



FEDERAL RESERVE BANK  
OF DALLAS

WILLIAM H. WALLACE  
FIRST VICE PRESIDENT

December 12, 1986

DALLAS, TEXAS 75222

Circular 86-112

**TO:** The Daylight Overdraft Coordinator  
or the Chief Executive Officer of  
the depository institution addressed

**SUBJECT**

**Request for public comment on five sets of proposals relating to the  
Federal Reserve Payment System Risk (Daylight Overdraft) Program**

**DETAILS**

The Board of Governors of the Federal Reserve System has requested public comment on five sets of proposals dealing with the Federal Reserve's Payment System Risk (Daylight Overdraft) Program, and has amended the Payments System Risk Policy Statement in one particular. A copy of the Board's press release on these actions and the orders detailing them are attached.

The proposals on which comment is requested are listed below, with docket numbers and due dates for comments:

Book-entry securities transfers, Docket No. R-0587,  
comments to be received by February 9, 1987.

Cap levels, Docket No. R-0588, comments to be received by  
February 9, 1987.

De Minimis caps, Docket No. R-0589, comments to be received  
by February 9, 1987.

Limits on inter-affiliate Fedwire transfers, Docket No.  
R-0590, comments to be received by February 9, 1987.

Automated clearing house (ACH) transactions, Docket No.  
R-0591, comments to be received by March 16, 1987.

Pricing daylight overdrafts, Docket No. R-0592, comments to  
be received by April 13, 1987.

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For additional copies of any circular please contact the Public Affairs Department at (214) 651-6289. Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank (800) 442-7140 (intrastate) and (800) 527-9200 (interstate).

The amendment, Docket No. R-0515, reduces the frequency for self-assessments under the Program from once every six months to once a year.

Study papers on each of the above topics plus a separate overview paper have been prepared and are available on request to the Public Affairs Department of the Federal Reserve Bank of Dallas at (214) 651-6266.

Comments should be addressed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551. All such correspondence should refer to the appropriate docket numbers and should be received by the appropriate deadlines.

#### **ATTACHMENTS**

The Board's press release and the related orders are attached.

#### **MORE INFORMATION**

For further information please contact Senior Vice President George C. Cochran, III, at (214) 651-6257, Vice President James L. Stull at (214) 698-4286, Vice President Robert D. Hankins at (214) 651-6120, or Assistant Vice President Uzziah (Earl) Anderson at (214) 651-6275.

Sincerely yours,

A handwritten signature in cursive script that reads "William H. Wallau". The signature is written in dark ink and is positioned to the right of the typed name "William H. Wallau".

# FEDERAL RESERVE press release



For immediate release

December 10, 1986

The Federal Reserve Board today issued for comment a series of proposals to reduce and control the payments system risk faced by the Federal Reserve and individual depository institutions participating in large-dollar wire transfer networks, book-entry transfer systems, and automated clearing houses (ACHs). These proposals supplement the payment system risk policy announced by the Board on May 17, 1985.

Large-dollar funds transfer networks are an integral part of the payments and clearing mechanism, and total overdrafts by participants making funds transfers on these networks frequently exceed more than \$80 billion daily. A daylight overdraft occurs when an institution sends funds over Fedwire in excess of the balance in its reserve or clearing account, or sends more funds over a private network than it has received.

Another \$60 billion or more of overdrafts occur each day from book-entry transfers of U.S. Government and agency securities; book-entry overdrafts occur when a depository institution receives (and pays for) more securities over Fedwire than it has sent (and been paid for).

The Board's basic policy is designed to reduce the potential for Federal Reserve losses and systemic risk to the banking system associated with settlement failure through a reduction, over time, in both the total volume of daylight overdrafts and the number of institutions with a pattern of substantial reliance on such credit.

Changes proposed by the Board in its payment system risk policy, with a 60-day comment period, would:

- o provide depository institutions incurring daylight overdrafts as a result of book-entry government securities transactions with two options. First, depository institutions could include these overdrafts with net debits that arise from transfers of funds over Fedwire and private wire networks for purposes of determining the total debits subject to the ceiling on the amount of intra-day credit an institution can incur (net debit cap). Alternatively, depository institutions could collateralize their book-entry related overdrafts with eligible book-entry securities that the institutions receive over Fedwire and only the uncollateralized portion would be added to the net debit subject to the cap. Further, the Board is seeking specific comment on whether there should be a book-entry transfer limit and whether that limit should be \$25 or \$50 million. The Board plans to make the new policy effective on March 23, 1988.
- o reduce the levels for the net debit cap established in May 1985 by 25 percent effective June 18, 1987. At the end of 1987 the Board will consider whether to reduce the cap further.
- o establish a new de minimis cap category for institutions that do not incur large or frequent daylight overdrafts. This cap would be the lesser of 10 percent of capital or \$500,000 and would be available to institutions that do not undergo the self-assessment



required for establishing a positive net debit cap under the Board's policy. The institution's board of directors would have to approve the cap.

