

FEDERAL RESERVE SYSTEM

Docket No. OP-1182

Policy Statement on Payments System Risk

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy statement.

SUMMARY: The Board has revised its Policy Statement on Payments System Risk (PSR policy) to modify the daylight overdraft measurement rules (“posting rules”) for interest and redemption payments on securities issued by entities for which the Reserve Banks act as fiscal agents but whose securities are not obligations of, or fully guaranteed as to principal and interest by, the United States—that is, securities issued by government-sponsored enterprises (GSEs) and certain international organizations. In connection with this policy change, the Board supports the formation of an industry working group to promote a smooth transition through collaborative discussion of implementation issues. The working group will be coordinated through the Federal Reserve Banks’ Wholesale Product Office in New York; organizations that commented on the planned policy changes, members of those organizations, and fiscal principals to whom the policy applies will be invited to participate.

Additionally, the Board has revised its PSR policy to align the policy’s treatment of the general corporate account activity (activity other than interest and redemption payments) of GSEs and certain international organizations with the treatment of account activity of other Federal Reserve account holders that do not have regular access to the Federal Reserve’s discount window. Such treatment includes strongly discouraging daylight overdrafts and applying a penalty fee to daylight overdrafts that nonetheless result from these entities’ general corporate payment activity.

The Board has also revised its policy to reflect the recent changes to the operating hours of the on-line Fedwire Funds Service, to clarify certain items, and to remove or update items that have become outdated.¹

DATES: The PSR policy revisions concerning the posting rules for interest and redemption payments on securities issued by GSEs and certain international organizations and the revisions that align the policy’s treatment of the general corporate account activity of these entities will take effect on July 20, 2006. The other changes to the PSR policy are effective September 22, 2004.

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¹ Fedwire is a registered servicemark of the Federal Reserve Banks.

SUPPLEMENTARY INFORMATION

I. Background

In February 2004, the Federal Reserve Board announced two intended revisions to its PSR policy (69 FR 6292, Feb. 10, 2004). The first revision would modify the daylight overdraft posting rules under the PSR policy to specify that Reserve Banks will release interest and redemption payments on the Fedwire-eligible securities issued by a GSE or international organization only when the issuer's Federal Reserve account contains funds equal to or in excess of the amount of the interest and redemption payments to be made.^{2,3} The second revision would align the PSR policy's treatment of the general corporate account activity of these entities with the treatment of activity of other account holders that do not have regular access to the discount window.⁴ Such treatment would include applying a penalty fee to daylight overdrafts resulting from these entities' general corporate payment activity and potentially applying additional risk controls as a means of deterring further the use of Federal Reserve daylight credit.^{5,6}

The policy revisions result from an assessment of the temporary exemption granted to GSEs under the Board's 1994 interpretation of the PSR policy (59 FR 25060, May 13, 1994). That earlier interpretation had stated that GSEs should not incur daylight overdrafts in their accounts and would not be allowed to adopt positive net debit caps because they do not have regular access to the discount window. However, in its 1994 interpretation, the Board granted a temporary exemption from fees on daylight overdrafts resulting from the Reserve Banks' release of interest and redemption payments on Fedwire-eligible securities issued by GSEs prior to the issuers' full funding of such payments.⁷ The Board granted this temporary exemption because it was uncertain of the effect that daylight overdraft fees would have on

² The GSEs include Fannie Mae, the Federal Home Loan Mortgage Corporation (Freddie Mac), entities of the Federal Home Loan Bank System (FHLBS), the Farm Credit System, the Federal Agricultural Mortgage Corporation (Farmer Mac), the Student Loan Marketing Association (Sallie Mae), the Financing Corporation, and the Resolution Funding Corporation. The international organizations include the World Bank, the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank.

³ In their role as fiscal agents, the Reserve Banks maintain securities issued by GSEs and international organizations on the Fedwire Securities Service and make interest and redemption payments to depository institutions on each issuer's behalf, in addition to providing other payment services generally related to these fiscal agency services.

⁴ Under the PSR policy, an institution's eligibility to access daylight credit is contingent upon whether the institution is eligible for regular access to the Federal Reserve's discount window and whether it is in sound financial condition. By statute, regular access to the discount window generally is available to institutions that are subject to reserve requirements (12 U.S.C. 461(b)(7)).

⁵ A daylight overdraft occurs when an account holder's Federal Reserve account is in a negative position during the business day.

⁶ The penalty fee is equal to the regular daylight overdraft fee, currently 36 basis points, plus 100 basis points. A Reserve Bank may apply other risk controls to an account holder's payment activity if the account holder incurs daylight overdrafts in violation of the PSR policy or if the Reserve Bank believes that the account holder poses credit risk in excess of what the Reserve Bank determines to be prudent. For example, a Reserve Bank may place real-time controls on the account holder's payment activity, so as to reject those payments that would create, or increase, a daylight overdraft in the entity's account. These payment types include Fedwire funds transfers, National Settlement Service (NSS) transactions, and certain automated clearing house transactions. The Reserve Bank could also require the account holder to pledge collateral to cover any daylight overdrafts it does incur.

⁷ The term "interest and redemption payments" refers to payments of principal, interest, and redemption on securities maintained on the Fedwire Securities Service.

securities markets and did not want to introduce too much change at one time. The Board, however, indicated that it would revisit the temporary exemption after market participants adjusted to the effects of daylight overdraft fees. In addition, the Board applied the regular daylight overdraft fee to the daylight overdrafts arising from the GSEs' general corporate funding activity, but did not apply the penalty fee that applies to other institutions that lack regular discount window access.⁸ The Board stated it was not, however, ruling out the future application of the penalty fee.

In 2000, the Board began a general evaluation of the effectiveness of the PSR policy's daylight overdraft fee. Recognizing that significant changes had occurred in the banking, payments, and regulatory environment since the fee was introduced in 1994, the Board decided to broaden its evaluation of the fee to include all aspects of the Federal Reserve's daylight credit policies. Based on its review, the Board identified growing liquidity pressures among certain payments system participants and, as a result, made several modifications to the PSR policy (66 FR 64419, Dec. 13, 2001).⁹ The Board also determined that the PSR policy appears 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 market participants appear to have adjusted to daylight overdraft fees; this determination prompted an assessment of the Board's 1994 interpretation of the PSR policy. In conducting this assessment, the Board evaluated the treatment of interest and redemption payments on Fedwire-eligible securities issued by GSEs and certain international organizations as well as the treatment of other payment services these entities use for their general corporate payment activity. The Board's assessment led to the policy modifications discussed below.

A. Treatment of Interest and Redemption Payments

According to the Board's current daylight overdraft measurement rules, U.S. Treasury and government agency interest and redemption payments are posted, that is, debited from the issuers' accounts and credited to the receivers' accounts, by 9:15 a.m. ET and original issues of securities are posted on a flow basis, as they are issued, but no earlier than 9:15 a.m. ET.¹⁰ These posting rules were designed primarily to grant depository institutions the benefit of receiving interest and redemption payments on U.S. Treasury or government agency securities prior to debits being made to their accounts for the purchase of new issues. For operational ease, the Reserve Banks have applied the same posting rules to interest and redemption payments on Fedwire-eligible securities issued by GSEs and international organizations.

In the course of its assessment of the 1994 policy interpretation, the Board found that the dollar volume of interest and redemption payments on Fedwire-eligible securities issued by GSEs and international organizations that are credited to the receiving depository institutions'

⁸ To facilitate measurement of overdrafts arising from the different activity, the Board required the GSEs and Reserve Banks to establish separate GSE accounts for principal and interest activity (P&I account) and for general corporate payment activity (general account).

⁹ These modifications included changes to the net debit cap calculation for U.S. branches and agencies of foreign banks and a provision that would allow certain depository institutions to pledge collateral to the Federal Reserve in order to access additional daylight overdraft capacity above their net debit caps, subject to Reserve Bank approval.

¹⁰ While transactions for various payment types are processed throughout the business day, daylight overdrafts in an entity's Federal Reserve account are calculated on an ex post basis according to the daylight overdraft posting rules.

Federal Reserve accounts prior to such payments being fully funded by the issuer has grown significantly and to very large amounts over the past ten years. In large part, this increase owes to the rapid growth in Fedwire-eligible securities issued by GSEs. In addition, for some issuers, the lag between the time the Reserve Banks credit depository institutions' accounts for the interest and redemption payments and the time the issuer covers the payments extends, at times, until shortly before the close of the Fedwire Funds Service.¹¹

The Board determined that the practice of releasing such payments before they are fully funded by the issuer is neither necessary to achieve the Federal Reserve's statutory mission nor appropriate risk management policy for the central bank. To control their risks, private issuing and paying agents generally do not allow payments to be made for a securities issuer before the issuer has fully funded its payments. The Board, therefore, announced in February 2004 its intention to revise its policy to specify that the Reserve Banks will release interest and redemption payments on Fedwire-eligible securities issued by a GSE or an international organization only when the issuer's Federal Reserve account contains funds equal to or in excess of the amount of the issuer's interest and redemption payments to be made and provided that these funds are in the issuer's Federal Reserve account prior to an established cut-off hour on the Fedwire Securities Service.¹² This stated policy direction was intended to eliminate the Federal Reserve's intraday credit exposure that results from the current manner in which the Reserve Banks process and post interest and redemption payments on securities issued by GSEs and international organizations to the receiving depository institutions' Federal Reserve accounts prior to such payments being fully funded by the issuer.

B. Treatment of Other Payment Services

In its assessment of the 1994 policy interpretation, the Board also evaluated the treatment of other Federal Reserve payment services used by GSEs and international organizations for their general corporate payment activity, that is, payment activity unrelated to interest and redemption payments. While most of these entities only infrequently incur daylight overdrafts at Federal Reserve Banks as a result of their general corporate payment activity, a few of these entities incur such daylight overdrafts on an almost daily basis.

