S. payment system. We also welcome the opportunity to discuss further our specific comments and responses with Federal Reserve staff if requested.

<u>Summary Views on Potential Changes in Market Practices, Fed Operations and PSR Policy</u>

- **Citigroup strongly favors the development of liquidity saving mechanisms for the Fedwire funds transfer system, in particular a centralized queue.** We believe that such a mechanism would be a highly effective way to facilitate a number of large-value Fedwire payments earlier in the day. It would directly address the large number of late-day payments that result from the general liquidity management strategies employed by depository institutions that rely on internal queuing of Fedwire payments to reduce daylight overdrafts and related charges. We see a centralized Fedwire queue as an optimal way to reduce intraday liquidity, credit and operational risks associated with Fedwire payments while also improving the efficiency of the U.S. payment system.

- **To further reduce intraday liquidity, credit and operational risks relating to Fedwire funds transfers, Citigroup believes that there may have to be changes to certain private settlement arrangements, such as DTC, CHIPS, and custodian tri-party repo arrangements.** Citigroup is aware of and participating in Federal Reserve and industry initiatives in this regard.

- **Citigroup is not in favor of full transition of Fedwire to a mandatory, fully collateralized intraday credit RTGS system, as exists in Europe, even if such intraday liquidity is provided free of charge.** Such a change could have an adverse impact, as we currently do not maintain the levels of collateral required to support mandatory collateralization of our Fedwire payment activity.

<u>**Responses to Questions in the Consultation Paper**</u>

General

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?**

    - Citigroup recognizes that the collateralization of daylight overdrafts at a zero fee would lower the direct exposure of the Reserve Banks to depository institutions, and perhaps reduce or eliminate any current incentives by depository institutions to hold back Fedwire payments for liquidity saving reasons. To the extent that this reduces the amount of late in the day payments, operational risk would be reduced. However, in terms of managing the intraday collateral processes, the complexity of moving multiple forms of collateral may introduce another type of operational risk. Impact on liquidity risk is uncertain, but to the extent that liquidity needs are spread more evenly throughout the day, the impact should be positive.

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

    This will depend on the collateral arrangements to be put in place for cover of intraday overdrafts. Procedural and systems changes will be required, but the timing and implementation of the changes will be dependent on details of the collateral requirements.

Collateral

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?**

Yes, Citibank is a regular user of Federal Reserve daylight credit. While we may currently have sufficient unencumbered eligible collateral to pledge to the Reserve Bank to partially collateralize overdrafts, it may not be economic to do so, or always be the case that collateral will be available to fully collateralize our daylight overdraft requirements. Also, given wide swings from day to day, and intraday, for daylight credit, there may be days where intraday credit is only partially collateralized or not collateralized at all.

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

We estimate that we would intend to collateralize 50% for average day usage, 30% for month-end usage and 20% of peak day usage.

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?**

   Our expectation is that Citigroup's overall requirement for intraday credit will continue to rise and volatility of that demand will also increase in line with increased volatility in the capital and money markets. For the same reason, it is likely that intraday credit usage of depository institutions as a group will also increase.

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?**

   On a normal day with sufficient collateral available at the Discount Window, collateralization of intraday overdrafts (in part or whole) is not difficult or particularly costly. However, in times of market volatility and if required at short notice, access to collateral can be very costly. The admin cost of entering into the Reserve Bank's borrowing documents should not be a deterrent.

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?**

   - Pledging incremental collateral above the level that is already at the discount window will result in a loss of flexibility to access diversified secured financing sources (for example, repos, TIO, TAF, FHLB, etc.)

   - Increased demand will drive funding costs higher than current market rates. A significant portion of current system liquidity will, of course, be diverted to this activity.

   - The more collateral that is used/pledged for daylight overdrafts, the less there is available for other purposes. In particular, this will be the case if the collateral pledged for daylight overdraft is "locked in", and not structured so that participants can move collateral in and out on short notice as needed to collateralize overdrafts in near real time.

7. **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)?**

   - The Fed's ability to move collateral directly and quickly is an important consideration.

   - Specific options might include:

     - Expanded options for eligible assets
     - Use of letters of credit or other credit enhancements in lieu of pledged assets
     - Intraday use of pledged assets with the ability to then utilize the same assets for overnight funding/liquidity purposes.

   - We would expect that the Reserve Banks would set up collateral management capabilities to flexibly handle the participants' ability/desire to move collateral in and out on short notice to maximize the efficient use of available collateral.

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?**

   Citigroup already has a borrowing agreement to pledge collateral at the Discount Window.

Pricing

9. **To what extent would your institution make payments earlier in the day as a result of the proposed pricing changes?**

   - We would expect a minimal impact to the flow of payments if the cost of collateral exceeds the daylight overdraft charges. Only when the internal cost of collateral falls below a certain threshold, would the bank contemplate pledging collateral to support intra-day payments and securities transactions.

   - If the cost of collateral (measured as 24h day) is less than the Daylight Overdraft charges (measured as a fraction of the 24h day) then payments will flow earlier in the day. Citigroup would "earmark" a subset of the collateral to support intra-day time critical payments such as CLS funding payments, GCE and other intra-day contractual payments. The residual collateral can be freely used for payments.

   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?

   Under the scenarios proposed by the Fed, queuing of payments may increase given the substantial increase in the cost for a bank to run a higher daylight overdraft. Only if the internal cost of collateral fell below a certain threshold would the pledge of collateral impact the queues.

What further steps would encourage queue reductions?

- Provide visibility for banks into all payments queued and held at other Fed Banks. This would allow banks to release payments to banks with equivalent flows returning to them.
- Encourage net in-flows to the banks earlier in the day i.e. move DTCC settlement to more than once a day.
- Queue reduction can be most efficiently achieved via a centralized queue manager.

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?**

- While the Fed may not charge a fee for collateralized daylight overdrafts, the impact of the collateral charges within a bank may make this proposition quite expensive (much more so than the fees currently levied).
- A change would not happen automatically. This would need to be addressed via market practice group/forum.

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?**

A change would not happen automatically. This would need to be addressed via market practice group/forum.

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?**

Adjustments will be made based on the relative cost of collateral and the increased cost in Daylight Overdrafts.

Regards,

Mr. Bharat Sarpeshkar
Managing Director