

FEDERAL RESERVE SYSTEM

Docket No. R-1107

Policy Statement on Payments System Risk

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Interim policy statement with request for comment.

SUMMARY: The Board is issuing and requesting comment on an interim policy statement that allows a depository institution that has a self-assessed net debit cap (average, above average, or high) to pledge collateral to its Federal Reserve Bank in order to access additional daylight overdraft capacity above its net debit cap level. The Board may modify the final policy statement after considering the comments received.

DATES: The interim policy statement is effective on May 30, 2001. Comments on the interim policy must be received by August 6, 2001.

ADDRESSES: Comments, which should refer to Docket No. R-1107, may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, D.C. 20551 or mailed electronically to regs.comments@federalreserve.gov. Comments addressed to Ms. Johnson also may be delivered to the Board's mailroom between 8:45 a.m. and 5:15 p.m. and to the security control room outside of those hours. Both the mailroom and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in Room MP-500 between 9:00 a.m. and 5:00 p.m. weekdays, pursuant to §261.12, except as provided in §261.14, of the Board's Rules Regarding Availability of Information, 12 CFR 261.12 and 261.14.

FOR FURTHER INFORMATION CONTACT: Paul Bettge, Associate Director (202/452-3174) or Stacy Coleman, Manager (202/452-2934), Division of Reserve Bank Operations and Payment Systems.

SUPPLEMENTARY INFORMATION: This is one of five notices regarding payments system risk that the Board is issuing for public comment today. Three near-term proposals concern the net debit cap calculation for U.S. branches and agencies of foreign banks (Docket No. R-1108), modifications to the procedures for posting electronic check presentments to depository institutions' Federal Reserve accounts for purposes of measuring daylight overdrafts (Docket No. R-1109), and the book-entry securities transfer limit (Docket No. R-1110). In addition, the Board is requesting comment on the benefits and drawbacks to several potential longer-term changes to the Board's payments system risk (PSR) policy, including lowering self-assessed net debit caps, eliminating the two-week average caps, implementing a two-tiered pricing system for collateralized and uncollateralized daylight overdrafts, and rejecting payments with settlement-

day finality that would cause an institution to exceed its daylight overdraft capacity level (Docket No. R-1111). Furthermore, to reduce burden associated with the PSR policy, the Board recently rescinded the interaffiliate transfer (Docket No. R-1106) and third-party access policies (Docket No. R-1100).

The Board requests that in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each. This will facilitate the Board's analysis of all comments received.

I. Background

Beginning in 1985, the Board adopted and has subsequently modified a policy to reduce the risks that payments systems present to the Federal Reserve Banks, to the banking system, and to other sectors of the economy. An integral component of the current PSR policy is a program to control depository institutions' use of intraday Federal Reserve credit, commonly referred to as "daylight credit" or "daylight overdrafts." The Board's intention was to address the Federal Reserve's risk as well as risks on private-sector networks, primarily large-dollar payments systems. Risk can arise from transactions on the Federal Reserve's wire transfer system (Fedwire); from other types of payments, including checks and automated clearing house (ACH) transactions; and from transactions on private large-dollar networks.

The Federal Reserve Banks face direct risk of loss should depository institutions be unable to settle their daylight overdrafts in their Federal Reserve accounts before the end of the day. Moreover, systemic risk may occur if an institution participating on a private large-dollar payments network were unable or unwilling to settle its net debit position. If such a settlement failure occurred, the institution's creditors on that network might also be unable to settle their commitments. Serious repercussions could, as a result, spread to other participants in the private network, to other depository institutions not participating in the network, and to the nonfinancial economy generally. A Reserve Bank could be exposed to indirect risk if Federal Reserve policies did not address this systemic risk.

The 1985 policy required all depository institutions incurring daylight overdrafts in their Federal Reserve accounts as a result of Fedwire funds transfers to establish a maximum limit, or net debit cap, on those overdrafts (50 FR 21120, May 22, 1985).¹ Initially, the Board exempted book-entry securities overdrafts from quantitative overdraft controls because of concerns about the effect that overdraft restrictions could have on the U.S. government securities market and on the Federal Reserve's ability to conduct monetary policy through open market operations. In 1990, however, the Board announced that a depository institution's funds and book-entry securities overdrafts would be combined for purposes of determining the institution's compliance with its cap (55 FR 22087, May 31, 1990).