The Board determined that GSEs and international organizations for which the Reserve Banks act as fiscal agents should not be permitted the same access to intraday credit as depository institutions because, by statute, the former do not have regular access to the discount window. Therefore, to provide uniform treatment of account holders that do not have regular access to the discount window, the Board announced its intention to apply the same penalty fee that applies to daylight overdrafts of these entities to daylight overdrafts that result from GSEs' and international organizations' general corporate payment activity. This policy change will be implemented concurrent with the posting rule change for interest and redemption payments described above. This policy change supersedes the Board's 1994 temporary exemption

¹¹ The scheduled close of the Fedwire Funds Service is 6:00 p.m. ET for third-party transfers and 6:30 pm ET for bank-to-bank transfers.

¹² The Board established a cut-off hour of 4:00 p.m. ET by which issuers must fund the amount of their respective interest and redemption payments to be made on a given day in order for Reserve Banks to release such payments on that day.

pertaining to GSEs, and the Board, therefore, is rescinding its 1994 interpretation upon implementation of the new policy.

C. Request for Comment

With respect to the posting rule changes described above, the Board requested comment on how best to implement the policy change in order to promote a smooth market adjustment. More specifically, if market participants believed that a phased approach would better facilitate implementation of the planned change, the Board requested comment on the rationale for why such an approach is considered preferable to one of full implementation as of a single date and on the specific structure and objectives of any such approach. Below is a summary and analysis of the comments received on the planned policy changes.

II. Summary of Comments and Analysis

The Board received ten comment letters on its proposed policy changes. The commenters included five commercial banking organizations, two GSEs, two industry groups, and one Federal Reserve Bank. The majority of the comments focused on different approaches for implementing the posting rule changes. Although several commenters recognized the policy changes as consistent with the overall objectives of the PSR policy, one commenter noted that the posting rule change may represent a suboptimal solution to the current practice because it may only redistribute credit risk from the Federal Reserve to other parties rather than reduce or eliminate it. Four commenters proposed the formation of a working group to evaluate further the impact of the intended policy revisions. Three commenters discussed the appropriateness of the 4:00 p.m. ET cut-off hour. Finally, one commenter expressed concern that issuers might prioritize funding of their general corporate payment activity before funding of their interest and redemption payments, thereby delaying interest and redemption payments in order to avoid daylight overdrafts and the associated penalty fee under the Board's revised policy.

A. Implementation Approaches

1. Phased Implementation

Seven commenters recommended some form of a phased implementation. These commenters raised concerns that an abrupt change in available intraday liquidity under a full implementation scenario has the potential to increase systemic risk, particularly in light of the aggregate dollar amounts involved and the potential loss of liquidity early in the day. Two commenters urged a phased approach to avert potential payments gridlock stemming from the loss of market liquidity early in the day, arguing that this gridlock could increase the risk of overnight exposure if payment flows were to shift to later in the day. One commenter noted that the policy changes could put pressure on overnight investment markets to return funds earlier in the day. Three commenters expressed uncertainty as to whether sufficient intraday credit exists among depository institutions generally to absorb the issuers' liquidity demands. These commenters raised concerns that the effects of the policy changes would likely be concentrated among a small number of institutions, such as the larger custody and clearing banks. These commenters also stressed that daylight overdrafts and the associated costs at these institutions

would likely increase as a result of the policy changes and would make it difficult for them to serve as a potential source of liquidity to issuers. Another commenter raised concerns that full implementation with no phase-in would be unnecessarily burdensome to broker-dealers as well as depository institutions in terms of the availability and cost of daylight overdrafts.

The seven commenters generally viewed a phased approach to implementation as preferable because they believe it would promote better understanding of the effects of the posting rule change among market participants and allow for a more gradual and orderly adjustment to the potential removal of liquidity currently provided early in the day, thereby reducing the potential for unintended consequences. One commenter stated that a phased implementation would also allow issuers time to identify and gradually access alternative sources of funding. Two commenters emphasized that a phased approach would have information value to market participants and the Federal Reserve and could provide the Federal Reserve with a better opportunity to observe and assess the effects of the policy changes prior to full implementation. One commenter likened phasing in this policy change to the approach the Board used to introduce pricing of daylight overdrafts.

Commenters described a variety of potential phased approaches that attempt to address the concerns outlined above. These approaches include phasing in the changes by payment type, by product type, or by time of day. One commenter suggested treating the issuers' accounts, during a predefined phase-in period, similarly to those of other account holders that do not have regular access to the discount window, which implies applying a penalty fee to daylight overdrafts resulting from the release of the issuers' interest and redemption payments. Two commenters recommended piloting the changes with a subset of issuers. One of these commenters suggested that such an approach could begin prior to July 2006. Three commenters recommended that a phased implementation begin in July 2006. One commenter suggested adoption of a phased approach after a study of potential market implications. Each of the commenters' suggested phase-in options is described below.

Two commenters recommended a phased implementation approach by payment type, whereby an issuer's principal and interest payments would be separated from its redemption payments. These commenters are likely referring to mortgage-backed securities, whose payments have a principal and interest component as well as a redemption component. One of these commenters reasoned that the funding for principal and interest payments is presumably more readily available than the funding for redemption payments because the principal and interest payments accrue (as the mortgages that underlie the securities are paid) and are invested over time and should be available on payment date, whereas redemption payments are funded from the proceeds of new securities issuances. Under these assumptions, the commenter suggested that the Board consider continuing to fund one type of payment and phase in the funding requirement on the other. Another commenter suggested the option of a phasing in implementation by product type under each issuer, whereby the provision of intraday credit supporting the release of interest and redemption payments on different products would be removed gradually.

Three commenters addressed the potential for a phased implementation by time of day. One commenter suggested an approach that would gradually reduce the amount of time

between the release of interest and redemption payments and the deadline for reimbursement of those funds. Another commenter described a similar approach whereby the Federal Reserve would continue to extend credit during an interim period in order to release the interest and redemption payments, but the time at which these payments are made would be pushed back gradually until such time that the credit is ultimately withdrawn. The commenter noted that this approach would ensure that interest and redemption payments would be made during the interim period and could avert precipitation of systemic liquidity problems. A third commenter, however, expressed concern that the latter approach may not be worth pursuing because the system changes required to adopt such an approach would be short-lived.

One commenter suggested that the Board consider an approach whereby the Federal Reserve continues to fund issuers' interest and redemption payments in the early morning over an interim period while treating the issuers' accounts in the same manner as other account holders that do not have regular access to the discount window. The Board notes that such treatment includes strongly discouraging daylight overdrafts and applying a penalty fee to daylight overdrafts that nonetheless result. Under this approach, the Reserve Banks' release of the interest and redemption payments could result in daylight overdrafts in the issuers' Federal Reserve accounts to which the penalty fee would then be applied. The commenter reasoned that this phased approach could reduce the daylight overdraft implications to depository institutions as compared with an approach of full implementation, and it would allow them more time to assess the effect of the policy changes.

Two commenters suggested the option of phasing in the policy changes on an issuer-by-issuer basis to allow market participants to gradually adjust practices. The Federal Farm Credit Banks Funding Corporation expressed its willingness to participate in a pilot program of the policy changes prior to July 2006 if the Board viewed such an approach as useful. This commenter, self-described as "a smaller GSE debt-issuing agent," proposed the approach as a means for the Federal Reserve to gain experience with the policy changes with smaller organizations prior to implementation with the largest organizations that presumably have greater intraday credit demands.

2. Full Implementation

One commenter supported full implementation of the planned policy changes, stating that the entities potentially affected by the changes have sufficient capability and appropriate incentives to transition to the new policy without further guidance from the Board. This commenter believed that a phased approach was unnecessary and that the policy changes should be implemented fully beginning July 2006.

One commenter noted that separation of each issuers' principal and interest payments from its redemption payments (again, likely referring to payments on mortgage-backed securities) and potentially further separation of each issuers' payments by product type would allow issuers to segment their respective funding requirements to potentially more manageable levels throughout the day. The commenter recognized that decisions regarding separation and prioritization of payments are at the discretion of each issuer, but anticipated that such an approach would be supported by market participants, including issuers, because the commenter

believes the approach would reduce the potential adverse effects of the Board's posting rule change on financial markets generally and, in particular, on the marketplace for these issuers' securities.

Another commenter urged consideration of an alternative method of processing interest and redemption payments that would involve an acceleration of new issue processing that allows for netting of refunding instruments against interest and redemption payments. The commenter noted that this approach could allow for periodic posting of debits to issuers' accounts throughout the day as opposed to the current process of posting single, aggregate debits early in the day and would reduce issuers' intraday credit needs to the residual amount resulting from any mismatch between new issuances and interest and redemption payments. This commenter suggested that the Board additionally consider some form of a collateralized borrowing arrangement or a committed, but unfunded backup line of credit to further offset a portion of an issuer's funding requirement.

3. Assessment of Implementation Approaches

As mentioned, those commenters supporting a phased approach to one of full implementation asserted that, in general, such an approach would allow market participants to adapt gradually to the potential removal of liquidity early in the day and would decrease the potential for payments gridlock that could otherwise increase systemic risk. These commenters further asserted that a phased implementation would promote a better understanding among market participants, including the Federal Reserve, of the liquidity and operational effects of the policy changes.

As explained in more detail below, the Board does not view a phased implementation as necessary or in the public interest. The Board acknowledges that the posting rule modification for the interest and redemption payments on securities issued by GSEs and certain international organizations will remove one source of free intraday credit and necessitate adjustments by market participants. However, after reviewing commenters' rationales for a phased implementation, including their concerns regarding liquidity and gridlock, the Board does not believe that commenters identified any particular aspect of the planned policy changes or related adjustments that would impede a smooth implementation or that would cause significant market disruptions were the new policy to become effective without a phase-in period. In addition, experiences with previous changes to the PSR policy indicate that full implementation of such changes can occur successfully and without disrupting payments systems, provided market participants have adequate lead time and engage in active planning. To facilitate such planning and information sharing among affected parties, the Board supports the formation of an industry working group, as described further below.