- o amend its policy statement on payment system risk to indicate that efforts by holding companies to consolidate payment activities at one subsidiary through affiliate transfers over Fedwire that create a pattern of overdrafts at the sending institution would either (a) be prohibited or (b) permitted only under certain conditions consistent with safe and sound banking practices. Comment on the above proposals should be received by February 9.

In addition, the Board proposed several changes affecting automated clearing house (ACH) procedures. These changes include: (1) for purposes of calculating daylight overdraft levels only, posting all entries for ACH debit payments and checks as of 1 p.m. Eastern time, (2) granting finality for ACH credit payments of \$5,000 or less at 1 p.m. local time, and (3) treating as provisional credit all ACH debit and those ACH credit items over \$5,000 until the Reserve Banks have actually received the funds. Comment for these changes is requested by March 16.

In connection with its proposals on daylight overdrafts, the Board is seeking comment on the concept of charging a fee for all daylight overdrafts in accounts maintained with the Federal Reserve that are subject to the net debit cap. The objective of this fee would be to provide an additional incentive for depository institutions and their customers to adopt policies

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and procedures that would reduce daylight overdrafts. Comment is requested by April 13.

Orders detailing the above proposals are attached.

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Attachment

FEDERAL RESERVE SYSTEM

[Docket No. R-0587]

Request for Comments on Proposals Regarding

Payment System Risks

Book-Entry Securities Transfers

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board is proposing for public comment a policy for reducing the risks arising from daylight overdrafts associated with transfers of book-entry securities on Fedwire. The proposed policy includes the following principal components;

1. Depository institutions (and other entities, such as U.S. branches and agencies of foreign banks) would choose between including all book-entry overdrafts with their net debit positions arising from cross-system funds transfers for determining their total overdrafts subject to their net debit caps, or collateralizing book-entry overdrafts with the eligible incoming book-entry securities and including only the uncollateralized portion of their book-entry overdrafts with the cross-system funds overdrafts subject to their caps.

2. Each institutions choosing the collateralization option would enter into a written security agreement

with its Reserve Bank and warrant that a specified minimum percentage of book-entry overdrafts would always be covered by collateral. In monitoring an institution's compliance with the warranty, a Reserve Bank would apply a margin to the value of the securities to account for interest rate and clearing risk. The margin for clearing risk would be established for each institution choosing this option based on a self-evaluation conducted according to Board established guidelines.

3. Book-entry securities transfers on Fedwire (with the exception of original issue transactions and stripped securities) would be subjected to a transaction size limit of either \$50 or \$25 million, with public comment solicited on the most appropriate level.

DATE: Comments must be received by February 9, 1987. The Board expects that the policy will become effective on March 23, 1988.

ADDRESS: Comments, which should refer to Docket No. R-0587, should be addressed to the Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551, Attention: Mr. William W. Wiles, Secretary; or delivered to Room B-2223 between 8:45 a.m. and 5:15 p.m. Comments

received may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m., except as provided in § 261.6(a) of the Board's Rules Regarding Availability of Information, 12 C.F.R. § 261.6(a).

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director (202-452-3368), or Stephen A. Lumpkin, Economist (202-452-2378), Division of Research and Statistics; Elliott C. McEntee, Associate Director (202-452-2231), Division of Federal Reserve Bank Operations; Oliver I. Ireland, Associate General Counsel (202-452-3625), or Joseph R. Alexander, Senior Attorney (202-452-2489), Legal Division; Board of Governors of the Federal Reserve System, Washington, D.C. 20551. For the hearing impaired only: Telecommunications Device for the Deaf (202-452-3544), Earnestine Hill or Dorothea Thompson.

