

UNIVERSITY OF CALIFORNIA AT SANTA BARBARA, ET. AL., RODNEY GARRATT, ET.AL.

Proposal and Comment Information

Title: Proposed Revisions to the Federal Reserve Policy on Payment System Risk and the Guidelines for Account and Services Requests, OP-1878

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Submitter Information

Organization Name: University of California at Santa Barbara, et. al.

Organization Type: Organization

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Our comment is attached.

Re: Proposed Revisions to the Federal Reserve Policy on Payment System Risk and the Guidelines for Account and Services Requests, Docket No. OP-1878

To: Board of Governors of the Federal Reserve System

From: Rodney J. Garratt (Department of Economics, University of California at Santa Barbara) and Charles M. Kahn (Department of Finance, University of Illinois)

We previously commented on the Request for Information (RFI) on the Reserve Bank Payment Account prototype (Docket No. OP-1877; comment submitted February 5, 2026). In this comment we respond to the revised proposal. We continue to support the introduction of Payment Accounts, and we confine our comments to two of the specific questions posed in Section IV of the notice: question 2 (parts a and b), on codifying the Closing Balance Limit in Regulation D and the relationship between the interest prohibition and the Closing Balance Limit, and question 4a, on the appropriateness of the \$1 billion maximum.

Comment on Question 2

In our comment on the RFI we characterized the interest prohibition and the balance limit as overlapping controls aimed at preventing balances unrelated to payment activity from flowing onto the Fed's balance sheet. Section III.A.4 of the revised notice is consistent with the framing we proposed. Under normal conditions, a zero interest rate encourages holders to keep balances low. During periods of stress, when there is high demand for risk-free central bank balances, the Closing Balance Limit becomes the binding constraint.

Question 2b asks whether there are important interactions between the two balance controls that the Board has not identified. We believe there is one such interaction that is related to but distinct from the stress scenario the notice describes. Namely, the deterrent effect of the interest prohibition depends on the level of market interest rates. When market rates are at or near zero, the opportunity cost of holding a Payment Account balance disappears for every holder simultaneously. The interest prohibition then provides little or no deterrent, and balances would be expected to drift up through routine cash management until the Closing Balance Limit binds. This is particularly concerning because, while stress episodes are typically measured in weeks or months, zero-lower-bound episodes (2008-2015 and 2020-2022) can last for years. The Closing Balance Limit should therefore be understood not only as an emergency backstop but as the control that may operate alone on Payment Account balances for extended periods of time.

This characterization bears directly on question 2a, which asks whether the Board should consider codifying the Closing Balance Limit in Regulation D, along with the interest prohibition. Our answer is yes, with one refinement. We believe that the existence of the limit, its calibration to expected payment activity, and the process governing temporary breaches should be codified in Regulation D. However, changes to the numerical ceiling are better left in the Payment System Risk Policy, where they can be adjusted administratively as experience with Payment Accounts accumulates. This division gives the framework the procedural protection appropriate to a control that may at times be the only operative constraint, while preserving flexibility over a parameter that is likely to need frequent revision, for reasons we discuss next.

Comment on Question 4a

The Board justifies the \$1 billion maximum by reference to Appendix I, which shows that \$1 billion equals or exceeds approximately 97 percent of daily closing balances in existing Reserve Bank accounts over 2021 to 2025. We believe this benchmark does not provide adequate guidance for the institutions Payment Accounts are intended to serve.

There are three reasons.

First, the population is not comparable. The distribution in Appendix I appears to pool daily observations across all existing accounts and is therefore dominated by the thousands of small traditional depository institutions. The closing balances of these institutions carry little information about the needs of high-volume payments specialists.

Second, the constraints are different. Existing account holders do not need to carry the next day's funding in their closing balances. They have access to daylight overdrafts and the discount window, which allow them to operate with lower balances. They also hold other liquid assets that can be converted into settlement balances during business hours. Payment Account holders have none of these options. They have no intraday credit, no discount window access, and no way to convert other liquid assets into settlement balances during weekends or holidays, when Fedwire and money markets are closed but FedNow continues to operate. Everything they expect to pay out at the open of the next business day, or across a long weekend, must in practice already be in the account at the close, unless covered by incoming payments. For the same payment volume, Payment Account holders will require larger closing balances than the institutions in Appendix I needed to hold.

Third, the historical balances reflect both settlement demand and paid storage. Balances in Appendix I were formed, for the most part, in a regime where reserves earned meaningful interest, so it reflects, in part, balances held because they were remunerated. Payment Account balances will earn nothing and hence will reflect only prefunding demand. The comparison is therefore between balances shaped by backstops and remuneration and balances shaped by neither. The distortions run in both directions, and they make the benchmark uninformative.

We accordingly recommend two adjustments to the administration of the Closing Balance Limit. First, the Board should commit to a scheduled review of the \$1 billion ceiling as usage data from Payment Accounts becomes available. The benchmark should depend on the observed prefunding behavior of Payment Account holders themselves, accounting for clustering at the ceiling and the frequency and size of Temporary Closing Amount requests. Second, the Temporary Closing Amount process should be made routine rather than exceptional. The proposal states that requests to exceed the limit should be granted only rarely. We suggest instead a presumption of accommodation for foreseeable calendar events, such as holiday weekends and quarter ends, with consultation reserved for genuinely unusual cases.

Conclusion

The interest prohibition and the Closing Balance Limit are best understood as a single two-part instrument whose binding element shifts with the rate environment. This argues for codifying the

framework of the limit alongside the interest prohibition in Regulation D, while leaving the numerical ceiling to be set by policy. Moreover, since the proposed ceiling is benchmarked to the closing balances of institutions that operated with liquidity backstops and earned interest on reserves, neither of which applies to Payment Account holders, the Board should treat \$1 billion dollars as a starting point, subject to scheduled review and supported by a routine process for temporarily exceeding the limit.