The Board also believes that commenters' specific phased approaches have a number of disadvantages when compared to a full-implementation approach. In particular, some of the approaches, especially in their early stages, may not provide a good indication of the influences and pressures that will shape full implementation. That is, one stage of a phased implementation does not necessarily have predictive value for subsequent stages or for full implementation. The Board is concerned, therefore, that practices adopted under a phased

implementation may not facilitate smooth market functioning or preparedness when full implementation occurs. In addition, some of the approaches impose explicit conditions that would not exist upon full implementation of the policy changes. To the extent the proposed approach differs from the future steady-state environment, the approach may adversely affect market participants' ability to adapt effectively to the policy changes. Finally, many of the phased approaches would require numerous changes in practices and systems to accommodate the various steps, with the consequent potential for additional costs, coordination issues, and increased operational risk. For these reasons, the Board believes that the potential drawbacks of a phased implementation outweigh the potential benefits, and therefore that full implementation of the policy changes, with adequate planning, is appropriate.

In terms of commenters' specific concerns with the potential removal of liquidity early in the day, the Board believes that this concern is based on a belief that there may be insufficient market liquidity to smoothly adjust to the policy changes and that issuers will take little or no action to adjust their funding patterns in response to these changes. The Board acknowledges that while the policy changes will result in the removal of free Federal Reserve intraday credit and certain market participants will have to adjust, sufficient aggregate market liquidity exists to absorb the potential reduction in liquidity early in the day. Additionally, while the Board understands that there may be some uncertainty regarding the intraday timing of receipt of interest and redemption payments given that each issuer's response to the revised policy cannot be predicted, the Board believes it is likely that issuers have a strong business incentive to respond to the policy changes in a manner that would avoid potential adverse liquidity effects. Moreover, the Board believes that issuers and market participants, particularly those that receive interest and redemption payments on the issuers' securities, will have been provided ample time to engage one another in discussions regarding potential changes to funding patterns in response to the policy changes. These discussions should allow market participants to better anticipate issuer behavior and appropriately adjust liquidity and account management practices as necessary. The Board believes that the Federal Reserve's coordination of an industry working group may provide an effective forum for such discussions.

In response to commenters' gridlock concerns, the Board notes that similar concerns were raised before the Board's introduction of net debit caps that took effect in 1986, the reduction of net debit caps that took effect in 1988, and the announcement of daylight overdraft fees in 1992 (50 FR 21120, May 22, 1985; 52 FR 29255, Aug. 6, 1987; 54 FR 26094, June 21, 1989). With respect to the net debit cap introduction and subsequent reduction, the Board found no empirical support suggestive of any significant change to intraday payment patterns among depository institutions. With the introduction of daylight overdraft fees, while certain adjustments to payment patterns occurred, payments gridlock did not occur because institutions continued to have sufficient business incentive to ensure execution of their customers' payments, particularly those considered to be time-critical. Similarly, with the posting rule change for interest and redemption payments, the Board believes that market participants will make some adjustments to their payment patterns, but that wide-ranging payments gridlock is highly unlikely given the payment expectations of customers and the business incentives that exist between counterparties. The Board is confident that issuers would consider these expectations and incentives in their decisions regarding management of their interest and redemption payments and their general corporate payment activity.

Commenters also discussed approaches that the Board might consider with respect to full implementation of the posting rule change. Regarding one commenter's suggestion of netting new issuances against interest and redemption payments, the Board notes that this approach, as described by the commenter, involves a continued extension of Federal Reserve intraday credit to finance any mismatch in timing between new issuances and interest and redemption payments. This commenter also suggested that the Board consider some form of a collateralized borrowing arrangement or a backup line of credit as "readily available" to further offset a portion of an issuer's funding requirement, which also involves a continued extension of Federal Reserve intraday credit. As mentioned, the Board has determined that the Federal Reserve will not extend intraday credit to entities that do not have regular access to the discount window. As such, the aforementioned implementation approaches are not viable.

In summary, the Board does not view a phased implementation as necessary to ensure a smooth market adjustment or as preferable to an approach of full implementation. As such, the Board plans to implement fully without a phase-in the policy changes effective July 20, 2006. The Board believes that full implementation in July 2006 should provide market participants sufficient time to adjust their systems and account management practices, as needed, to address operational or liquidity concerns. The Federal Reserve will communicate operational changes related to this policy change with account holders in a timely manner over the planning period and provide opportunities to test those changes prior to implementation.

B. Formation of a Working Group

Four commenters discussed the merits of forming a work group to discuss the planned policy changes. The general consensus among these commenters was that the group should be sponsored by the Federal Reserve with representation from a cross-section of market participants. The commenters' objective is to facilitate information sharing to minimize potential market disruptions stemming from the planned policy changes, such as the removal of free liquidity that has been provided early in the day under the current practice of releasing interest and redemption payments by 9:15 a.m. ET. Three of the commenters stated that the formation of such a group would promote transparency in devising an appropriate implementation plan. One of the commenters noted that precedent exists for forming such an industry group: the group formed to facilitate the migration of Ginnie Mae securities from the Depository Trust and Clearing Corporation to the Fedwire Securities Service.

One commenter suggested that the group perform an impact study of the changes prior to implementation. Another commenter suggested that the group evaluate the credit implications of treating the issuers similarly to other large corporate customers. This commenter also recommended that the group evaluate the system requirements and operational issues associated with implementation. Another commenter suggested that the purpose of the group would be to formulate a phase-in plan, while another stated that the group should develop a conversion plan and implementation schedule, regardless of whether a phased approach was adopted.

One commenter suggested that the group analyze various aspects of the interest and redemption payment data in order to make recommendations on items such as the timing of each issuer's interest and redemption payments, possible implementation methods, potential sources of credit to facilitate processing of interest and redemption payments, and management of depository institutions' daylight overdrafts. The proposed analysis would include evaluation of the dollar amounts of historical and prospective interest and redemption payments as well as the current timing of and any related overdrafts associated with these payments. The Board notes, however, that data regarding individual account holders' payment or daylight overdraft activity are confidential, and, as such, cannot be shared without their permission.

The Board recognizes that the effect of these policy changes on market participants may vary depending on the payment practices that each issuer ultimately adopts. As such, the Board sees value in fostering collaborative discussion among stakeholders regarding the policy implementation and will sponsor a working group, coordinated through the Federal Reserve Banks' Wholesale Product Office in New York. The Board believes that such a group could help to identify potential market adaptations to the policy changes and associated operational considerations. The Board also believes that the working group could enhance stakeholders' understanding of the future steady-state environment and therefore minimize the potential for market disruptions.

Organizations that commented on the planned policy changes, members of those organizations, and fiscal principals affected by these policy changes will be invited to participate in the working group. The Board notes that participation is not mandatory. In order to allow market participants and the Reserve Banks sufficient time to implement the planned policy changes on July 20, 2006, the majority of system requirements to implement the changes will need to be well-formulated by year-end 2004. Throughout implementation, the Wholesale Product Office will work closely with account holders to address operational considerations associated with the policy changes, as it does for other significant Fedwire-related operational changes.

The working group may also find it useful to discuss issues identified by two commenters relating to account reconciliation and repo tracking.¹³ One commenter noted that, with the planned posting rule change, it would be necessary for payment recipients to receive an end-of-day file from the Reserve Banks to facilitate reconciliation of expected interest and redemption payments with those that were actually released on a given day. Another commenter recommended that the Federal Reserve examine the effects of the policy changes on the repo tracking functionality currently available to participants on the Fedwire Securities Service, given that payments will be processed by individual issuer under the revised policy.

¹³ Repo tracking is a facility that allows adjustments to be made to the accounts of participants on the Fedwire Securities Service to ensure that the appropriate party receives principal and interest payments on mortgage-backed securities that have been marked with a repo identifier. The holder of one of these securities at close of business on record date will receive the associated principal and interest payment. However, the holder (identified as the "repo in" party) is not entitled to this payment in transactions such as those involving a repurchase agreement. The Reserve Banks keep track of repo records and make the necessary adjustment to ensure that the appropriate party receives the payment. The "repo in" party will receive a funds debit, and the "repo-out" party will receive a funds credit through the NSS. For more information, see <http://www.frb services.org/Wholesale/CM-2001/CM-221.pdf>.

The Board recognizes that the PSR policy changes will necessitate some operational changes to Federal Reserve systems and operating practices, such as the provision of additional files or modifications to allow interest and redemption payments to be released on an issuer-by-issuer basis. As such, Reserve Banks will conduct a comprehensive analysis of the current processes and system requirements to determine the necessary modifications to implement the policy changes effectively. The Board believes that the working group may be instrumental in identifying and discussing issues of this nature.

C. Establishment of a Cut-off Hour

Three commenters addressed the establishment of a 4:00 p.m. ET cut-off hour by which issuers must fund their respective interest and redemption payments. One commenter urged the Federal Reserve to keep processing interest and redemption payments to the extent they are funded up until the close of the Fedwire Funds Service (6:30 p.m. ET) to avoid a technical default on the part of the issuer. Two commenters supported a cut-off hour earlier than 4:00 p.m. ET. Specifically, one of these commenters recommended that the cut-off hour be set at 3:30 p.m. ET to facilitate processing of payments dependent on the receipt of interest and redemption payments. Another commenter recommended a cut-off hour more similar to that of other issuing and paying agents, indicating that an earlier cut-off hour would facilitate orderly end-of-day processing and provide sufficient time for affected parties to make appropriate funding arrangements, if necessary. In addition, this commenter indicated that an earlier cut-off hour might reduce intraday liquidity pressures on interest and redemption payment recipients, presumably because it would offer greater predictability of payment receipt. This commenter also supported the ability for Reserve Banks to grant extensions of the cut-off hour in instances of significant market disruptions to ensure orderly settlement.

The Board established a cut-off hour of 4:00 p.m. ET because it is the latest time by which issuers could fund their interest and redemption payments for release that day and still allow the Reserve Banks to close the Fedwire Securities Service on time.¹⁴ The Board views the establishment of a deadline no later than 4:00 p.m. ET as necessary to avoid disruptions to end-of-day processing for this and related systems. With respect to establishing a cut-off hour earlier than 4:00 p.m. ET, the Board views it as appropriate to base the cutoff hour on the Reserve Banks' operational capabilities, rather than on some other measure, such as the funding needs of individual market participants, because the Board views the former basis as both objective and transparent.

