

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: November 14, 2022
To: Board of Governors
From: Staff¹
Subject: Improvements to the *Federal Reserve Policy on Payment System Risk* to Increase Access to Intraday Credit, Support the FedNow Service, and Simplify the *Federal Reserve Policy on Overnight Overdrafts*

Action Requested

Staff requests that the Board approve the attached draft final *Federal Register* notice, which would announce changes to the *Federal Reserve Policy on Payment System Risk* (PSR policy) and the *Federal Reserve Policy on Overnight Overdrafts* (Overnight Overdrafts policy) substantially as proposed in the request for comment. Staff requests the authority to make technical, non-substantive changes to the Federal Register notice prior to publication.

The changes would (i) expand the eligibility of depository institutions (institutions) to request collateralized intraday credit from Reserve Banks and reduce the administrative steps associated with requesting collateralized capacity, (ii) clarify the eligibility standards for accessing uncollateralized intraday credit, (iii) modify the PSR policy to support the deployment of the FedNowSM Service, and (iv) simplify and incorporate into the PSR policy the related Overnight Overdrafts policy. These changes are part of an ongoing initiative to improve the effectiveness of the PSR policy while controlling credit risk to Reserve Banks.

Staff recommends that the modifications to the PSR policy to support the deployment of the FedNow Service and the changes related to the Overnight Overdrafts policy become effective when Reserve Banks begin processing live transactions for FedNow Service participants (expected in 2023). The remaining changes would become effective 60 days following publication in the *Federal Register*.

Background

1. PSR and the Overnight Overdrafts Policies

To ensure the smooth functioning of payment and settlement systems, Reserve Banks provide intraday credit (also known as daylight overdrafts) to institutions with accounts at the

¹ Jason Hinkle, Michelle Olivier, Brajan Kola (RBOPS); Evan Winerman, Jess Cheng, and Cody Gaffney (Legal).

Reserve Banks. Part II of the PSR policy outlines the methods that the Reserve Banks use to control credit risk when they provide intraday credit to institutions. In general, under the PSR policy, an eligible institution may, at the discretion of the Reserve Bank, incur a daylight overdraft in its Federal Reserve account on an uncollateralized basis up to a dollar amount known as its “net debit cap.” Separately, an institution may pledge collateral to its Reserve Bank to secure additional daylight overdraft capacity (in excess of its net debit cap) if the institution has first obtained the highest level of uncollateralized capacity through a “self-assesseds” net debit cap and has undertaken certain administrative steps and analysis.² An institution’s net debit cap plus its additional collateralized daylight overdraft capacity is referred to as its “maximum daylight overdraft capacity” or “max cap.” Recognizing that collateralization of daylight overdrafts reduces credit risk to the Reserve Banks, the PSR policy incorporates a dual-pricing framework intended to incentivize institutions to collateralize their daylight overdrafts.³

The PSR policy is closely related to the Overnight Overdrafts policy, which prescribes penalty fees that apply when an institution has a negative balance in its Federal Reserve account at the end of the business day.

2. *The FedNow Service*

In 2019, the Board approved the FedNow Service, a new interbank 24x7x365 real-time gross settlement service with clearing functionality to support end-to-end retail instant payments in the United States. The FedNow Service will settle funds transfers between institutions through debit and credit entries in accounts at the Reserve Banks. Access to intraday credit will be available on a 24x7x365 basis to participant institutions under the same terms and conditions as for other Reserve Bank services. While intraday credit from the Reserve Banks is currently available during the 22-hour business day of the Fedwire Funds Service, the FedNow Service will have a 24-hour business day, each day of the week, including weekends and holidays.

Discussion of Proposed Changes to the PSR and the Overnight Overdrafts Policies

On June 3, 2021, the Board published a notice in the *Federal Register* that requested comment on four sets of proposed changes to the PSR and the Overnight Overdrafts policies.⁴

² The types of collateral that may be pledged to the Reserve Banks for this purpose are the same types of collateral that may be pledged to the discount window.

³ Under the dual-pricing framework, institutions are charged no fee for collateralized daylight overdrafts, but a fee of 50 basis points (annual rate) for uncollateralized daylight overdrafts.

⁴ The Board also proposed a set of technical changes to the PSR policy. For example, the Board proposed to replace the term “well capitalized” with “highly capitalized” in a footnote to the PSR policy discussing

The Board received thirteen comment letters from six trade organizations, two institutions, one payment services operator, one payment standards organization, one academic, one think tank, and one consulting firm. The proposed changes, commenter feedback, and the draft final changes are described below.⁵

1. Changes Related to Collateralized Intraday Credit

The proposed changes would expand the eligibility of institutions to request collateralized intraday credit from the Reserve Banks and reduce the administrative steps associated with requesting collateralized capacity. Specifically, the Board proposed to make institutions with any type of net debit cap – rather than only those institutions with a so-called “self-assessed” net debit cap – eligible to request collateralized capacity, provided that the institution is eligible for regular access to the discount window and its capital designation is “undercapitalized” or better.⁶ In addition, the Board proposed to eliminate certain administrative requirements for requesting collateralized capacity, including eliminating (in most circumstances) the requirement that an institution provide a written business case and the requirement that an institution’s board of directors submit an annual resolution approving the institution’s collateralized capacity.⁷

Five commenters supported the proposed changes, stating that the changes would assist with liquidity planning and risk management, expand access to collateralized capacity for small institutions and community banks that have not typically qualified for collateralized capacity, and would help institutions avoid uncollateralized overdrafts. However, two commenters opposed the proposed changes, with one commenter arguing that the changes would increase credit risk to the Reserve Banks, and the other commenter stating that the changes would exacerbate the already high demand for collateral accepted by the Reserve Banks.