The Board recognized that receivers of book-entry securities generally cannot control the timing of their book-entry securities overdrafts, but that intraday book-entry

¹ Net debit caps are calculated by applying a cap multiple from one of six cap classes (zero, exempt, de minimis, average, above average, and high) to a capital measure. Cap multiples are determined through either a self-assessment process (for average, above average, and high cap classes) or a board-of-directors resolution or assigned by the Reserve Bank. Requests for a particular cap multiple are granted at the discretion of the Reserve Bank.

securities overdrafts, like funds overdrafts, have the potential to become overnight overdrafts. Given the seller-driven nature of the book-entry system and the Board's sensitivity to the markets it supports, the Board determined that only collateralized book-entry securities overdrafts would be exempt from cap limits.² This aspect of the policy was designed to protect the Reserve Banks from the very large exposures that can result from book-entry transfers without creating serious disruptions in the market.

In 1989, the Board requested comment on a proposed change to its payments system risk reduction program that would assess a fee of 60 basis points, phased in over three years, for average daily overdrafts in excess of a deductible of 10 percent of risk-based capital (54 FR 26094, June 21, 1989). In October 1992, the Board approved charging a fee for daylight overdrafts, which was to be phased in as 24 basis points in 1994, 48 basis points in 1995, and 60 basis points in 1996 (57 FR 47084, October 14, 1992).³ The purpose of the fee was to induce behavior that would reduce risk and increase efficiency in the payments system.

Some depository institutions and securities dealers commented that they opposed a fee on book-entry securities overdrafts that were collateralized. These depository institutions and securities dealers argued that pricing book-entry securities overdrafts was inequitable because collateral protected the Federal Reserve against losses and there are already costs associated with pledging collateral. For that reason, these institutions and securities dealers argued that pricing and requiring collateral for book-entry securities overdrafts was unduly burdensome. The Board stated, however, that allowing collateral to substitute for daylight overdraft fees would not provide a meaningful incentive for depository institutions or their dealer customers to change their procedures and reduce daylight overdrafts.⁴

In March 1995, the Board decided to raise the daylight overdraft fee to 36 basis points instead of 48 basis points (60 FR 12559, March 7, 1995). Because aggregate daylight overdrafts fell approximately 40 percent after the introduction of fees, the Board was concerned that raising the fee to 48 basis points could produce undesirable market effects contrary to the objectives of the risk-control program. The Board believed, however, that an increase in the overdraft fee was needed to provide additional incentives for institutions to reduce overdrafts related to funds transfers. The Board stated it would evaluate further fee increases two years after the 1995 fee increase.⁵

² The policy requires that depository institutions with "frequent and material" book-entry securities overdrafts fully collateralize these overdrafts. Book-entry daylight overdrafts become frequent and material when an account holder exceeds its net debit cap, because of book-entry securities transactions, on more than three days in any two consecutive reserve maintenance periods and by more than 10 percent of its capacity.

³ To facilitate the pricing of daylight overdrafts, the Federal Reserve also adopted a modified method of measuring daylight overdrafts that more closely reflects the timing of actual transactions affecting an institution's intraday Federal Reserve account balance. This measurement method incorporates specific account posting times for different types of transactions.

⁴ The Board also stated that collateral is required for large book-entry overdrafters as an exception that permits clearing banks and similarly situated institutions to exceed their caps because of the difficulty of controlling book-entry securities overdrafts.

⁵ On an average annual basis since 1995, overdrafts caused by book-entry securities transfers have decreased almost 10 percent per year and the value of book-entry securities transfers has grown more than 5 percent per year; whereas funds overdrafts and the value of Fedwire funds transfers have grown between 15 and 18 percent per year. The growth in funds overdrafts appears to be directly related to the growth in large-value funds transfers.