In the event an issuer does not fund its interest and redemption payments by the established cut-off hour of 4:00 p.m. ET, its payments would not be processed on that day. Requests by an issuer for extensions of the 4:00 p.m. ET funding deadline would not be granted in the normal course. Rather, the Reserve Banks would exercise their discretion in determining whether an extension is warranted in instances of significant market disruptions.

¹⁴ According to the Reserve Banks' Operating Circular 7, *Fedwire Securities Account Maintenance and Transfer Services*, funds-only transactions on the Fedwire Securities Service cannot be processed after 4:30 p.m. ET. Interest and redemption payments on Fedwire-eligible securities are processed through the Fedwire Securities Service as funds-only transactions. As such, a 4:00 p.m. ET cut-off hour provides the Reserve Banks a 30-minute window in which to complete the requisite processing for funds-related transactions in order to close the Fedwire Securities Service on time.

III. Other Policy Revisions

In addition to the changes described above, the Board has revised its policy to reflect recent changes to the operating hours of the on-line Fedwire Funds Service, to remove or update items that have become outdated, and to incorporate minor editorial changes to clarify meaning. The principal changes are described below.

Beginning in May 2004, the Federal Reserve changed the operating hours of the on-line Fedwire Funds Service from 18 to 21.5 hours. Because daylight overdraft fees are calculated based on the number of hours in the Fedwire Funds Service operating day, the fee calculation as described in the policy has been revised. The Board notes that the effective daily rates for both the regular daylight overdraft fee and the penalty fee have been truncated at seven decimal places because of programming changes made to Federal Reserve systems to expedite processing.¹⁵ Similarly, the effective daily rate used to calculate the value of the deductible has been rounded to seven decimal places.¹⁶ The Board recognizes that these changes may affect the fee calculations for some account holders; however, none of the changes result in increased daylight overdraft fees. The revised calculation is described in detail in section I.B. of the policy.

The Board has modified the posting rule for payments on U.S. Treasury and government agency matured coupons or definitive securities. The posting rule now distinguishes U.S. Treasury and government agency securities from securities issued by GSEs or international organizations. Until July 20, 2006, the posting rule for matured coupons and definitive securities issued by GSEs and international organizations will continue to specify that electronic credits for these items will post to recipients' Federal Reserve accounts by 9:15 a.m. ET.¹⁷ Beginning on July 20, 2006, however, these payments will post throughout the business day as directed by the issuer, but only when the issuer's Federal Reserve account contains funds equal to or in excess of the amount of the payments to be made. This change is consistent with the aforementioned principle that entities that do not have regular access to the discount window are not eligible for intraday credit.

Finally, the Board has revised its policy to remove language pertaining to foreign banking organizations that became outdated as of February 20, 2002 and to remove language pertaining to electronic check presentments that became outdated as of April 1, 2002.

IV. 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

¹⁵ The effective daily rate used in the calculation of the regular daylight overdraft fee has been truncated to 0.0000089. The effective daily rate used in the calculation of the penalty daylight overdraft fee has been truncated to 0.0000338.

¹⁶ The effective daily rate used in the calculation of any applicable deductible amount has been rounded to 0.0000042.

¹⁷ The policy clarifies that most payments on matured coupons or definitive securities are made by check and, as such, will post according to the policy's established check posting rules.

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.

V. Federal Reserve Policy Statement on Payments System Risk

Section I. of the PSR policy is revised, effective September 22, 2004, to read as follows:

INTRODUCTION

I. FEDERAL RESERVE DAYLIGHT CREDIT POLICIES

- A. Daylight overdraft definition and measurement
- B. Pricing
- C. Net debit caps
 - 1. Definition
 - 2. Cap categories
 - a. Self-assessed
 - b. De minimis
 - c. Exempt-from-filing
 - d. Zero
 - 3. Capital measure
 - a. U.S.-chartered institutions
 - b. U.S. branches and agencies of foreign banks
- D. Collateralized capacity
- E. Special situations
 - 1. Edge and agreement corporations
 - 2. Bankers' banks
 - 3. Limited-purpose trust companies
 - 4. Government-sponsored enterprises and international organizations
 - 5. Problem institutions
- F. Monitoring
 - 1. Ex post
 - 2. Real time
 - 3. Multi-district institutions
- G. Transfer-size limit on book-entry securities

INTRODUCTION

The Federal Reserve Board has developed this policy to address the risks that payment systems present to the Federal Reserve Banks (Reserve Banks), to the banking system, and to other sectors of the economy. This policy is directed primarily at risks on large-dollar payment systems, including Federal Reserve and private-sector systems. Risk can arise from transactions on the Federal Reserve's real-time gross settlement system (Fedwire), from transactions processed in other Federal Reserve payment systems (for example, the automated clearinghouse (ACH) system), and from transactions on private large-dollar systems.

The Reserve Banks face direct risk of loss should institutions be unable to settle their intraday or "daylight" overdrafts in their Federal Reserve accounts before the end of the

day.¹ Moreover, systemic risk may occur if an institution participating in a private large-dollar payment system were unable to settle its net debit position. If this were to occur, the institution's creditors in that system might then be unable to settle their obligations in that system or other systems. Serious repercussions could spread to other participants in the private system, to other institutions not participating in the system, and to the nonfinancial economy generally. A Reserve Bank could be exposed to an indirect risk if the Federal Reserve's policies did not address this systemic risk. Finally, institutions create risk by permitting their customers, including other depository institutions, to incur daylight overdrafts in the institutions' accounts in anticipation of receiving covering funds before the end of the day.

The Board is aware that large-dollar systems are an integral part of clearing and settlement systems and that it is vital to keep the payments mechanism operating without significant disruption. Recognizing the importance of avoiding such disruptions, the Board continues to seek to reduce the risks of settlement failures that could cause these disruptions. The Board is also aware that some intraday credit may be necessary to keep the payments mechanism running smoothly and efficiently. The reduction and control of intraday credit risks, although essential, must be accomplished in a manner that will minimize disruptions to the payments mechanism. The Board expects to reduce and control risks without unduly disrupting the smooth operation of the payments mechanism by establishing guidelines for use by institutions and relying largely on the efforts of individual institutions to identify, control, and reduce their own exposures.

The Board expects institutions to manage their Federal Reserve accounts effectively and use Federal Reserve daylight credit efficiently and appropriately, in accordance with this policy. Although some intraday credit may be necessary, the Board expects that, as a result of its policies, relatively few institutions will consistently rely on significant amounts of intraday credit supplied by the Federal Reserve to conduct their business. The Board will continue to monitor the effect of its policies on the payments system.

The general methods used to control intraday credit exposures are explained in the policies below. These methods include limits on daylight overdrafts in institutions' accounts at Reserve Banks; collateralization, in certain situations, of daylight overdrafts at the Federal Reserve; limits on the maximum level of credit exposure that can be produced by each participant on private large-dollar systems; availability of backup facilities capable of completing daily processing requirements for private large-dollar systems; and credit and liquidity safeguards for private delivery-against-payment systems. To assist institutions in implementing the Board's policies, the Federal Reserve has prepared two documents, the "Overview of the Federal Reserve's Payments System Risk Policy" (Overview) and the "Guide to the Federal Reserve's Payments System Risk Policy" (Guide), which are available online at <http://www.federalreserve.gov/PaymentSystems/PSR>. The Overview summarizes the Board's policy on payments system risk, including net debit caps and daylight overdraft fees and is intended for use by institutions that incur only small and infrequent daylight overdrafts. The

¹ In this policy statement, the term "institution" will be used to refer to institutions defined as "depository institutions" in 12 U.S.C. 461(b)(1)(A), U.S. branches and agencies of foreign banking organizations, Edge and agreement corporations, bankers' banks, limited-purpose trust companies, government-sponsored enterprises, and international organizations, unless the context indicates a different reading.

Guide explains in detail how these policies apply to different institutions and includes procedures for completing a self-assessment and filing a cap resolution, as well as information on other aspects of the policy.

I. FEDERAL RESERVE DAYLIGHT CREDIT POLICIES

A. Daylight Overdraft Definition and Measurement

A daylight overdraft occurs when an institution's Federal Reserve account is in a negative position during the business day. The Reserve Banks use an ex post system to measure daylight overdrafts in institutions' Federal Reserve accounts. Under this ex post measurement system, certain transactions, including Fedwire funds transfers, book-entry securities transfers, and net settlement transactions, are posted as they are processed during the business day. Other transactions, including ACH and check transactions, are posted to institutions' accounts according to a defined schedule. The following table presents the schedule used by the Federal Reserve for posting transactions to institutions' accounts for purposes of measuring daylight overdrafts.

Procedures for Measuring Daylight Overdrafts²

Opening Balance (Previous Day's Closing Balance)

Post Throughout Business Day:

- +/- Fedwire funds transfers
- +/- Fedwire book-entry securities transfers
- +/- National Settlement Service entries.

Post Throughout Business Day (Beginning July 20, 2006):

- + Fedwire book-entry interest and redemption payments on securities that are not obligations of, or fully guaranteed as to principal and interest by, the United States^{3,4,5}

² This schedule of posting rules does not affect the overdraft restrictions and overdraft-measurement provisions for nonbank banks established by the Competitive Equality Banking Act of 1987 and the Board's Regulation Y (12 CFR § 225.52).

³ The Reserve Banks act as fiscal agents for certain entities, such as government-sponsored enterprises (GSEs) and international organizations, whose securities are Fedwire-eligible but are not obligations of, or fully guaranteed as to principal and interest by, the United States. The GSEs include Fannie Mae, the Federal Home Loan Mortgage Corporation (Freddie Mac), entities of the Federal Home Loan Bank System (FHLBS), the Farm Credit System, the Federal Agricultural Mortgage Corporation (Farmer Mac), the Student Loan Marketing Association (Sallie Mae), the Financing Corporation, and the Resolution Funding Corporation. The international organizations include the World Bank, the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank. The Student Loan Marketing Association Reorganization Act of 1996 requires Sallie Mae to be completely privatized by 2008; however, Sallie Mae plans to complete privatization by September 2006. Upon privatization, the Reserve Banks will no longer act as fiscal agents for new issues of Sallie Mae securities, and the new Sallie Mae will not be considered a GSE.