SUPPLEMENTARY INFORMATION:

This is one of a series of proposals regarding payment system risk that the Board is issuing for public comment today. The others concern the net debit cap (Docket Nos. R-0588 and R-0589), pricing of daylight overdrafts (Docket No. R-0592), consolidation of affiliated institutions for cap monitoring purposes (Docket No. R-0590), and treatment of payments processed through automated clearing houses (Docket No. R-0591). The Board encourages all interested parties to comment on each of these proposals.

The Board urges that in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each.

This procedure will facilitate the Board's processing and analysis of the comments on these complex proposals, and will ensure that each comment is quickly brought to the attention of those responsible for analysing the proposal.

#### BACKGROUND

In May, 1985, the Board announced its policy to reduce the risks that large-dollar payments systems present to the Federal Reserve, to depository institutions and other entities (such as U.S. branches and agencies of foreign banks and Edge Act corporations) using such systems (hereafter referred to as "institutions"), to the banking system, and to other sectors of the economy. 50 Fed. Reg. 21,120 (May 22, 1985). In formulating this policy, the Board was concerned about the effect that overdraft restrictions could have on the U.S. government securities market, the smooth functioning of which is vital both to the conduct of monetary policy through Federal Reserve open market operations and to the efficient funding of the federal debt. Consequently, the Board exempted from quantitative overdraft controls, such as sender net debit caps, Fedwire daylight overdrafts resulting from the transfer of book-entry securities. Rather, the Board sought comment on a proposal to control the risks associated with such overdrafts by requiring institutions incurring them to choose one of three collateralization options. 51 Fed. Reg. 21,132 (May 22, 1985).

Comments on these proposals were largely negative, and the Board's staff reevaluated the proposals. As a result of this reconsideration, together with discussion with industry

groups, new collateralization options were developed, supplemented by other proposals not previously considered. These staff recommendations formed the basis for the proposals on which the Board is now seeking comment. Full details on the staff's recommendations, including a detailed comment summary, an analysis of the markets in Treasury and agency securities, an evaluation of policy options, and likely market responses, may be found in the staff study, Book-Entry Daylight Overdrafts (Nov. 1986). Copies of this study are available free of charge from the Secretary of the Board at the address noted above, or from the Daylight Overdraft Liason Officer of each Federal Reserve Bank. The Board encourages all parties interested in commenting to obtain a copy of the staff study, as it contains background information that may enable them more readily to understand the rationale for the Board's proposals.

Because the issues associated with these proposals have been subjected to comment previously and interested parties are familiar with them, the Board believes that a 60-day comment period is sufficient. Further, in order to provide the public with time to prepare for implementation, the Board plans to implement this new policy on March 23, 1988, unless the public comments reveal substantial, unforeseen difficulties with the Board's proposal that require a significantly different policy.

PROPOSAL

Introduction

The Board's May, 1985, proposals would have required institutions incurring book-entry overdrafts to select one of three collateralization options: (1) Treat book-entry overdrafts the same as other daylight overdrafts, subjecting both to the sender net debit cap; (2) establish a stable pool of collateral to secure book-entry overdrafts; or (3) establish a pledge account containing securities, including customer securities, that could be pledged to collateralize book-entry overdrafts. Under the third option, institutions would have been required to shift securities out of the pledge account when they no longer became eligible to pledge, say, as a result of a payment for the securities by an institution's customer.

The proposal on which the Board is now requesting comment would continue to permit institutions to choose the first option; the other two options, however, have been dropped. In place of the two collateralization options, the Board is proposing a modified pledge account option that will allow an institution to collateralize book-entry overdrafts with the incoming book-entry securities (other than paid for securities and securities not eligible to pledge) and to include with cross-system funds overdrafts subject to the sender net debit cap only that portion of the book-entry daylight overdraft that is not so collateralized. For ex post monitoring purposes, each institution choosing the



collateralization option would warrant to its Federal Reserve Bank that a specific minimum percentage of its book-entry overdrafts would be collateralized by securities in the pledge account. A margin would be applied to the value of the securities offered as collateral to represent risks to the Reserve Banks of (1) declines in collateral values and (2) deficiencies in the pledgor institution's internal operating controls over its securities transfer and clearing business. The Board's policy is rounded out by (1) the use of a supplementary self-assessment of each institution's own book-entry operations and controls as a factor in determining margin amounts, and (2) a maximum limitation on Fedwire book-entry transactions of either \$25 or \$50 million.