In considering its obligation to evaluate further fee increases, the Board recognized that significant changes have occurred in the banking, payments, and regulatory environment in the past few years and, as a result, decided to conduct a broad review of the Federal Reserve's daylight credit policies. During the course of its review, the Board evaluated the effectiveness of the current daylight credit policies and determined that these policies appear to be generally effective in controlling risk to the Federal Reserve and creating incentives for depository institutions to manage their intraday credit exposures. In addition, the Board determined that the current policy is well understood by the industry and that private-sector participants generally have benefited from the policy's risk controls. The Board also recognizes, however, that the policy has imposed costs on the industry and is considered burdensome by some depository institutions.

In conducting its review, the Board evaluated the impact of past policy actions on depository institutions' behavior and on the markets generally. The Board also took into consideration the effect of various payment system initiatives on payments activity and the demand for daylight credit. While the Board believes that the current policy is generally effective, it did identify growing liquidity pressures among certain payment system participants. Specifically, the Board learned that a small number of financially healthy institutions regularly find their net debit caps to be constraining, causing them to delay sending payments and, in some cases, to turn away business.⁶ Payment system initiatives, such as the Clearing House Interbank Payments System with intraday finality (new CHIPS), the Continuous Linked Settlement (CLS) system, and the Federal Reserve's settlement-day finality for ACH credit transactions, may exacerbate these institutions' liquidity needs at specific times during the day.⁷

II. Interim Policy Statement

The Board is adopting an interim policy statement that allows depository institutions with net debit caps derived through a self-assessment to pledge collateral voluntarily to the Federal Reserve Banks in order to access additional daylight overdraft capacity above their net debit cap levels.⁸ The Board's analysis of overdraft levels, liquidity patterns, and payment system developments revealed that while net debit caps provide sufficient liquidity to most institutions, some depository institutions are experiencing liquidity pressures. The Board recognizes that the interim policy could increase the public sector's credit exposure but believes that requiring collateral will allow the Federal Reserve to protect the public sector from additional credit exposure while providing extra liquidity to the few institutions that might otherwise be constrained. Providing extra liquidity to constrained institutions should help prevent liquidity-related market disruptions. The option to pledge collateral for additional

⁶ Current net debit cap levels provide sufficient liquidity for the majority of depository institutions. Approximately 97 percent of depository institutions with positive net debit caps use less than 50 percent of their daylight overdraft capacity for their average daily peak overdrafts.

⁷ New CHIPS was implemented on January 22, 2001, CLS is scheduled for implementation in the fourth quarter of 2001, and ACH credit transactions will be final on the settlement date beginning in mid-2001. Settlement-day finality for ACH credit transactions may exacerbate liquidity pressures for credit originators on the real-time monitor that must prefund.

⁸ Depository institutions that wish to have access to larger amounts of intraday credit than that provided by the exempt-from-filing and de minimis net debit caps must perform a self-assessment of their creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures to support a higher daylight overdraft cap.

daylight overdraft capacity would provide the private sector with the flexibility that it has requested to relieve liquidity pressures that have arisen or may arise from payment system innovations such as new CHIPS, CLS, and ACH finality as well as other payment system initiatives.

The Board believes it is important to provide an environment in which payment systems may function effectively and efficiently and remove barriers, as appropriate, to foster risk-reducing payment system initiatives. The Board recognizes that large-dollar networks are an integral part of clearing and settlement systems, that it is of considerable importance to keep the payments system operating without significant disruption, and that some intraday credit may be necessary to keep the payments system running smoothly and efficiently. Given these principles, the Board believes that allowing depository institutions with self-assessed net debit caps to pledge collateral for additional daylight overdraft capacity will continue to promote the PSR policy's risk-reduction efforts while minimizing disruptions to the payments system. In addition, daylight overdraft fees will continue to apply to all overdrafts, collateralized or uncollateralized, as the fee provides a meaningful incentive for depository institutions to manage efficiently their use of Federal Reserve daylight credit.