⁴ The term "interest and redemption payments" refers to payments of principal, interest, and redemption on securities maintained on the Fedwire Securities Service.

⁵ The Reserve Banks will post these transactions, as directed by the issuer, provided that the issuer's Federal Reserve account contains funds equal to or in excess of the amount of the interest and redemption payments to be

- + Electronic payments for matured coupons and definitive securities that are not obligations of, or fully guaranteed as to principal and interest by, the United States.⁶

Post at 8:30 a.m. Eastern Time:

- +/- Government and commercial ACH credit transactions⁷
- + Treasury Electronic Federal Tax Payment System (EFTPS) investments from ACH credit transactions
- + Advance-notice Treasury investments
- + Treasury checks, postal money orders, local Federal Reserve Bank checks, and EZ-Clear savings bond redemptions in separately sorted deposits; these items must be deposited by 12:01 a.m. local time or the local deposit deadline, whichever is later
- Penalty assessments for tax payments from the Treasury Investment Program (TIP).⁸

Post at 8:30 a.m. Eastern Time and Hourly, on the Half-Hour, Thereafter:

- +/- Main account administrative investment or withdrawal from TIP
- +/- Special Direct Investment (SDI) administrative investment or withdrawal from TIP
- + 31 CFR Part 202 account deposits from TIP
- Uninvested paper tax (PATAX) tax deposits from TIP
- Main account balance limit withdrawals from TIP
- Collateral deficiency withdrawals from TIP
- 31 CFR Part 202 deficiency withdrawals from TIP.

Post at 8:30 a.m., 1:00 p.m., and 6:30 p.m. Eastern Time:

- Main account Treasury withdrawals from TIP.⁹

Post by 9:15 a.m. Eastern Time:

- + U.S. Treasury and government agency Fedwire book-entry interest and redemption

made. In the normal course, if a Reserve Bank does not receive funding from an issuer for the issuer's interest and redemption payments by the established cut-off hour of 4:00 p.m. Eastern Time on the Fedwire Securities Service, the issuer's payments will not be processed on that day.

⁶ Electronic payments for credits on these securities will post according to the posting rules for the mechanism through which they are processed, as outlined in this policy. However, the majority of these payments are made by check and will be posted according to the established check posting rules as set forth in this policy.

⁷ Institutions that are monitored in real time must fund the total amount of their commercial ACH credit originations in order for the transactions to be processed. If the Federal Reserve receives commercial ACH credit transactions from institutions monitored in real time after the scheduled close of the Fedwire Funds Service, these transactions will be processed at 12:30 am the next business day, or by the ACH deposit deadline, whichever is earlier. The Account Balance Monitoring System provides intraday account information to the Reserve Banks and institutions and is used primarily to give authorized Reserve Bank personnel a mechanism to control and monitor account activity for selected institutions. For more information on ACH transaction processing, refer to the ACH Settlement Day Finality Guide available through the Federal Reserve Financial Services website at <http://www.frbservices.org>.

⁸ The Reserve Banks will identify and notify institutions with Treasury-authorized penalties on Thursdays. In the event that Thursday is a holiday, the Reserve Banks will identify and notify institutions with Treasury-authorized penalties on the following business day. Penalties will then be posted on the business day following notification.

⁹ On rare occasions, the Treasury may announce withdrawals in advance that are based on institutions' closing balances on the withdrawal date. The Federal Reserve will post these withdrawals after the close of Fedwire.

- payments¹⁰
- + Electronic payments for U.S. Treasury and government agency matured coupons and definitive securities.¹¹

Post by 9:15 a.m. Eastern Time (Until July 20, 2006):

- + Fedwire book-entry interest and redemption payments on securities that are not obligations of, or fully guaranteed as to principal and interest by, the United States¹²
- + Electronic payments for matured coupons and definitive securities that are not obligations of, or fully guaranteed as to principal and interest by, the United States.¹³

Post Beginning at 9:15 a.m. Eastern Time:

- Original issues of Treasury securities.¹⁴

Post at 9:30 a.m. Eastern Time and Hourly, on the Half-Hour, Thereafter:

- + Federal Reserve Electronic Tax Application (FR-ETA) value Fedwire investments from TIP.

Post at 11:00 a.m. Eastern Time:

- +/- ACH debit transactions
- + EFTPS investments from ACH debit transactions.

Post at 11:00 a.m. Eastern Time and Hourly Thereafter:

- +/- Commercial check transactions, including returned checks^{15,16}
- +/- Check corrections amounting to \$1 million or more
- + Currency and coin deposits

¹⁰ For purposes of this policy, government agencies are those entities (other than the U.S. Treasury) for which the Reserve Banks act as fiscal agents and whose securities are obligations of, or fully guaranteed as to principal and interest by, the United States.

¹¹ Electronic payments for credits on these securities will post by 9:15 a.m. Eastern Time; however, the majority of these payments are made by check and will be posted according to the established check posting rules as set forth in this policy.

¹² See footnote 3.

¹³ See footnote 11.

¹⁴ Original issues of government agency, government-sponsored enterprise, or international organization securities are delivered as book-entry securities transfers and will be posted when the securities are delivered to the purchasing institutions.

¹⁵ This does not include electronic check presentments, which are posted at 1:00 pm local time and hourly thereafter. Paper check presentments are posted on the hour at least one hour after presentment. Paper checks presented before 10:01 a.m. Eastern Time will be posted at 11:00 a.m. Eastern Time. Presentment times will be based on surveys of endpoints' scheduled courier deliveries and so will occur at the same time each day for a particular institution.

¹⁶ Institutions must choose one of two check-credit posting options: (1) all credits posted at a single, float-weighted posting time, or (2) fractional credits posted throughout the day. The first option allows an institution to receive all of its check credits at a single time for each type of cash letter. This time may not necessarily fall on the clock hour. The second option lets the institution receive a portion of its available check credits on the clock hours between 11 a.m. and 6 p.m. Eastern Time. The option selected applies to all check deposits posted to an institution's account. Reserve Banks will calculate crediting fractions and float-weighted posting times for each time zone based on surveys. Credits for mixed cash letters and other Fed cash letters are posted using the crediting fractions or the float-weighted posting times for the time zone of the Reserve Bank servicing the depositing institution. For separately sorted deposits, credits are posted using the posting times for the time zone of the Reserve Bank servicing the payor institution.

- + Credit adjustments amounting to \$1 million or more.

Post at 12:30 p.m. Eastern Time and Hourly, on the Half-Hour, Thereafter:

- + Dynamic investments from TIP.

Post by 1:00 p.m. Eastern Time:

- + Same-day Treasury investments.

Post at 1:00 p.m. Local Time and Hourly Thereafter:

- Electronic check presentments.¹⁷

Post at 5:00 p.m. Eastern Time:

- + Treasury checks, postal money orders, and EZ-Clear savings bond redemptions in separately sorted deposits; these items must be deposited by 4:00 p.m. Eastern Time
- + Local Federal Reserve Bank checks; these items must be presented before 3:00 p.m. Eastern Time
- +/- Same-day ACH transactions; these transactions include ACH return items, check-truncation items, and flexible settlement items.

Post at 6:30 p.m. Eastern Time:¹⁸

- + Penalty Abatements from TIP.

Post After the Close of Fedwire Funds Service:

- +/- All other transactions. These transactions include the following: local Federal Reserve Bank checks presented after 3:00 p.m. Eastern Time but before 3:00 p.m. local time; noncash collection; currency and coin shipments; small-dollar credit adjustments; and all debit adjustments. Discount-window loans and repayments are normally posted after the close of Fedwire as well; however, in unusual circumstances a discount window loan may be posted earlier in the day with repayment 24 hours later, or a loan may be repaid before it would otherwise become due.

Equals:

Closing Balance.

B. Pricing

Reserve Banks charge institutions for daylight overdrafts incurred in their Federal Reserve accounts. For each two-week reserve-maintenance period, the Reserve Banks calculate and assess daylight overdraft fees, which are equal to the sum of any daily daylight overdraft

¹⁷ The Federal Reserve Banks will post debits to institutions' accounts for electronic check presentments made before 12:00 p.m. local time at 1:00 p.m. local time. The Reserve Banks will post presentments made after 12:00 p.m. local time on the next clock hour that is at least one hour after presentment takes place but no later than 3:00 p.m. local time.

¹⁸ The Federal Reserve Banks will process and post Treasury-authorized penalty abatements on Thursdays. In the event that Thursday is a holiday, the Federal Reserve Banks will process and post Treasury-authorized penalty abatements on the following business day.

charges during the period.

Daylight overdraft fees are calculated using an annual rate of 36 basis points, quoted on the basis of a 24-hour day. To obtain the effective annual rate for the standard Fedwire operating day, the 36-basis-point annual rate is multiplied by the fraction of a 24-hour day during which Fedwire is scheduled to operate. For example, under a 21.5-hour scheduled Fedwire operating day, the effective annual rate used to calculate daylight overdraft fees equals 32.25 basis points (36 basis points multiplied by 21.5/24).¹⁹ The effective daily rate is calculated by dividing the effective annual rate by 360.²⁰ An institution's daily daylight overdraft charge is equal to the effective daily rate multiplied by the institution's average daily daylight overdraft minus a deductible valued at the deductible's effective daily rate.

An institution's average daily daylight overdraft is calculated by dividing the sum of its negative Federal Reserve account balances at the end of each minute of the scheduled Fedwire operating day by the total number of minutes in the scheduled Fedwire operating day. In this calculation, each positive end-of-minute balance in an institution's Federal Reserve account is set to equal zero.

The daily daylight overdraft charge is reduced by a deductible, valued at the effective daily rate for a 10-hour operating day. The deductible equals 10 percent of a capital measure (see section I.C.3., "Capital measure"). Because the effective daily rate applicable to the deductible is kept constant at the 10-hour-operating-day rate, any changes to the scheduled Fedwire operating day should not significantly affect the value of the deductible.²¹ Reserve Banks will waive fees of \$25 or less in any two-week reserve-maintenance period. Certain institutions are subject to a penalty fee and modified daylight overdraft fee calculation as described in section I.E.