The Board has previously recognized that collateralized intraday credit poses less risk to the Reserve Banks than uncollateralized intraday credit. As such, the criteria for requesting

streamlined max cap procedures for highly capitalized foreign banking organizations (FBOs). The Board did not receive comments on these proposed changes, and the *Federal Register* notice would adopt them as proposed.

⁵ The Board also received nine comments that touched on topics that were outside the scope of the proposal (*e.g.*, comments regarding various features of the FedNow Service). The attached *Federal Register* notice mentions, but does not respond to, these comments.

⁶ Under the PSR policy, an institution’s net debit cap is based in part on its “cap category,” which is in turn based on the institution’s supervisory rating and capital designation (*e.g.*, for a domestic institution, the institution’s Prompt Corrective Action designation). An institution’s cap category is one of six classifications: three self-assessed categories (“high,” “above average,” and “average”); “de minimis;” “exempt-from-filing;” and “zero.”

⁷ Under the proposed changes, an institution’s board of directors would still need to approve both the initial request for collateralized capacity and subsequent requests to increase collateralized capacity.

collateralized intraday credit should be more accommodative than the criteria for requesting uncollateralized intraday credit. Further, staff emphasizes that the availability of collateralized intraday credit would remain at the discretion of the Reserve Banks (who can request additional information when evaluating requests in order to control their credit risk). Lastly, staff does not believe that the changes would lead to a collateral shortage since institutions can pledge a wide range of securities and loans as collateral for both intraday credit and discount window purposes. The draft final *Federal Register* notice would adopt the changes related to collateralized intraday credit capacity as proposed.

2. *Changes Related to Uncollateralized Intraday Credit*

The proposed changes would clarify and modify the eligibility standards for accessing uncollateralized intraday credit from Reserve Banks.⁸ The proposed changes would incorporate into the PSR policy a table that lays out the eligibility criteria for requesting a positive net debit cap⁹ and enable an otherwise eligible institution to request uncollateralized capacity in cases where an institution's holding company or affiliate is assigned a low supervisory rating.¹⁰

Six commenters supported the proposed changes. The Board did not receive any comments opposed to these proposed changes. With the exception of a minor technical change, the draft final *Federal Register* notice would adopt as proposed the changes related to uncollateralized intraday credit.

3. *Modifications to Support the Deployment of the FedNow Service*

The Board proposed to make certain changes to the PSR policy to support the deployment of the FedNow Service. Among these changes, the Board proposed to redefine the term “business day” in the PSR policy to reflect the 24-hour operating environment of the FedNow Service. Consistent with past changes to operating hours, the Board also proposed to revise how daylight overdraft fees and penalty fees are calculated.¹¹

Two commenters supported these proposed changes. However, eight commenters opposed these changes because the proposal stated that daylight overdraft fees and penalty fees

⁸ The proposal would not modify the PSR policy's requirement that an institution be “financially healthy” and have regular access to the discount window to adopt a net debit cap greater than zero.

⁹ A substantially similar table is already included in the *Guide to the Federal Reserve's Payment System Risk Policy*, which is available to the public on the Board's website.

¹⁰ Currently, such institutions are ineligible for a positive net debit cap. Under the proposed changes, the institution would not be eligible to request the “above average” or “high” cap categories.

¹¹ The proposal would add a new posting rule for FedNow Service transactions and would modify an existing posting rule to ensure that all credits and debits in an institution's account post within the 24-hour business day.

would slightly increase (by less than 0.4 percent on average) as a result of the move from the current 22-hour business day to the 24-hour business day.

In analyzing these comments, Board staff discovered that, due to a calculation error, the request for comment erroneously stated that both daylight overdraft fees and penalty fees would slightly increase. However, in fact, both of these fees would slightly decrease for all institutions.¹² As such, the draft *Federal Register* notice would adopt the modifications to support the deployment of the FedNow Service substantially as proposed.

4. *Changes Related to the Overnight Overdrafts Policy*

The Board proposed to incorporate the Overnight Overdrafts policy as part III of the PSR policy and proposed changes to simplify the Overnight Overdrafts policy. Specifically, the Board proposed to eliminate the overnight overdraft fee-escalation feature.¹³ The Board also proposed to eliminate the automatic multiday charge for FedNow Service participants and participants in the private-sector instant payment service to reflect the fact that participants are able to cure overnight overdrafts during weekends and holidays.

Three commenters supported these proposed changes. Two commenters expressed concern that automatically applying the multiday charge to institutions that do not participate in the FedNow Service would disadvantage these institutions.

The draft *Federal Register* notice would adopt the changes related to the Overnight Overdrafts policy as proposed.¹⁴ Under this approach, all institutions, regardless of services used, would be charged for each calendar day that an overnight overdraft is actually outstanding. The multiday charge for institutions that do not participate in the FedNow Service or the private-sector instant payment service would reflect the number of calendar days that an overnight overdraft is outstanding given that such institutions have not enrolled in services that would impact their accounts during weekends and holiday. By contrast, FedNow Service participants and participants in the private-sector instant payment service would be able to cure some or all overnight overdrafts during weekends or holidays due to the operating hours of the services.

Attachment

¹² To clarify the impact of the proposed fee changes, Board staff contacted the eight commenters that opposed the proposed fee changes, and discussed the issue with three such commenters. Following these discussions, all three commenters indicated that their concerns regarding the proposed fee changes have been fully addressed.

¹³ Currently, the Overnight Overdrafts policy includes a fee-escalation feature where the penalty fee for an overnight overdraft increases by one percentage point for each overnight overdraft after an institution has already experienced three overnight overdrafts in a rolling 12-month period.

¹⁴ In addition, the Federal Reserve Administrative Manual (FRAM) will be updated to reflect the changes related to the Overnight Overdrafts policy.