August 2, 2021

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Request for Comment on Proposed Changes to Part II of the Federal Reserve Policy on Payment System Risk (PSR policy), Docket No. OP-1749

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the notice of proposed rulemaking captioned above ("proposal"),[2] issued by the Board of Governors of the Federal Reserve System ("Board"), regarding revisions to its Payment System Risk policy.

While encouraging collateralization of daylight overdrafts is an important risk management effort, the proposal seeks to do so without sufficient consideration of the risks created by the proposed changes that would expand access to banks that may be undercapitalized and/or assessed by Federal Reserve supervisors as being badly managed. First, the effective removal of supervisory considerations from the eligibility criteria would undermine the supervisory process by weakening yet another incentive for banks to effectively manage their operations and their risks, and ignore the assessments of the Federal Reserve's supervisors. These assessments should be used to inform the Fed about which banks are and are not appropriate counterparties for transactions with the central bank. Second, expansion of access to collateralized daylight overdrafts, particularly to institutions that currently are prohibited from having either collateralized capacity or even a positive net debit cap, would increase risk to the system by encouraging adverse selection. Banks that are weak or poorly-run and represent a higher level of risk to the Fed – a level that has traditionally been seen as disqualifying -- would

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies— including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.
[2] 86 FR 29776

be more likely to utilize the intraday credit if they are allowed access. Lastly, the Board has failed to provide sufficient support and justification for the proposed changes despite these serious issues.

BACKGROUND

Effective management of risks within the Federal Reserve's payment system has been debated for many years over the main dilemma that higher standards of risk management can lead to less efficiency in the payments system and the markets it supports, and vice versa. This has led to several modifications to the policy over the last thirty years as the Board has conducted studies and sought industry feedback. Broadly speaking, these efforts established four "dimensions" by which the Board managed risk – fees, collateral, monitoring of institutions, and institution reputation. While certain debates have been left to history, the policy around collateralized daylight overdrafts ("CDOs") has continued to be modified, all along the way moving from the exception to the rule though changes that explicitly encourage the usage of collateralized overdrafts.

Indeed, in response to commenters on proposed modifications to the PSR policy in 1992, the Board stated that collateralized over drafting is "an exception that permits clearing institutions and similarly situated institutions to exceed their caps because of the difficulty of controlling book entry securities overdrafts."[3] At that time, it was decided that such exceptional CDOs should be charged the same fee as uncollateralized daylight overdrafts (UDOs) because the Board felt that removing the fee from CDOs and only relying on collateral would eliminate any meaningful incentive for depository institutions or their dealer customers to reduce reliance on the Fed to provide daylight overdrafts.

A proposal and final rule in 2001 moved CDOs from being an exception to formally being part of the overall daylight overdraft capacity by allowing institutions to apply for collateralized overdraft capacity over and above the net debit cap.[4] The combination of the net debit cap and the additional collateralized capacity resulted in the so-called maximum capacity or "max cap" allowance. However, the reputation of the borrowing bank was still considered a key risk management tool, and the changes to the PSR required institutions to apply for this additional capacity. The final policy made approval contingent on an institution already having a positive net debit cap, being in good standing with its Reserve Bank, and having performed a self-assessment.

Importantly, a positive net debit cap was only granted to institutions that were "financially healthy" and had regular access to the discount window, and so only the most credit worthy institutions could also apply for the additional collateralized capacity. The self-assessment requirement included creditworthiness, intraday funds management and control, customer credit policies and controls, operating controls, and contingency procedures. Additionally, institutions were required to provide a business case outlining their need for

[3] 57 FR 47084
[4] Proposal at 66 FR 30199; Finalization at 66 FR 64419

collateralized capacity, and submit a board of directors' resolution approving the collateralized capacity at least annually and whenever the collateralized capacity was modified. Fees on collateralized capacity were maintained for the same reason as in the 1989 proposal.

In 2008, in response to liquidity pressures and the highest publicly reported usage of DOs, the Board proposed and finalized changes to the PSR policy that removed fees from collateralized DOs but increased the fee on UDOs from 36 to 50 basis points.[5] This change was in recognition of the apparent need for increased DO capacity in times of extreme stress. The Board also appropriately wanted to incentivize institutions to use collateralized overdrafts instead of uncollateralized. This change was an implicit admission by the Board that they no longer cared to incentivize firms to reduce DO usage.