Details of the Board's proposal follow:

1. Collateralization

A. Pledge Agreement

A depository institution or other entity choosing to collateralize its book-entry overdrafts would take two steps. First it would enter into a written agreement with its Reserve Bank granting the Reserve Bank a security interest in all those securities that are eligible collateral under the Board's policy.<sup>1/</sup> A Reserve Bank's actual collateral position at any time during the day would be determined by the total market

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<sup>1/</sup> See Section B, below, for a discussion of eligible collateral.

value of the book-entry securities eligible to be pledged under the Board's policy. Given accounting lags, market price changes, and possible conflicting interests in the securities, a Reserve Bank would know the actual value of the securities in which it could successfully assert a security interest only after the fact.

Second, recognizing the impossibility of tracking the exact collateral amount that secures a book-entry overdraft at any point in time, the institution would warrant to its Reserve Bank that the adjusted value<sup>2/</sup> of its pledgeable securities would be no less than a stated warranty ratio.<sup>3/</sup> This ratio would be used to determine collateralized and uncollateralized book-entry overdraft amounts for day-to-day ex post cap monitoring purposes. As described in detail below, the relationship of the warranty to actual collateral values would be checked on a periodic basis.

B. Eligible Collateral

The Board believes that institutions should be permitted to pledge only securities that were received through book-entry transfers to secure book-entry related overdrafts. A healthy institution should not be permitted to pledge portfolio assets or securities released each day from pledge as collateral for dealer loans and maturing hold-in-custody and

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<sup>2/</sup> See Section C, on adjustments to collateral values, below.

<sup>3/</sup> See Section D, on the warranty, below.

three-party repurchase agreements (RPs). Accordingly, the Board proposes to permit institutions to count as collateral for book-entry related overdrafts only those book-entry securities that the institution is authorized to pledge and that are transferred to the pledging institution over Fedwire on the particular day they are pledged.

The Board realizes that excluding collateral released from maturing RPs and loans may require an increase in costs to depository institutions to track throughout the day those securities in a dealer's position that do not come in during the day on the book-entry wire. Therefore, the Board is requesting comment on what the increase in costs for institutions such tracking is likely to be. Specifically, the Board is interested in knowing the cost to clearing banks of excluding from their own customers' collateral used to secure credit extensions those securities that were not transferred over the book-entry wire that day--and hence did not give rise to a book-entry overdraft.

### C. Value Adjustments

In order to protect Reserve Banks against credit exposures and to increase incentives for institutions to improve prudential controls over (and reduce the size of) their book-entry overdrafts, the Board proposes two adjustments to the value of eligible-to-pledge collateral.

First, for purposes of book-entry collateralization only, a market risk adjustment would be subtracted to protect the Reserve Banks against interest rate changes over the

interval between the time the collateral is taken and the time the Reserve Bank's claim is extinguished. The Board is proposing to adopt a market risk "haircut" of between three and five per cent to be applied to book-entry securities collateral on a daily basis. Reserve Banks would be given the flexibility to choose haircut factors within this range for purposes of applying the standard to particular institutions. The size of the individual institution market-risk haircut could be reviewed as often as the Reserve Bank wishes, but on any day it would be fixed within the three to five per cent range. Given recent price history, a daily haircut for market risk in this range should be sufficient to account for most day-to-day fluctuations in prices of government securities. The Board specifically requests comment on whether this procedure is desirable, whether a fixed haircut should be applied to all institutions, or whether the criteria for application of the haircut to institutions should be further refined.

A supplementary haircut in addition to the market risk margin, which would be specific to each institution's own operations, would be based on the results of each institution's self-assessment of these risks. This haircut, which would be subject to supervisory review, is initially expected to be between 0 and 10 per cent for institutions with excellent to satisfactory assessments.

The self-assessment of an individual institution's controls and procedures in its book-entry operations would be an extension of the self-assessment approach of the earlier

Policy Statement, which addressed policies, procedures, internal controls, and monitoring capabilities. Under the proposed policy on book-entry risks, four basic areas would be addressed in detail as they relate to book-entry clearing and settlement activities:

- Credit policy and controls;
- Collateral monitoring and control;
- Operational risk; and
- Funding capacity.

The self-assessment of credit policy and controls would look in detail at the adequacy of an institution's policies and procedures for establishing credit limits for a customer or a group of related customers and monitoring the intra-day exposures within these limits. Although the focus of the monitoring would be heavily on the book-entry activity, the institution's overall exposure to the customer would also be taken into account.