A. Payment System Initiatives

CHIPS Real-Time Final Settlement

On January 22, 2001, the Clearing House Interbank Payments Company L.L.C. (CHIPCo) converted CHIPS from an end-of-day multilateral net settlement system to one that provides real-time final settlement for all payment orders as they are released.⁹ Under an end-of-day system, the delay between the release of a payment order and its settlement results in the risk that the failure of one or more participants could trigger a failure of the system to settle. In response to demands of CHIPS participants to eliminate any possibility of an unwind, CHIPCo developed a method to achieve real-time final settlement of CHIPS payment orders. Under real-time final settlement, all CHIPS payment instructions are settled against a positive current position in the CHIPS prefunded balance account held at the Federal Reserve Bank of New York (FRBNY) or simultaneously offset by incoming payments or both. As a result, real-time final settlement eliminates the complexity and potential systemic risks of an end-of-day settlement failure that could lead to a general unwinding of CHIPS payments. In addition, the real-time final settlement of new CHIPS reduces credit and liquidity risks.

To accomplish real-time final settlement, each CHIPS participant must transfer (directly or through another participant) a predetermined amount into the CHIPS "prefunded balance account" on the books of FRBNY. While new CHIPS settles all of the payment orders when they are released, some payment orders remain unreleased at the end of the day. These payment orders are netted and set off against one another on a multilateral basis, with each participant in a net debit closing position transferring the amount of its closing position requirement into the prefunded balance account. Many CHIPS participants use Federal Reserve daylight credit to pay their end-of-day closing position requirements on CHIPS. Some of these participants have stated that making these Fedwire payments has, on occasion, increased their demand for intraday credit.

⁹ CHIPCo is the affiliate of The New York Clearing House Association L.L.C. that owns and operates CHIPS.

CLS Bank

CLS Bank is being designed as a multi-currency facility for settling foreign exchange transactions. Under the proposed procedures, participating institutions will be required to make daily U.S. dollar payments to CLS Bank over Fedwire during the early hours of the Fedwire funds transfer operating day. Because U.S. financial money markets are not currently active during those hours, a number of CLS members assert that they will use Federal Reserve daylight credit to fund their CLS-related payment obligations and have requested that the Federal Reserve grant them additional intraday credit.¹⁰

ACH Settlement-Day Finality

In November 1999, the Board announced a decision to make the settlement of ACH credit transactions processed by the Federal Reserve final when posted to the accounts of the receivers, which is currently 8:30 a.m. ET on the day of settlement (64 FR 62673, November 17, 1999). The Board noted that, in order to protect the Federal Reserve from the credit risk of granting finality to receiving depository institutions, the Reserve Banks would require settling depository institutions that are monitored in real time to prefund the total of their ACH credit originations before the transactions are processed. Settlement-day finality for ACH credit transactions reduces risk to receiving depository institutions and receivers while the prefunding requirement permits the Reserve Banks to manage their settlement risk for ACH credit transactions as they do for other services with similar finality features.

When the Board requested comment on the ACH finality proposal, a number of depository institutions asked that the Federal Reserve allow the flexibility of posting collateral as an alternative to the prefunding requirement (63 FR 70132, December 18, 1998). The Board noted that allowing collateral to cover non-securities related overdrafts was not in accordance with the PSR policy. The Board, however, also indicated that it would consider the commenters' request in future reviews of its PSR policies. Under the conditions described in this interim policy, some depository institutions submitting ACH credit transactions on the day of settlement will be able to secure additional daylight overdraft capacity.¹¹

B. Collateralized Daylight Overdraft Capacity

Depository institutions with self-assessed net debit caps that wish to expand their daylight overdraft capacity levels by pledging collateral should consult with their Reserve Banks. In developing guidelines for approving maximum limits on collateralized daylight overdraft capacity beyond net debit cap levels, the Board and Reserve Bank staff will consider financial and supervisory information. The financial and supervisory information may include, but is not limited to, potential daylight credit usage, 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 banks.