Rather, the removal of the fee on CDOs changed the Board's balance of posture to be more heavily weighted towards market efficiency rather than risk management within the system by signaling to institutions that DO usage is not discouraged as long as it is collateralized. The change also made the Federal Reserve System a provider of what is essentially free collateralized intraday lending. However, in a sign that the Board still felt that only healthier institutions should have access to the max cap program, the Board kept in place the requirement that such access was still contingent on a firm's ability to be good standing per its own self-assessment and the assessment of its Reserve Bank. Notably, an institution's supervisory rating, as well as the ratings of its holding company and affiliate institutions, remained key components of the process for determining an institution's eligibility for intraday credit.

SUMMARY OF KEY COMPONENTS OF THE PROPOSAL – ACCESS TO COLLATERALIZED DAYLIGHT OVERDRAFT CAPACITY

The current proposal seeks to "expand access" to collateralized DOs and to "reduce the administrative steps" that are required to obtain access to collateralized DOs. The proposed changes would expand access by allowing institutions that meet the following criteria to request access to collateralized DO capacity:

1. Institutions with net debit cap categories of "zero," "exempt," or "de minimis." It is important to note the "zero" net debit cap category is either because the bank has chosen to have no debit cap or has not been allowed to have one based on the Reserve Bank's determination.
2. Domestic institutions with a Prompt Corrective Action (PCA) designation of "undercapitalized," "adequately capitalized," or "well capitalized"
3. A U.S. branch or agency of a foreign banking organization (FBO) whose PSR capital category is "undercapitalized," "sufficiently capitalized," or "highly capitalized."
4. Institutions with any supervisory rating, including "unsatisfactory".

[5] Proposal at 73 FR 12417; Finalization at 73 FR 79109

These changes would essentially eliminate all current requirements an institution must meet to request access. Furthermore, the proposal would reduce the "administrative steps" in requesting access to collateralized DO capacity by:

1. Eliminating the requirement that an institution provide its Reserve Bank with a business case unless
    a. the institution's requested max cap exceeds the institution's capital measure multiplied by 2.25, which is the cap multiple associated with the "High" self-assessed cap category or
    b. a business case is explicitly requested by the Reserve Bank due to recent developments in the institution's condition.
2. Changing the requirement that the institution's board of directors submit a resolution approving the capacity request annually to submission only upon initial request from the Fed.

COMMENTS ON PROPOSED MODIFICATIONS RELATED TO COLLATERALIZED CAPACITY

A. The removal of supervisory assessments as a key element of the criteria for granting access to collateralized capacity would weaken the system and combine with deregulatory efforts that are undermining the importance of supervisors' assessments of banks to make it more difficult for supervisors to incentivize banks to fix dangerously bad practices

Over the last four years, the Board has been pursing an agenda that has sought to minimize the influence of supervisory discretion. This agenda has been most apparent in the changes that were implemented to capital requirements and supervision, which severely weakened the original Comprehensive Capital Analysis and Review (CCAR) program, one of the most important post-crisis initiatives designed to strengthen oversight of the largest banks and subject them to meaningful consequences when they are badly run. Stress-based capital was shifted from being an effective requirement through CCAR to being part of a firm's real-time capital requirement. And the capacity to hold banks accountable through the supervisory process was significantly diluted with the removal of the "qualitative objection."[6] The agenda has also been apparent in smaller proposals, such as the recent misguided and totally unnecessary final rule that codified the role of supervisory guidance within the supervisory process.[7] This proposal is yet another step in undermining the important role of the Federal Reserve's bank supervision responsibilities.