The assessment of an institution's ability to monitor the position of a customer's collateral would focus on this critical element of the institution's exposure in book-entry activity. A sound credit judgment would be impossible without both a good measure of control over what collateral is available to secure a customer's overdraft position in book-entry securities.

The assessment of an institution's operational environment would have to identify risks posed by such factors as capacity constraints, internal bottlenecks, and other

operating conditions that (1) could affect internal information flows needed to make otherwise sound policies and procedures work properly, or (2) could affect the overall operation of the book-entry securities market and the exposures of the institution itself and other institutions in the market. The reliability of automated systems, the availability of back-up processing capability, and the ability to reconcile and resolve fails and suspense items would be key factors in this area.

Finally, the assessment of funding capacity would look at the ability of the institution to tap the funds market to support not only its normal level of funding needs, but also its ability to fund large book-entry securities positions of its own or its customers in situations involving temporary operational disruptions or external market strains. In this regard, market perception of the institution, existing and normal funding patterns, demonstrated funding capacity, and identified contingency funding plans are key factors.

Each of the four factors (credit policy and controls, collateral monitoring and control, operational risk, and funding capacity) would be rated on a four level scale of Excellent, Very Good, Satisfactory, and Unsatisfactory, with an overall summary rating. Any institution rated unsatisfactory on any of the four factors would not be eligible to participate in the option permitting collateralization of overdrafts related to book-entry activity, and all of its book-entry overdrafts would be included with cross-system funds overdrafts

for purposes of the consolidated net debit cap.<sup>4/</sup> Institutions with an overall rating of excellent would require no additional haircut on their pool of eligible collateral after the adjustment for market risk. Institutions rated satisfactory on all four factors would take an additional haircut of 10 per cent. Those with a very good rating would take an additional haircut of 5 per cent.

Further details on this self-assessment procedure may be found in the staff study referred to earlier.

The Board requests comments on whether the additional haircut to cover these risks is needed, and whether the self-assessment guidelines that the Board is proposing are appropriate.

D. Warranty

As part of the collateralization agreement, the pledging institution would warrant to its Reserve Bank that a specific percentage of its book-entry related overdrafts would always be covered by eligible collateral as adjusted. This warranty ratio would be used for cap monitoring purposes only, i.e. for determining the uncollateralized daylight overdraft that would be subject to the cap. The Board estimates that banks providing clearing services for broker-dealers should have adjusted-collateral-value-to-book-entry-overdraft ratios of 85 to 95 per cent, and thus would be able to use warranty ratios of at least that amount.

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<sup>4/</sup> See Section E, below, on the consolidated sender net debit cap.



The warranty ratio selected by each institution would be based on the historical evidence of the adjusted values of eligible-to-pledge securities relative to its book-entry overdrafts. Each institution would have to present evidence to its Reserve Bank to support or modify its warranty ratio; the Reserve Bank would be able to change that ratio if the Reserve Bank's independent review called for it. This review could take several forms. The normal periodic examination would, for example, test the warranty and review the margin for other Reserve Bank risks associated with the self-evaluation guidelines. Moreover, on a random basis--say twice a month for clearing banks--the Reserve Bank would ask the institution at the end of the day to demonstrate ex post that the adjusted value of its eligible collateral in its accounting record at a specific time that day was equal to or larger than the warranty percentage of its book-entry overdrafts. If it was not, the Reserve Bank might lower the warranty ratio, pending new evidence from the institution. Thus, spot checks, as well as periodic certification coupled with normal examination, would provide checks on the adequacy of the warranty.

With the warranty ratio used only for monitoring purposes and the real collateral position coming from the repledging of eligible incoming securities, there would be no need to require institutions to reposition collateral between accounts at Reserve Banks, as under the pledge account option published for comment in 1985.



Under the proposal, each institution would be given the choice--but not be permitted to switch back and forth-- of either (1) using the warranty percentage throughout each day, or (2) adjusting the intra-day warranty amount the next day by providing its Reserve Bank with the measured adjusted dollar amount of pledgeable collateral the institution held each 15 minutes during the day. Institutions choosing the second option could have the benefit of eligible collateral in excess of their own warranty when they could demonstrate it. They would also bear the cost--higher uncollateralized overdrafts subject to cap--when the collateral data available the next day indicated a level below their warranty ratio. This approach would provide an incentive for institutions to develop collateral tracking programs in order to be able to show collateral positions above their minimum warranty ratio and thus lower their overdraft subject to cap. At each institution, the collateral tracking data would only have to be recaptured ex post. Under either approach, Reserve Banks would have to compare from time-to-time warranty ratios (or amounts) with the ex post adjusted value of pledgeable securities for which a security interest has been taken. The actual pledged securities would be the same under both approaches.