C. Net Debit Caps

1. Definition

To limit the aggregate amount of daylight credit that the Reserve Banks extend, each institution incurring daylight overdrafts in its Federal Reserve account must adopt a net debit cap, that is, a ceiling on the uncollateralized daylight overdraft position that it can incur during a given interval. If an institution's daylight overdrafts generally do not exceed the lesser of \$10 million or 20 percent of its capital measure, the institution may qualify for the exempt-from-filing cap. An institution must be financially healthy and have regular access to the discount window in order to adopt a net debit cap greater than zero or qualify for the filing exemption.

An institution's cap category and capital measure determine the size of its net

¹⁹ A change in the length of the scheduled Fedwire operating day should not significantly change the amount of fees charged because the effective daily rate is applied to average daylight overdrafts, whose calculation would also reflect the change in the operating day.

²⁰ Under the current 21.5-hour Fedwire operating day, the effective daily daylight-overdraft rate is truncated to 0.0000089.

²¹ Under the current 21.5-hour Fedwire operating day, the effective daily deductible rate is rounded to 0.0000042.

debit cap. More specifically, the net debit cap is calculated as an institution’s cap multiple times its capital measure:

$$\text{net debit cap} = \text{cap multiple} \times \text{capital measure}$$

Cap categories (see section I.C.2., “Cap categories”) and their associated cap levels, set as multiples of capital measure, are listed below:

Net Debit Cap Multiples		
<i>Cap category</i>	<i>Single day</i>	<i>Two-week average</i>
High	2.25	1.50
Above average	1.875	1.125
Average	1.125	0.75
De minimis	0.40	0.40
Exempt-from-filing ²²	\$10 million or 0.20	\$10 million or 0.20
Zero	0.0	0.0

An institution is expected to avoid incurring daylight overdrafts whose daily maximum level, averaged over a two-week period, would exceed its two-week average cap, and, on any day, would exceed its single-day cap.²³ The two-week average cap provides flexibility, in recognition that fluctuations in payments can occur from day to day. The purpose of the higher single-day cap is to limit excessive daylight overdrafts on any day and to ensure that institutions develop internal controls that focus on their exposures each day, as well as over time.

The Board’s policy on net debit caps is based on a specific set of guidelines and some degree of examiner oversight. Under the Board’s policy, a Reserve Bank may limit or prohibit an institution’s use of Federal Reserve intraday credit if (1) the institution’s use of daylight credit is deemed by the institution’s supervisor to be unsafe or unsound; (2) the institution does not qualify for a positive net debit cap (see section I.C.2., “Cap categories”); or (3) the institution poses excessive risk to a Reserve Bank by incurring chronic overdrafts in excess of what the Reserve Bank determines is prudent.

While capital measures differ, the net debit cap provisions of this policy apply to foreign banking organizations (FBOs) to the same extent that they apply to U.S. institutions. The Reserve Banks will advise home-country supervisors of the daylight overdraft capacity of U.S. branches and agencies of FBOs under their jurisdiction, as well as of other pertinent information related to the FBOs’ caps. The Reserve Banks will also provide information on the daylight overdrafts in the Federal Reserve accounts of FBOs’ U.S. branches and agencies in response to requests from home-country supervisors.

²² The net debit cap for the exempt-from-filing category is equal to the lesser of \$10 million or 0.20 multiplied by the institution’s capital measure.

²³ The two-week period is the two-week reserve-maintenance period. The number of days used in calculating the average daylight overdraft over this period is the number of business days the institution’s Reserve Bank is open during the reserve-maintenance period.

2. Cap categories

The policy defines the following six cap categories, described in more detail below: high, above average, average, de minimis, exempt-from-filing, and zero. The high, above average, and average cap categories are referred to as “self-assessed” caps.

a. Self-assessed. In order to establish a net debit cap category of high, above average, or average, an institution must perform a self-assessment of its own creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures.²⁴ The assessment of creditworthiness is based on the institution’s supervisory rating and Prompt Corrective Action (PCA) designation.²⁵ An institution may perform a full assessment of its creditworthiness in certain limited circumstances, for example, if its condition has changed significantly since its last examination or if it possesses additional substantive information regarding its financial condition. An institution performing a self-assessment must also evaluate its intraday funds-management procedures and its procedures for evaluating the financial condition of and establishing intraday credit limits for its customers. Finally, the institution must evaluate its operating controls and contingency procedures to determine if they are sufficient to prevent losses due to fraud or system failures. The “Guide to the Federal Reserve’s Payments System Risk Policy” includes a detailed explanation of the self-assessment process.

Each institution’s board of directors must review that institution’s self-assessment and recommended cap category. The process of self-assessment, with board-of-directors review, should be conducted at least once in each twelve-month period. A cap determination may be reviewed and approved by the board of directors of a holding company parent of an institution, provided that (1) the self-assessment is performed by each entity incurring daylight overdrafts, (2) the entity’s cap is based on the measure of the entity’s own capital, and (3) each entity maintains for its primary supervisor’s review its own file with supporting documents for its self-assessment and a record of the parent’s board-of-directors review.²⁶

²⁴ This assessment should be done on an individual-institution basis, treating as separate entities each commercial bank, each Edge corporation (and its branches), each thrift institution, and so on. An exception is made in the case of U.S. branches and agencies of FBOs. Because these entities have no existence separate from the FBO, all the U.S. offices of FBOs (excluding U.S.-chartered bank subsidiaries and U.S.-chartered Edge subsidiaries) should be treated as a consolidated family relying on the FBO’s capital.

²⁵ An insured depository institution is (1) “well capitalized” if it significantly exceeds the required minimum level for each relevant capital measure, (2) “adequately capitalized” if it meets the required minimum level for each relevant capital measure, (3) “undercapitalized” if it fails to meet the required minimum level for any relevant capital measure, (4) “significantly undercapitalized” if it is significantly below the required minimum level for any relevant capital measure, or (5) “critically undercapitalized” if it fails to meet any leverage limit (the ratio of tangible equity to total assets) specified by the appropriate Federal banking agency, in consultation with the FDIC, or any other relevant capital measure established by the agency to determine when an institution is critically undercapitalized (12 U.S.C. 1831o).

²⁶ An FBO should undergo the same self-assessment process as a domestic bank in determining a net debit cap for its U.S. branches and agencies. Many FBOs, however, do not have the same management structure as U.S. institutions, and adjustments should be made as appropriate. If an FBO’s board of directors has a more limited role to play in the bank’s management than a U.S. board has, the self-assessment and cap category should be reviewed by senior management at the FBO’s head office that exercises authority over the FBO equivalent to the authority

In applying these guidelines, each institution should maintain a file for examiner review that includes (1) worksheets and supporting analysis used in its self-assessment of its own cap category, (2) copies of senior-management reports to the board of directors of the institution or its parent (as appropriate) regarding that self-assessment, and (3) copies of the minutes of the discussion at the appropriate board-of-directors meeting concerning the institution's adoption of a cap category.²⁷

As part of its normal examination, the institution's examiners may review the contents of the self-assessment file.²⁸ The objective of this review is to ensure that the institution has applied the guidelines appropriately and diligently, that the underlying analysis and method were reasonable, and that the resultant self-assessment was generally consistent with the examination findings. Examiner comments, if any, should be forwarded to the board of directors of the institution. The examiner, however, generally would not require a modification of the self-assessed cap category, but rather would inform the appropriate Reserve Bank of any concerns. The Reserve Bank would then decide whether to modify the cap category. For example, if the institution's level of daylight overdrafts constitutes an unsafe or unsound banking practice, the Reserve Bank would likely assign the institution a zero net debit cap and impose additional risk controls.

The contents of the self-assessment file will be considered confidential by the institution's examiner. Similarly, the Federal Reserve and the institution's examiner will hold the actual cap level selected by the institution confidential. Net debit cap information should not be shared with outside parties or mentioned in any public documents; however, net debit cap information will be shared with the home-country supervisor of U.S. branches and agencies of foreign banks.

The Reserve Banks will review the status of any institution with a self-assessed net debit cap that exceeds its cap during a two-week reserve-maintenance period and will decide if the cap should be maintained or if additional action should be taken (see section I.F., "Monitoring").

b. De minimis. Many institutions incur relatively small overdrafts and thus pose little risk to the Federal Reserve. To ease the burden on these small overdrafters of engaging in the self-assessment process and to ease the burden on the Federal Reserve of administering caps, the Board allows institutions that meet reasonable safety and soundness standards to incur de minimis amounts of daylight overdrafts without performing a self-assessment. An institution may incur daylight overdrafts of up to 40 percent of its capital measure if the institution submits

exercised by a board of directors over a U.S. institution. In cases in which the board of directors exercises authority equivalent to that of a U.S. board, cap determination should be made by the board of directors.

²⁷ In addition, for FBOs, the file that is made available for examiner review by the U.S. offices of an FBO should contain the report on the self-assessment that the management of U.S. operations made to the FBO's senior management and a record of the appropriate senior management's response or the minutes of the meeting of the FBO's board of directors or other appropriate management group, at which the self-assessment was discussed.

²⁸ Between examinations, examiners or Reserve Bank staff may contact an institution about its cap if there is other relevant information, such as statistical or supervisory reports, that suggests there may have been a change in the institution's financial condition.

a board-of-directors resolution.

An institution with a de minimis cap must submit to its Reserve Bank at least once in each 12-month period a copy of its board-of-directors resolution (or a resolution by its holding company's board) approving the institution's use of daylight credit up to the de minimis level. The Reserve Banks will review the status of a de minimis cap institution that exceeds its cap during a two-week reserve-maintenance period and will decide if the de minimis cap should be maintained or if the institution will be required to perform a self-assessment for a higher cap.

c. Exempt-from-filing. Institutions that only rarely incur daylight overdrafts in their Federal Reserve accounts that exceed the lesser of \$10 million or 20 percent of their capital measure are excused from performing self-assessments and filing board-of-directors resolutions with their Reserve Banks. This dual test of dollar amount and percent of capital measure is designed to limit the filing exemption to institutions that create only low-dollar risks to the Reserve Banks and that incur small overdrafts relative to their capital measure.