Since the proposal to introduce the max cap program in May 2001, the Board has recognized the importance of the supervisory process in determining if an institution should be granted additional DO capacity. After all, collateralized or uncollateralized, DOs are intraday loans, and the financial health and creditworthiness of institutions must be considered when

[6] See Tim P. Clark (April 9, 2019), *Is the Fed in Retreat?*, Politico's The Agenda
[7] Proposal at 85 FR 70512; Finalization at 86 FR 18173

providing such credit. In that proposal, the Board recognized that "that the interim policy could increase the public sector's credit exposure." As such, the proposal noted that in consideration of providing additional capacity, the Board and Reserve Banks would consider financial and supervisory information including "capital and liquidity ratios, the composition of balance sheet assets, CAMELS or other supervisory ratings and assessments, and the Strength of Support Assessment rankings for U.S. branches and agencies of foreign bank." A bank could not even request additional collateralized capacity unless it already had a positive net debit cap.

These supervisory considerations were maintained with the 2008 modification to remove fees from CDOs. The fee removal was done explicitly to incentivize firms to utilize collateralized DOs over uncollateralized and to increase intraday liquidity. As with the modifications in 2001, this increase in intraday liquidity was to be provided only to "healthy" institutions, and the Board maintained the previous standards for consideration of access to the max cap program. That is, while the Board chose to increase intraday liquidity in the payments system, they did not choose to do so by compromising on credit risk and other assessment standards informed by the supervisory process.

The proposal aims to do exactly that: expand the access to intraday credit by allowing institutions that are of more questionable creditworthiness or badly managed -- even institutions with a Reserve Bank-imposed zero net debit cap due to supervisory concerns -- access to collateralized DOs. This change would increase the risk to the system without any proper justification (see below in part C). Supervisory assessments and ratings are explicitly excluded from the list of factors in the proposal that determine an institutions eligibility to request access to capacity for collateralized DOs. Such exclusion clearly ignores any relevant information developed through the supervisory process about risk management capabilities, creditworthiness and effectiveness of senior management at a banking organization. If a private sector bank ignored these issues when assessing counterparties, it would not be meeting the Fed's own expectations for effective risk management. Why then should the Fed ignore them? While, collateral is an important risk mitigant, it does not substitute for an assessment of whether or not credit should be extended in the first place. That distinction must be made and must include input from the supervisory professionals that are tasked with assessing the financial and operational health of these institutions.

The final policy should (1) add supervisory ratings and assessments as an eligibility factor in requesting access to collateralized DO capacity and (2) explicitly state supervisory ratings and assessments are a key factor that will inform consideration of whether to approve such capacity. If the Fed Board maintains the proposed rules-based approach to determining eligibility of an institution to request capacity, a factor should be added to the final policy that requires an institution to have a supervisory rating of at least "fair," as the Board is proposing as a requirement for uncollateralized DO capacity. Furthermore, the Board should add criteria by which requests for collateralized capacity are approved and those criteria should clearly include supervisory ratings and assessments.

B. The proposed changes would increase overall risk to the system and the Federal Reserve's role in private markets

By allowing more institutions access to collateralized capacity, particularly institutions that may be of questionable creditworthiness, the proposed changes would increase overall risk to the Federal Reserve System. While it is the case that collateralized overdrafts inherently have less risk than uncollateralized, the proposed changes likely will increase overall usage of the daylight overdraft program, perhaps materially so, which in turn would increase overall risk and make the Federal Reserve an even more prominent provider of intraday credit to private institutions.

Not only does the proposal open CDO capacity to more institutions, it severely diminishes one of the risk-mitigating dimensions that has been an integral part of risk management in the payment system – the bank's own reputation management and ownership of its potential risks to the payment system. The proposal essentially entirely eliminates the requirement that institutions provide their Reserve Bank with a business case for requesting CDO capacity. It also eliminates any ongoing reputational considerations by only requiring approval by an institution's board of directors upon initial request instead of the previous annual requirement. And importantly, by removing the requirement for an institution to already have a positive net debit cap, *the proposal implicitly removes the requirement for an institution to have conducted a self-assessment*, something the Board has always considered to be an important risk management component. This type of "out of sight, out of mind" policy will eliminate any accountability by an institution's board of directors and senior management, particularly for the most credit-questionable or badly run institutions that are not allowed a net debit cap.