E. Consolidated Net Debit Cap

The voluntary sender net debit cap--now applicable to cross-system funds overdrafts--would, under the proposed policy, become a cross-system consolidated net debit cap

applicable to the sum of cross-system funds and uncollateralized book-entry overdrafts. Institutions would continue to establish their own caps through a self-evaluation based on current Board guidelines; those institutions not adhering to the guidelines and the policy would, as under the present policy, be prohibited from incurring funds transfer overdrafts on Fedwire. Under the new policy, they would also not be able to incur book-entry overdrafts. The Board would also consider it an inappropriate use of Fedwire to substitute purposefully book-entry transfers (which can be collateralized) for funds transfers (which cannot) in order to avoid the constraints of the consolidated sender net debit cap.

The current daylight overdraft policy authorizes a Reserve Bank to take full collateral for Fedwire funds overdrafts whenever it believes it is necessary to protect its own position with an individual institution. The Board proposes that this policy be extended for book-entry overdrafts at problem institutions as well, permitting Reserve Banks to take other collateral for book-entry overdrafts, if deemed necessary. Full collateralization is required by the Board's current policy for all the Fedwire funds overdrafts of Edge corporations, bankers' banks, institutions with negative adjusted primary capital, and for the amount by which the Fedwire funds overdrafts of U.S. branches and agencies of foreign banks exceeds their cap based on their "U.S. capital equivalency." The Board proposes that the required

collateralization for Fedwire funds transfers for these special entities be extended to book-entry overdrafts as well.

## 2. Transfer Limits

The Board is also proposing to adopt a mandatory size limit on book-entry securities transfers of either \$25 or \$50 million. The Board believes that this limit would not change market trade size, but would likely alter delivery practices so that transactions would be split, and partial delivery of orders could begin earlier in the day. The Board estimates that this size limit would increase transactions by less than 10 per cent of all transactions, but would affect about one-third of the dollar value of book-entry transfers. The objective of the transfer limit is to constrain intra-day position-building by dealers, spread book-entry volume more evenly over the day, and limit the level of book-entry overdrafts. Maximum transfer limits would not apply to either original issue transactions or to transfers of stripped securities.

These limitations would only be effective if sellers and purchasers of securities are willing to accept and pay for multiple transactions, know what their rights are in the case of a failure to deliver one or more transactions involved in a single trade, and do not simply continue to build positions thereby increasing the size and duration of overdrafts and contributing to end-of-day volume bottlenecks. Thus, to ensure that transfer size limits are effective, the staff of the Board

and the Federal Reserve Bank of New York will work with the various committees of the Public Securities Association, as well as other industry representatives, to encourage development of conforming delivery practices and compensation rules.

The Board is requesting public comment on whether the proposed maximum transaction limit should be \$25 or \$50 million. With a lower limit, position building may be minimized, but such a limit may unduly increase the transactions costs of large trades and have negative market effects.

If the Board finally adopts this policy of a size limit of either amount, it will modify its current policy on proper uses of Fedwire. On March 29, 1984, the Board issued a policy statement stating that "use of Fedwire for the avoidance of Federal Reserve or private sector risk reduction measures is not appropriate." With the May, 1985, policy statement, the Board reaffirmed this policy. If the Board adopts a maximum transfer limit as a risk reduction measure, the Board will similarly consider it an unacceptable use of Fedwire to avoid the intent of the transfer limit, such as by multiple deliveries at the same time for the account of the same customer, unless the securities were already in position at the time of the order. Reserve Banks would monitor the book-entry wire and take appropriate action to end violations of the Board's policy.

As with levels for sender net debit caps, the Board is intentionally setting the transfer limit at a high level, and plans to reduce the level over time as more experience is gained. The Board is interested in the public's view as to whether the initial limit should be set lower, such as \$25 million.