¹⁰ For additional information on payment system initiatives, refer to the Payments Risk Committee's report entitled "Intraday Liquidity Management in the Evolving Payment System: A Study of the Impact of the Euro, CLS Bank, and CHIPS Finality," New York, April 2000. <http://www.ny.frb.org/prc/intraday.html>.

¹¹ Federal Reserve systems in place today would not be effective for monitoring the collateralization of ACH credit transactions over several days.

Depository institutions may pledge the same types of collateral they do today for discount window or PSR purposes. In addition, the Board believes that it would be reasonable for depository institutions to use collateral pledged to the discount window for additional daylight overdraft capacity and notes that more than 25 percent of account holders already have collateral pledged to the Reserve Banks.¹² While several hundred depository institutions have collateral pledged to the Federal Reserve, the Board expects that very few depository institutions will seek to expand their daylight overdraft capacity levels by pledging collateral because approximately 97 percent of all account holders use less than 50 percent of their net debit caps for their average peak overdrafts. This modification of the PSR policy, allowing depository institutions with self-assessed net debit caps to pledge collateral for extra daylight overdraft capacity, affects other areas of the policy, including the policy's treatment of U.S. branches and agencies of foreign banks, book-entry securities transfers, and account monitoring procedures.

U.S. Branches and Agencies of Foreign Banks

For U.S. branches and agencies of foreign banks, net debit caps on daylight overdrafts in Federal Reserve accounts are calculated by applying the cap multiples for each cap category to a foreign banking organization's (FBO's) consolidated "U.S. capital equivalency."¹³ U.S. capital equivalency is calculated in one of several ways. In the case of FBOs whose home-country supervisors adhere to the Basle Capital Accord, U.S. capital equivalency is equal to the greater of 10 percent of worldwide capital or 5 percent of the liabilities to nonrelated parties of each agency or branch.¹⁴ For FBOs whose home-country supervisors do not adhere to the Basle Capital Accord, U.S. capital equivalency is measured as the greater of (1) the sum of the amount of capital (but not surplus) that would be required of a national bank being organized at each agency or branch location, or (2) the sum of 5 percent of the liabilities to nonrelated parties of each agency or branch.

The current policy allows U.S. branches and agencies of FBOs whose home-country supervisors do not adhere to the Basle Capital Accord to incur daylight overdrafts above their net debit caps up to a maximum amount equal to their cap multiples times 10 percent of their FBOs' capital, provided that any overdrafts above the net debit caps are collateralized. The interim policy offers all foreign banks, under terms that reasonably limit Reserve Bank risk, a level of overdrafts based on the same proportion of worldwide capital. Under the interim policy statement, the above distinction is no longer pertinent because any U.S. branch or agency of a foreign bank that has a self-assessed net debit cap and that would like to access daylight credit above its net debit cap level may consult with its Administrative Reserve Bank to discuss an appropriate daylight overdraft capacity level.¹⁵ In addition, a notice published elsewhere in today's Federal Register requests comment on the net debit cap calculation for U.S. branches and

¹² The Board notes that the majority of Federal Reserve daylight credit extensions are currently implicitly collateralized because depository institutions that have pledged collateral must sign Operating Circular 10, which provides the Reserve Banks with a secured interest in any collateral recorded on the Reserve Banks' books.

¹³ The term "U.S. capital equivalency" is used in this context to refer to the particular capital measure used to calculate daylight overdraft net debit caps and does not necessarily represent an appropriate capital measure for supervisory or other purposes.

¹⁴ Liabilities to nonrelated parties include acceptances but excludes accrued expenses and amounts due and other liabilities to offices, branches, and subsidiaries of the foreign bank.

¹⁵ The Administrative Reserve Bank is responsible for managing an institution's account relationship with the Federal Reserve.

agencies of foreign banks (Docket No. R-1108).