The Reserve Banks will review the status of an exempt institution that incurs overdrafts in its Federal Reserve account in excess of \$10 million or 20 percent of its capital measure on more than two days in any two consecutive two-week reserve-maintenance periods. The Reserve Bank will decide if the exemption should be maintained or if the institution will be required to file for a cap. Granting of the exempt-from-filing net debit cap is at the discretion of the Reserve Bank.

d. Zero. Some financially healthy institutions that could obtain positive net debit caps choose to have zero caps. Often these institutions have very conservative internal policies regarding the use of Federal Reserve daylight credit or simply do not want to incur daylight overdrafts and any associated daylight overdraft fees. If an institution that has adopted a zero cap incurs a daylight overdraft, the Reserve Bank counsels the institution and may monitor the institution's activity in real time and reject or delay certain transactions that would cause an overdraft. If the institution qualifies for a positive cap, the Reserve Bank may suggest that the institution adopt an exempt-from-filing cap or file for a higher cap if the institution believes that it will continue to incur daylight overdrafts.

In addition, a Reserve Bank may assign an institution a zero net debit cap. Institutions that may pose special risks to the Reserve Banks, such as those without regular access to the discount window, those incurring daylight overdrafts in violation of this policy, or those in weak financial condition, are generally assigned a zero cap (see section I.E.5., "Problem institutions"). Recently-chartered institutions may also be assigned a zero net debit cap.

3. Capital measure

As described above, an institution's cap category and capital measure determine the size of its net debit cap. The capital measure used in calculating an institution's net debit cap depends upon its chartering authority and home-country supervisor.

a. U.S.-chartered institutions. For institutions chartered in the United States, net debit caps are

multiples of “qualifying” or similar capital measures that consist of those capital instruments that can be used to satisfy risk-based capital standards, as set forth in the capital adequacy guidelines of the federal financial regulatory agencies. All of the federal financial regulatory agencies collect, as part of their required reports, data on the amount of capital that can be used for risk-based purposes – “risk-based” capital for commercial banks, savings banks, and savings associations and total regulatory reserves for credit unions. Other U.S.-chartered entities that incur daylight overdrafts in their Federal Reserve accounts should provide similar data to their Reserve Banks.

b. 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 the FBO’s U.S. capital equivalency measure.²⁹ U.S. capital equivalency is equal to the following:

- 35 percent of capital for FBOs that are financial holding companies (FHCs)³⁰
- 25 percent of capital for FBOs that are not FHCs and have a strength of support assessment ranking (SOSA) of 1³¹
- 10 percent of capital for FBOs that are not FHCs and are ranked a SOSA 2
- 5 percent of “net due to related depository institutions” for FBOs that are not FHCs and are ranked a SOSA 3.

Granting a net debit cap, or any extension of intraday credit, to an institution is at the discretion of the Reserve Bank. In the event a Reserve Bank grants a net debit cap or extends intraday credit to a financially healthy SOSA 3-ranked FBO, the Reserve Bank may require such credit to be fully collateralized, given the heightened supervisory concerns with SOSA 3-ranked FBOs.

D. Collateralized capacity

The Board recognizes that while net debit caps provide sufficient liquidity to most institutions, some institutions may still experience liquidity pressures. The Board believes it is important to provide an environment in which payment systems may function effectively and efficiently and to remove barriers, as appropriate, to foster risk-reducing payment system initiatives. Consequently, certain institutions with self-assessed net debit caps may pledge

²⁹ The term “U.S. capital equivalency” is used in this context to refer to the particular capital measure used to calculate net debit caps and does not necessarily represent an appropriate capital measure for supervisory or other purposes.

³⁰ The Gramm-Leach-Bliley Act defines a financial holding company as a bank holding company that meets certain eligibility requirements. In order for a bank holding company to become a financial holding company and be eligible to engage in the new activities authorized under the Gramm-Leach-Bliley Act, the Act requires that all depository institutions controlled by the bank holding company be well capitalized and well managed (12 U.S.C. 1841(p)). With regard to a foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States, the Act requires the Board to apply comparable capital and management standards that give due regard to the principle of national treatment and equality of competitive opportunity (12 U.S.C. 1843(l)).

³¹ The SOSA ranking is composed of four factors, including the FBO’s financial condition and prospects, the system of supervision in the FBO’s home country, the record of the home country’s government in support of the banking system or other sources of support for the FBO; and transfer risk concerns. Transfer risk relates to the FBO’s ability to access and transmit U.S. dollars, which is an essential factor in determining whether an FBO can support its U.S. operations. The SOSA ranking is based on a scale of 1 through 3, with 1 representing the lowest level of supervisory concern.

collateral to their administrative Reserve Banks to secure daylight overdraft capacity in excess of their net debit caps, subject to Reserve Bank approval.^{32,33} This policy is intended to provide extra liquidity through the pledge of collateral to the few institutions that might otherwise be constrained from participating in risk-reducing payment system initiatives.³⁴ The Board believes that requiring collateral allows the Federal Reserve to protect the public sector from additional credit risk. Additionally, providing extra liquidity to these few institutions should help prevent liquidity-related market disruptions.

An institution with a self-assessed net debit cap that wishes to expand its daylight overdraft capacity by pledging collateral should consult with its administrative Reserve Bank. Institutions that request daylight overdraft capacity beyond the net debit cap must have already explored other alternatives to address their increased liquidity needs.³⁵ The Reserve Banks will work with an institution that requests additional daylight overdraft capacity to determine the appropriate maximum daylight overdraft capacity level. In considering the institution's request, the Reserve Bank will evaluate the institution's rationale for requesting additional daylight overdraft capacity as well as its financial and supervisory information. The financial and supervisory information considered may include, but is not limited to, capital and liquidity ratios, the composition of balance sheet assets, CAMELS or other supervisory ratings and assessments, and SOSA rankings (for U.S. branches and agencies of foreign banks). An institution approved for a maximum daylight overdraft capacity level must submit at least once in each twelve-month period a board-of-directors resolution indicating its board's approval of that level.

If the Reserve Bank approves an institution's request, the Reserve Bank approves a maximum daylight overdraft capacity level. The maximum daylight overdraft capacity is defined as follows:

$$\begin{aligned} \text{maximum daylight overdraft capacity} = \\ \text{single-day net debit cap} + \\ \text{collateralized capacity}^{36} \end{aligned}$$

An institution that has a self-assessed net debit cap and that has also been

³² The administrative Reserve Bank is responsible for the administration of Federal Reserve credit, reserves, and risk management policies for a given institution or other legal entity.

³³ Institutions have some flexibility as to the specific types of collateral they may pledge to the Reserve Banks; however, all collateral must be acceptable to the Reserve Banks. The Reserve Banks may accept securities in transit on the Fedwire book-entry securities system as collateral to support the maximum daylight overdraft capacity level. Securities in transit refer to book-entry securities transferred over the Fedwire Securities Service that have been purchased by an institution but not yet paid for and owned by the institution's customers.

³⁴ Institutions may consider applying for a maximum daylight overdraft capacity level for daylight overdrafts resulting from Fedwire funds transfers, Fedwire book-entry securities transfers, National Settlement Service entries, and ACH credit originations. Institutions incurring daylight overdrafts as a result of other payment activity may be eligible for administrative counseling flexibility (59 FR 54915-18, November 2, 1994).

³⁵ Some potential alternatives available to an institution to address increased intraday credit needs include shifting funding patterns, delaying the origination of funds transfers, or transferring some payments processing business to a correspondent bank.

³⁶ Collateralized capacity, on any given day, equals the amount of collateral pledged to the Reserve Bank, not to exceed the difference between the institution's maximum daylight overdraft capacity level and its single-day net debit cap.

approved for a maximum daylight overdraft capacity level has a two-week average limit equal to its two-week average net debit cap plus its collateralized capacity, averaged over a two-week reserve-maintenance period. The single-day limit is equal to an institution's single-day net debit cap plus its collateralized capacity. The institution should avoid incurring daylight overdrafts whose daily maximum level, averaged over a two-week period, would exceed its two-week average limit, and, on any day, would exceed its single-day limit. The Reserve Banks will review the status of any institution that exceeds its single-day or two-week limit during a two-week reserve-maintenance period and will decide if the maximum daylight overdraft capacity should be maintained or if additional action should be taken (see section I.F., "Monitoring").

Institutions with exempt-from-filing and de minimis net debit caps may not obtain additional daylight overdraft capacity by pledging collateral without first obtaining a self-assessed net debit cap. Likewise, institutions that have voluntarily adopted zero net debit caps may not obtain additional daylight overdraft capacity by pledging collateral without first obtaining a self-assessed net debit cap. Institutions that have been assigned a zero net debit cap by their administrative Reserve Bank are not eligible to apply for any daylight overdraft capacity.

E. Special Situations

Under the Board's policy, certain institutions warrant special treatment primarily because of their charter types. As mentioned previously, an institution must have regular access to the discount window and be in sound financial condition in order to adopt a net debit cap greater than zero. Institutions that do not have regular access to the discount window include Edge and agreement corporations, bankers' banks that are not subject to reserve requirements, limited-purpose trust companies, government-sponsored enterprises (GSEs), and certain international organizations.³⁷ Institutions that have been assigned a zero cap by their Reserve Banks are also subject to special considerations under this policy based on the risks they pose. In developing its policy for these institutions, the Board has sought to balance the goal of reducing and managing risk in the payments system, including risk to the Federal Reserve, with that of minimizing the adverse effects on the payments operations of these institutions.

Regular access to the Federal Reserve discount window generally is available to institutions that are subject to reserve requirements. If an institution that is not subject to reserve requirements and thus does not have regular discount-window access were to incur a daylight overdraft, the Federal Reserve might end up extending overnight credit to that institution if the daylight overdraft were not covered by the end of the business day. Such a credit extension would be contrary to the quid pro quo of reserves for regular discount-window access as reflected in the Federal Reserve Act and in Board regulations. Thus, institutions that do not have regular access to the discount window should not incur daylight overdrafts in their Federal Reserve accounts.