### 3. Netting Arrangements

The Federal Reserve System will continue to monitor private sector initiatives to develop a non-Federal Reserve facility for netting of securities trades made prior to a given date. The Board understands that participants of such a facility would be mainly dealers and brokers. The facility would net positions multilaterally and then settle the nets through the Federal Reserve's book-entry wire. Such an approach, by reducing daylight exposure and intra-day credit risks, especially at the large clearing banks, could significantly reduce Federal Reserve market exposure. The Board believes this private sector initiative should be monitored closely, however, to ensure that these reduce both Federal Reserve and systemic risks in a fashion that provides adequate safeguards and limitations within the netting system.

The Board proposes that any private network desiring to obtain Federal Reserve net settlement services for the clearing of U.S. Treasury or agency securities would have to provide intra-day data on each participant's net positions and adjusted collateral values. Net debits on such networks that

are collateralized in ways acceptable to the Board would be exempt from the consolidated cap (whether or not the network uses Federal Reserve net settlement services).

#### 4. Monitoring

The Board's current policy on funds daylight overdrafts calls for ex post monitoring and counseling of those institutions whose overdrafts exceed their caps. Moreover, the Fedwire funds transfers of problem institutions are to be monitored as they occur (i.e., in "real-time"), and those transfers exposing the Reserve Bank to excessive risk, after available collateral is considered, are to be held until sufficient funds are available or rejected outright. By March, 1987, all Reserve Banks are to have the capability to do such monitoring on an automated basis, and those that cannot do so prior to that time are to be able to limit funds transfers of problem institutions by manual intervention.

Book-entry securities transfers, however, are initiated by the seller of securities (sending institution) who gives up securities and receives funds from the buyer (receiving institution). The receiving institution does not directly control either the timing or the exact amount of the charge to its account that occurs with the securities transfer. Moreover, unlike a rejection of a funds transfer which is known only to--and is controllable by--the sending institution, both the sender and receiver would know if a

securities transfer were to be rejected because of insufficient funds at a troubled receiving institution. It seems clear that a real-time monitoring process cannot simply reject a securities transfer to a troubled institution, as might be done in funds transfer monitoring. Rather, securities transfers being received by troubled institutions should be made only on a fully collateralized basis.

The Board assumes that prior to real-time monitoring, the warranty ratio of a financially troubled institution would have been gradually reduced by the Reserve Bank. Thus, increasing amounts of the institution's book-entry exposures would be included in, and controlled by, its consolidated cap. The Board also assumes that the institution would be monitored in real-time against its cap, and that excessive exposures would have to be secured by a stable, nontransferable pool of collateral held by the Reserve Bank. When the Reserve Bank decides to implement full real-time controlled book-entry monitoring for a troubled institution, it will, in effect, reduce the institutions warranty ratio to zero and require the institution to supplement its collateral to cover both its expected funds and securities overdrafts.

With a real-time book-entry monitor the value of an incoming book-entry transfer would be compared in real-time to available funds balances and the value of the collateral pool. If these amounts were sufficient to cover the transfer, the incoming securities would be released to the receiving

institution. (It should be noted that securities receipts delivered against funds balances and collateral could severely restrict the institution's ability to make funds transfers.) If funds balances and collateral values were insufficient to cover the book-entry transfer, it would be held until funds were available to cover the purchase. (The sending institution would receive payment and be unaware that the securities were being held by the receiving institution's Reserve Bank.) The securities being held could become available to the receiving institution either through incoming funds transfers, sales of other securities, or transfers of securities to another institution against payment. Thus, a continual check of funds balances as well as the cash position arising out of securities transfers would be necessary to determine when the book-entry transfer could be processed.

Board of Governors of the Federal Reserve System,  
December 10, 1986.

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William W. Wiles  
Secretary of the Board



FEDERAL RESERVE SYSTEM

[Docket No. R-0588]

Request for Comments on Proposals Regarding  
Payment System Risks  
Cap Levels

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board is proposing for public comment an amendment to its policy regarding risks on large-dollar payment systems. The proposal would reduce the levels for the sender net debit cap in the present policy by 25 per cent. The Board has also announced that it plans to consider further cap reductions at the end of 1987.

DATE: Comments must be received by February 9, 1987. The Board is proposing that the cap reductions become effective on June 18, 1987.

ADDRESS: Comments, which should refer to Docket No. 0588, should be addressed to the Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551, Attention: Mr. William W. Wiles, Secretary, or delivered to Room B-2223 between 8:45 a.m. and 5:15 p.m. Comments received may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m., except as provided in § 261.6(a) of the Board's Rules Regarding Availability of Information, 12 C.F.R. § 261.6(a).