Book-Entry Securities Transactions

The current policy stipulates that depository institutions with book-entry securities overdrafts that meet the frequency and materiality thresholds must fully collateralize these overdrafts, not only the overdraft amount that exceeds the net debit cap level.¹⁶ Under the interim policy statement, the Board is eliminating the frequent and material collateralization requirement for self-assessed depository institutions' book-entry securities overdrafts. Instead, the policy statement will allow Reserve Banks to require collateral from self-assessed depository institutions that frequently exceed their caps as a result of transactions with settlement-day finality.^{17,18} While the interim policy statement requires collateralization of overdrafts only above net debit cap levels, which could increase the Federal Reserve's credit exposure, the Board believes an increase in Federal Reserve credit risk would be minimal given that very few institutions that participate in the government-securities market meet the frequent and material criteria. The Board also believes that eliminating the frequent and material collateralization requirement for book-entry securities overdrafts specifically and developing guidelines that require collateralization of overdrafts above net debit cap levels regardless of the cause would simplify administration of and compliance with the policy.

The changes described above do not apply to institutions with exempt-from-filing or de minimis net debit caps. Under the interim policy, the Board plans to continue to allow depository institutions with exempt-from-filing or de minimis caps to collateralize voluntarily all or part of their book-entry securities overdrafts. The Board also intends to continue

- Requiring depository institutions with exempt-from-filing or de minimis caps that frequently exceed their caps, even if only partly because of book-entry securities transactions, to collateralize all of their book-entry securities overdrafts.
- Prohibiting depository institutions with exempt-from-filing or de minimis caps to pledge collateral to increase their daylight overdraft capacity for funds overdrafts.
- Requiring depository institutions with zero caps that have access to the discount window to collateralize fully all book-entry securities overdrafts.

With the adoption of a final policy statement, the Board intends to eliminate the current policy's separate treatment of book-entry securities overdrafts. The policy will require any depository institution with an exempt-from-filing or de minimis cap to apply for a higher net debit cap if the institution frequently exceeds its cap because of transactions with settlement-day

¹⁶ Book-entry daylight overdrafts become "frequent and material" when an account holder exceeds its net debit cap, due to book-entry securities transactions, by more than 10 percent of its capacity and on more than three days in any two consecutive reserve maintenance periods.

¹⁷ These transactions include Fedwire funds and book-entry securities transfers, enhanced net settlement service transactions, and ACH credit originations (beginning in mid-2001).

¹⁸ Under the interim policy, "frequently" will continue to mean more than three days in any two consecutive reserve maintenance periods. In the vast majority of cases where depository institutions' overdrafts exceed their net debit cap levels, the materiality threshold is met. The Board, therefore, is eliminating the "materiality" criteria entirely from the policy because it has little practical purpose.

finality. The Board believes that such a change would simplify administration and compliance with the policy. Furthermore, the Board notes that very few depository institutions (currently there are six) with exempt-from-filing or de minimis caps voluntarily hold collateral to cover their book-entry securities overdrafts and would not be adversely affected by the proposed policy change.¹⁹

Account Monitoring

Currently, a depository institution's funds and book-entry securities overdrafts are combined for purposes of determining the institution's compliance with its cap. Under the ex post monitoring procedures, the Reserve Banks contact and counsel institutions with net debit positions in excess of their caps, discussing ways to reduce their excessive use of intraday credit. Each Reserve Bank retains the right to protect its risk exposure from individual institutions by unilaterally reducing net debit cap levels, imposing collateralization or clearing-balance requirements, holding or rejecting Fedwire transfers or enhanced net settlement service transactions during the day until the institution has collected balances in its Federal Reserve account, or, in extreme cases, prohibiting it from using Fedwire.

The Board does not intend to modify significantly the Federal Reserve's ex post monitoring procedures. The Board notes, however, that three aspects of the ex post monitoring procedures warrant clarification with implementation of the interim policy. First, the Reserve Banks will monitor the net debit positions of depository institutions with self-assessed caps that choose to pledge collateral voluntarily for additional overdraft capacity against these institutions' daylight overdraft capacity levels and not their net debit cap levels.

Second, Reserve Banks may require depository institutions with self-assessed net debit caps that frequently exceed their daylight overdraft capacity levels to collateralize the difference between their peak daylight overdrafts and their net debit cap levels. Depository institutions have some flexibility as to the specific types of collateral they may pledge to the Reserve Banks; all collateral, however, must be acceptable to the Reserve Banks.