Certain institutions are subject to a daylight-overdraft penalty fee levied against the average daily daylight overdraft incurred by the institution. These include Edge and agreement corporations, bankers' banks that are not subject to reserve requirements, and limited-

³⁷ See footnote 3.

purpose trust companies. The annual rate used to determine the daylight-overdraft penalty fee is equal to the annual rate applicable to the daylight overdrafts of other institutions (36 basis points) plus 100 basis points multiplied by the fraction of a 24-hour day during which Fedwire is scheduled to operate (currently 21.5/24). The daily daylight-overdraft penalty rate is calculated by dividing the annual penalty rate by 360.³⁸ The daylight-overdraft penalty rate applies to the institution's average daily daylight overdraft in its Federal Reserve account. The daylight-overdraft penalty rate is charged in lieu of, not in addition to, the rate used to calculate daylight overdraft fees for institutions described in section I.B. Institutions that are subject to the daylight-overdraft penalty fee do not benefit from a deductible and are subject to a minimum fee of \$25 on any daylight overdrafts incurred in their Federal Reserve accounts.³⁹

1. Edge and agreement corporations⁴⁰

Edge and agreement corporations should refrain from incurring daylight overdrafts in their Federal Reserve accounts. In the event that any daylight overdrafts occur, the Edge or agreement corporation must post collateral to cover the overdrafts. In addition to posting collateral, the Edge or agreement corporation would be subject to the daylight-overdraft penalty rate levied against the average daily daylight overdrafts incurred by the institution, as described above.

This policy reflects the Board's concerns that these institutions lack regular access to the discount window and that the parent company may be unable or unwilling to cover its subsidiary's overdraft on a timely basis. The Board notes that the parent of an Edge or agreement corporation could fund its subsidiary during the day over Fedwire or the parent could substitute itself for its subsidiary on private systems. Such an approach by the parent could both reduce systemic risk exposure and permit the Edge or agreement corporation to continue to service its customers. Edge and agreement corporation subsidiaries of foreign banking organizations are treated in the same manner as their domestically owned counterparts.

2. Bankers' banks⁴¹

Bankers' banks are exempt from reserve requirements and do not have regular access to the discount window. They do, however, have access to Federal Reserve payment services. Bankers' banks should refrain from incurring daylight overdrafts and must post

³⁸ Under the current 21.5-hour Fedwire operating day, the effective daily daylight-overdraft penalty rate is truncated to 0.0000338.

³⁹ While daylight overdraft fees are calculated differently for these institutions than for institutions that have regular access to the discount window, overnight overdrafts at Edge and agreement corporations, bankers' banks that are not subject to reserve requirements, limited-purpose trust companies, GSEs, and international organizations are priced the same as overnight overdrafts at institutions that have regular access to the discount window.

⁴⁰ These institutions are organized under section 25A of the Federal Reserve Act (12 U.S.C. 611–631) or have an agreement or undertaking with the Board under section 25 of the Federal Reserve Act (12 U.S.C. 601–604(a)).

⁴¹ For the purposes of this policy statement, a bankers' bank is a depository institution that is not required to maintain reserves under the Board's Regulation D (12 CFR 204) because it is organized solely to do business with other financial institutions, is owned primarily by the financial institutions with which it does business, and does not do business with the general public. Such bankers' banks also generally are not eligible for Federal Reserve Bank credit under the Board's Regulation A (12 CFR § 201.2(c)(2)).

collateral to cover any overdrafts they do incur. In addition to posting collateral, a bankers' bank would be subject to the daylight-overdraft penalty fee levied against the average daily daylight overdrafts incurred by the institution, as described above.

The Board's policy for bankers' banks reflects the Reserve Banks' need to protect themselves from potential losses resulting from daylight overdrafts incurred by bankers' banks. The policy also considers the fact that some bankers' banks do not incur the costs of maintaining reserves as do some other institutions and do not have regular access to the discount window.

Bankers' banks may voluntarily waive their exemption from reserve requirements, thus gaining access to the discount window. Such bankers' banks are free to establish net debit caps and would be subject to the same policy as other institutions. The policy set out in this section applies only to those bankers' banks that have not waived their exemption from reserve requirements.

3. Limited-purpose trust companies⁴²

The Federal Reserve Act permits the Board to grant Federal Reserve membership to limited-purpose trust companies subject to conditions the Board may prescribe pursuant to the Act. As a general matter, member limited-purpose trust companies do not accept reservable deposits and do not have regular discount-window access. Limited-purpose trust companies should refrain from incurring daylight overdrafts and must post collateral to cover any overdrafts they do incur. In addition to posting collateral, limited-purpose trust companies would be subject to the same daylight-overdraft penalty rate as other institutions that do not have regular access to the discount window.

4. Government-sponsored enterprises and international organizations (Beginning July 20, 2006)

The Reserve Banks act as fiscal agents for certain GSEs and international organizations in accordance with federal statutes. These institutions generally have Federal Reserve accounts and issue securities over the Fedwire Securities Service. The securities of these institutions are not obligations of, or fully guaranteed as to principal and interest by, the United States. Furthermore, these institutions are not subject to reserve requirements and do not have regular access to the discount window. GSEs and international organizations should refrain from incurring daylight overdrafts and must post collateral to cover any daylight overdrafts they do incur. In addition to posting collateral, these institutions would be subject to the same daylight-overdraft penalty rate as other institutions that do not have regular access to the discount window.

5. Problem institutions

For institutions that are in weak financial condition, the Reserve Banks will impose a zero cap. The Reserve Bank will also monitor the institution's activity in real time and

⁴² For the purposes of this policy statement, a limited-purpose trust company is a trust company that is a member of the Federal Reserve System but that does not meet the definition of "depository institution" in section 19(b)(1)(A) of the Federal Reserve Act (12 U.S.C. 461(b)(1)(A)).

reject or delay certain transactions that would create an overdraft. Problem institutions should refrain from incurring daylight overdrafts and must post collateral to cover any daylight overdrafts they do incur.

F. Monitoring

1. Ex Post

Under the Federal Reserve's ex post monitoring procedures, an institution with a daylight overdraft in excess of its maximum daylight overdraft capacity or net debit cap may be contacted by its Reserve Bank. The Reserve Bank may 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 net debit caps, imposing collateralization or clearing-balance requirements, rejecting or delaying certain transactions as described below, or, in extreme cases, taking the institution off line or prohibiting it from using Fedwire.

2. Real Time

A Reserve Bank will, through the Account Balance Monitoring System, apply real-time monitoring to an individual institution's position when the Reserve Bank believes that it faces excessive risk exposure, for example, from problem banks or institutions with chronic overdrafts in excess of what the Reserve Bank determines is prudent. In such a case, the Reserve Bank will control its risk exposure by monitoring the institution's position in real-time, rejecting or delaying certain transactions that would exceed the institution's maximum daylight overdraft capacity or net debit cap, and taking other prudential actions, including requiring collateral.⁴³

3. Multi-district Institutions

Institutions, such as those maintaining merger-transition accounts and U.S. branches and agencies of a foreign bank, that access Fedwire through accounts in more than one Federal Reserve District are expected to manage their accounts so that the total daylight overdraft position across all accounts does not exceed their net debit caps. One Reserve Bank will act as the administrative Reserve Bank and will have overall risk-management responsibilities for institutions maintaining accounts in more than one Federal Reserve District. For domestic institutions that have branches in multiple Federal Reserve Districts, the administrative Reserve Bank generally will be the Reserve Bank where the head office of the bank is located.

In the case of families of U.S. branches and agencies of the same foreign banking organization, the administrative Reserve Bank generally is the Reserve Bank that exercises the Federal Reserve's oversight responsibilities under the International Banking Act.⁴⁴ The

⁴³ Institutions that are monitored in real time must fund the total amount of their ACH credit originations in order for the transactions to be processed by the Federal Reserve, even if those transactions are processed one or two days before settlement.

⁴⁴ 12 U.S.C. 3101–3108.

administrative Reserve Bank, in consultation with the management of the foreign bank's U.S. operations and with Reserve Banks in whose territory other U.S. agencies or branches of the same foreign bank are located, may determine that these agencies and branches will not be permitted to incur overdrafts in Federal Reserve accounts. Alternatively, the administrative Reserve Bank, after similar consultation, may allocate all or part of the foreign family's net debit cap to the Federal Reserve accounts of agencies or branches that are located outside of the administrative Reserve Bank's District; in this case, the Reserve Bank in whose Districts those agencies or branches are located will be responsible for administering all or part of the collateral requirement.⁴⁵

G. Transfer-Size Limit on Book-Entry Securities

Secondary-market book-entry securities transfers on Fedwire are limited to a transfer size of \$50 million par value. This limit is intended to encourage partial deliveries of large trades in order to reduce position building by dealers, a major cause of book-entry securities overdrafts before the introduction of the transfer-size limit and daylight overdraft fees. This limitation does not apply to either of the following:

- a. Original issue deliveries of book-entry securities from a Reserve Bank to an institution
- b. Transactions sent to or by a Reserve Bank in its capacity as fiscal agent of the United States, government agencies, or international organizations.

Thus, requests to strip or reconstitute Treasury securities or to convert bearer or registered securities to or from book-entry form are exempt from this limitation. Also exempt are pledges of securities to a Reserve Bank as principal (for example, discount-window collateral) or as agent (for example, Treasury Tax and Loan collateral).

By order of the Board of Governors of the Federal Reserve System, September 22, 2004.

Robert deV. Frierson (signed)
Robert deV. Frierson,
Deputy Secretary of the Board.

⁴⁵ As in the case of Edge and agreement corporations and their branches, with the approval of the designated administrative Reserve Bank, a second Reserve Bank may assume the responsibility of managing and monitoring the net debit cap of particular foreign branch and agency families. This would often be the case when the payments activity and national administrative office of the foreign branch and agency family is located in one District, while the oversight responsibility under the International Banking Act is in another District. If a second Reserve Bank assumes management responsibility, monitoring data will be forwarded to the designated administrator for use in the supervisory process.