Based on publicly available data,[8] usage of daylight overdrafts clearly increases significantly in periods of acute stress, with both average and peak daylight overdrafts reaching their highest levels on record in 2008 and peak overdrafts increasing 85 percent around the collapse of Lehman Brothers. Since then, usage has decreased markedly to a low in 2015 but gradually has been increasing since then until the publicly available data series ends in mid-December of 2019.

Expanding access to CDOs to more institutions will increase usage, and especially among institutions that have questionable creditworthiness (i.e., are considered "undercapitalized") or are badly managed. This would likely expose the payment system to more risk associated with adverse selection. That is, institutions that are aware that they will have more difficulty in obtaining intraday credit in private markets than other institutions, particularly in times of market stress, will be more likely to take advantage of their new access to collateralized credit offered under the proposal. Indeed, the Board is proposing offering institutions access to collateralized credit to which it will not offer uncollateralized credit, almost encouraging such adverse selection, the consequences of which would be worst in periods of stress.

[8] Based on data available on the Board's website available at https://www.federalreserve.gov/paymentsystems/psr_dlod.htm

Therefore, when usage likely increases materially in future periods of stress, such as the acute pandemic-related market stress of March 2020, the proposed changes would likely result in greater risk to the payment system. Both overall exposure and probability of non-payment would increase. Furthermore, the Federal Reserve System would be even more broadly embedded in the intraday funding markets, potentially undermining the functioning of private funding markets and further increasing the need for and risk in the daylight overdraft program.

The requirements for a self-assessment, submission of a business case to an institution's Reserve Bank, and annual approval submissions by an institution's board of directors should be minimum expectations by the Federal Reserve and should be maintained in the final policy.

C. Despite the important issues that the proposal raises, sufficient justification supporting by compelling analysis of the need for the proposed changes has not been provided

As with many of its proposals over the last four years, the Board has failed to provide sufficient, compelling justification for the proposed changes to its PSR policy. In past proposals regarding the PSR policy, the Board supported its proposals and final modifications with data analysis and thoughtful qualitative rationale. This proposal provides neither and leaves the public unclear about the Federal Reserve Board's underlying reasons for proposing changes that clearly could only increase risk to the Federal Reserve System.

Regarding the expansion of access to CDO capacity, the Board asserts the following rationales, which fall far short of providing supporting, much less compelling, analysis of why a change is needed:

- "The Board believes that the eligibility criteria for requesting collateralized capacity should be less restrictive than the criteria for accessing uncollateralized capacity"
- "The Board believes that these proposed changes would provide institutions greater flexibility in managing intraday credit, would assist institutions with liquidity and risk-management planning, and would not materially increase credit risk to Reserve Banks"

Regarding the reduction of "administrative steps" (more appropriately, risk management efforts), the Board provides this statement as justification: "the Board believes that simplifying this process would encourage more institutions to obtain collateralized capacity, which could promote further collateralization of daylight overdrafts." And the Board's "impact analysis" only states "The Board believes that there would be no adverse effects to other service providers resulting from the proposed changes to the PSR policy and the Overnight Overdrafts policy."

However, the Board has not provided any support for these statements. Better Markets believes the Board's "justification" leaves open the following questions, which it requests the Board to respond to either in its finalization or some other venue:

- Why should eligibility criteria for collateralized capacity be so much less restrictive as to include banks that have no access at all currently, including for the reasons that such

banks are undercapitalized and/or badly managed (as reflected in supervisory assessments)?

- Has the Board conducted analysis that show the benefits outweigh any increased risk or that its expanded program will not adversely affect the private markets and to support their statement that the changes would not "materially increase credit risk to the Reserve Banks"? If not, why? If so, this should be provided to the public so it can provide response to this proposal informed by such analyses.
- Is the promotion of further collateralization of daylight overdrafts a good thing if it increases access by banks that are badly managed or of questionable credit worthiness?

CONCLUSION

Better Markets feels strongly that these misguided changes in the PSR policy will make the system less safe for the reasons noted above, and that the Board has failed to provide the necessary compelling justification for these changes. We strongly encourage the Board to not finalize these changes as proposed without making the modifications noted above and providing sufficient supporting justification with an extended period for the public to comment.

Sincerely,

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