Finally, the policy will continue to allow administrative counseling flexibility for institutions that frequently exceed their net debit caps due to the posting of transactions that do not have settlement-day finality, such as checks and ACH debit originations.²⁰ Escalated counseling or requiring collateral for daylight overdrafts caused by these transactions may be of limited use in reducing associated overdrafts.

III. Request for Comment

The Board requests comment on all aspects of the interim policy statement. The Board is also requesting specific comments on the following questions:

1. What are the benefits and drawbacks of allowing depository institutions with self-assessed net debit caps to pledge collateral for additional daylight overdraft capacity?

¹⁹ Currently there are no depository institutions with exempt-from-filing or de minimis caps that are required to pledge collateral for book-entry securities overdrafts as a result of meeting the frequency and materiality criteria.

²⁰ In October 1994, the Board approved administrative counseling flexibility for institutions that continue to exceed their net debit caps due to the posting of non-Fedwire transactions (59 FR 27122, November 2, 1994).

2. Would a policy change that requires depository institutions with exempt-from-filing and de minimis caps to apply for higher net debit caps if they frequently exceed their caps because of book-entry securities transfers simplify the policy or create an undue burden?
3. Would the interim policy cause institutions to pledge additional collateral to the Federal Reserve or would they primarily use collateral already pledged to a Reserve Bank?

IV. Competitive Impact Analysis

The Board has established procedures for assessing the competitive impact of rule or policy changes that have a substantial impact on payments system participants.²¹ Under these procedures, the Board assesses whether a change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services due to differing legal powers or constraints, or due to a dominant market position of the Federal Reserve deriving from such differences. If no reasonable modifications would mitigate the adverse competitive effects, the Board will determine whether the expected benefits are significant enough to proceed with the change despite the adverse effects.

The Board does not believe that the broader use of collateral for daylight overdraft purposes will have a direct and material effect on the ability of other service providers to compete with the Reserve Banks' payments services. The Board notes that the interim policy statement is intended to facilitate the smooth functioning of private-sector payment systems.

V. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. ch. 3506; 5 CFR 1320 Appendix A.1), the Board has reviewed the policy statement under the authority delegated to the Board by the Office of Management and Budget. No collections of information pursuant to the Paperwork Reduction Act are contained in the policy statement.

VI. Federal Reserve Policy Statement on Payments System Risk

The "Federal Reserve Policy Statement on Payments System Risk," section I is amended, effective **DATE**, as follows with changes identified by **italics**:

I. FEDERAL RESERVE POLICY

- A. Daylight overdraft definition
- B. Pricing
- C. Capital
 1. U.S.-chartered institutions
 2. U.S. agencies and branches of foreign banks

²¹ These procedures are described in the Board's policy statement "The Federal Reserve in the Payments System," as revised in March 1990. (55 FR 11648, March 29, 1990).

D. Net debit caps

1. Cap set through self-assessment
2. De minimis cap
3. Exemption from filing
4. Special situations
 - a. Edge and agreement corporations
 - b. Bankers' banks
 - c. Limited-purpose trust companies
 - d. Zero-cap depository institutions

E. Collateral

F. Book-entry securities transactions

1. Collateralization
2. Transfer-size limit

G. Monitoring

1. Ex post
2. Real time
3. Multi-District institutions
4. ACH controls

The last paragraph in section I.C.2., under the heading “U.S. agencies and branches of foreign banks.” has been deleted, effective **DATE**.

A new heading “Collateral” and text have been added to read as follows in section I.E., effective **DATE**:

E. Collateral

Depository institutions with self-assessed net debit caps may pledge collateral to their Administrative Reserve Banks to secure daylight overdraft capacity in excess of their net debit caps. The Reserve Banks will work with self-assessed depository institutions that request additional daylight overdraft capacity to decide on the appropriate maximum daylight overdraft capacity levels, that is, net debit cap levels plus allowable collateralized credit. Depository institutions have some flexibility as to the specific types of collateral they may pledge to the Reserve Banks; all collateral, however, must be acceptable to the Reserve Banks. Depository institutions with exempt-from-filing and de minimis net debit caps may not obtain additional capacity by pledging collateral. These depository institutions must perform a self-assessment of their creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures to support a higher daylight overdraft cap.

In addition, Reserve Banks may require depository institutions with self-assessed net debit caps that frequently exceed their caps due to transactions with settlement-day finality to collateralize the difference between their peak daylight overdrafts and their net debit cap levels. For the purposes of this policy, “frequently” means more than three occasions in two consecutive reserve-maintenance periods.

The policy allows administrative counseling flexibility for most institutions that frequently exceed their net debit caps because of the posting of transactions that lack settlement-day finality, such as checks and ACH debit originations. The Board's policy on net debit caps is intended to address intraday risk to the Federal Reserve arising from daylight overdrafts. Most transactions that lack settlement-day finality, however, pose primarily interday, rather than intraday, risk. Escalated counseling or requiring collateral for daylight overdrafts caused by these transactions may be of limited use in reducing associated overdrafts. Under administrative counseling flexibility, the Reserve Banks work with affected institutions on means of avoiding daylight overdrafts, but generally do not subject these institutions to escalated levels of counseling, require collateral, or assign a zero cap.

Section I.F.1., under the heading "Collateralization" is replaced, effective **DATE**, to read as follows:

F. Book-Entry Securities Transactions

1. Collateralization

A depository institution's funds and book-entry securities overdrafts are combined for purposes of determining an institution's compliance with its cap.¹⁸ The policy requires depository institutions with exempt-from-filing or de minimis caps that frequently exceed their caps, even if only partly because of book-entry securities transactions, to collateralize all of their book-entry securities overdrafts. For the purposes of this policy, "frequently" means on more than three occasions in two consecutive reserve-maintenance periods. To determine whether an institution exceeds its net debit cap because of book-entry securities transactions, the Reserve Bank determines what activity in an institution's Federal Reserve account is attributable to funds transfers and other payment transactions and what activity is attributable to book-entry securities transactions. A book-entry securities overdraft occurs when an institution's book-entry securities balance, less any credit in its funds balance, is a net debit.

In addition, all depository institutions with exempt-from-filing or de minimis caps may collateralize all or part of their book-entry securities overdrafts. Such secured overdrafts shall not be included with those overdrafts measured against their caps. For example, a depository institution with a de minimis cap of \$50 million and a \$30 million overdraft—\$15 million due to funds transfers and \$15 million due to book-entry securities transfers— would ordinarily have excess capacity of \$20 million. Such an institution may increase its excess capacity by \$15 million by collateralizing all of its book-entry securities overdrafts (or may increase its excess capacity by less than \$15 million by collateralizing some portion of its book-entry securities overdrafts). Such an institution may not increase its cap of \$50 million by over-collateralizing its book-entry securities overdrafts or by collateralizing any part of its funds overdrafts.

Section I.G.1., under the heading “Ex Post” is amended, effective **DATE**, as follows with changes identified by **italics**:

G. Monitoring

1. Ex Post

Under the ex post monitoring procedure, an institution with a net debit position in excess of its cap or daylight overdraft capacity level will be contacted by its Reserve Bank. The Reserve Bank will counsel the institution, discussing ways to reduce its excessive use of intraday credit. Each Reserve Bank retains the right to protect its risk exposure from individual institutions by unilaterally reducing Fedwire caps, imposing collateralization or clearing-balance requirements, holding or rejecting Fedwire transfers during the day until the institution has collected balances in its Federal Reserve account, or, in extreme cases, taking the institution off-line or prohibiting it from using Fedwire.

¹⁸ Funds overdrafts refer to overdrafts caused by funds transfers as well as NSS, TIP, cash, ACH, and check transactions.

By order of the Board of Governors of the Federal Reserve System, May 30, 2001.

(Signed) Jennifer J. Johnson

Jennifer J. Johnson,

Secretary of the Board.