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director (202-452-3368), or Matthew D. Gelfand, Economist (202-452-3634), Division of Research and Statistics; Elliott C. McEntee, Associate Director (202-452-2231), Division of Federal Reserve Bank Operations; Oliver I. Ireland, Associate General Counsel (202-452-3625), or Joseph R. Alexander, Senior Attorney (202-452-2489), Legal Division; Board of Governors of the Federal Reserve System, Washington, D.C. 20551. For the hearing impaired only: Telecommunications Device for the Deaf (202-452-3544) Earnestine Hill or Dorothea Thompson.

SUPPLEMENTARY INFORMATION: This is one of a series of proposals regarding payment system risk that the Board is issuing for public comment today. The other concern the book-entry securities (Docket No. R-0587), pricing of daylight overdrafts (Docket No. R-0592), consolidation of affiliated institutions for cap monitoring purposes (Docket No. R-0590), treatment of payments processed through automated clearing houses (Docket No. R-0591), and a new cap category (Docket No. R-0589). The Board encourages all interested parties to comment on each of these proposals.

The Board urges that in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each. This procedure will facilitate the Board's processing and

analysis of the comments on these complex proposals, and will ensure that each comment is quickly brought to the attention of those responsible for analysing the proposal.

#### BACKGROUND

In May, 1985, the Board announced its policy to reduce the risks that large-dollar payment systems present to the Federal Reserve, to the depository institutions using them, to the banking system, and to other sectors of the economy. 50 Fed. Reg. 21,120 (May 22, 1985). As a principal component of this policy, the Board strongly encouraged depository institutions and other entities (such as Edge corporations and U.S. branches and agencies of foreign banks) incurring daylight overdrafts on Fedwire or participating on a private large-dollar wire network (hereafter "institutions") to adopt voluntarily a cross-system sender net debit cap following guidelines established by the Board. To encourage institutions to perform the self-evaluation necessary for setting cap levels, the Board announced that institutions not complying with the policy would not be permitted to incur daylight overdrafts on Fedwire.

Under the Board's policy, an institution performing the self-evaluation rates itself in three categories: creditworthiness; operational controls, policies, and procedures; and credit policies and procedures. It then establishes an overall assessment of "High," "Above Average,"

"Average," and "No Cap."<sup>1/</sup> These translate into corresponding cap levels defined as a certain multiple of "adjusted primary capital."<sup>2/</sup> The cap multiples for each self-assessment cap category are as follows:

<u>Cap Class</u>	<u>Dual Sender Net Debit Cap</u>	
	<u>Two-Week</u> <u>Avg.</u>	<u>Plus Single-</u> <u>Day</u>
High	2.0	3.0
Above Average	1.5	2.5
Average	1.0	1.5
No Cap	0.0	0.0

Under the Board's policy, an institution is expected to avoid incurring cross-system net debits that, on average over a two-week period, exceed the two-week average cap, and, on any one day, exceed the single-day cap. Institutions that have negative adjusted primary capital or have recently grown

<sup>1/</sup> The overall rating is basically the lowest of the ratings in any one category.

<sup>2/</sup> "Primary capital" includes common stock, perpetual-preferred stock, surplus, undivided profits, contingency and other capital reserves, qualifying mandatory convertible instruments, allowances for possible loan and lease losses (exclusive of any allocated transfer risk reserves), and minority interests in equity accounts of consolidated subsidiaries, but excludes limited-life preferred stock. "Adjusted" primary capital is defined as the sum of these primary capital components less all intangible assets and deferred net losses on loans and other assets sold. Adjusted primary capital for thrift institutions includes any capital assistance provided by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation in the form of net worth certificates pursuant to 12 U.S.C. §§ 1729(f) or 1823(i). U.S. branches and agencies of foreign banks have a cap based on a "U.S. capital equivalency;" this "capital equivalency" follows the deposit requirements applied to federal branches and agencies by § 4(g) of the International Banking Act of 1978, 12 U.S.C. § 3102(g).

to a small positive adjusted primary capital position may incur overdrafts on Fedwire as large as 50 per cent of their unadjusted primary capital if they perform the self-evaluation and are judged otherwise satisfactory by their Reserve Banks. The Board has announced that the special cap levels for these institutions will be eliminated on January 1, 1989.<sup>3/</sup>

In its policy statement, the Board explained that its initial policy was

purposely designed to minimize initial disruptions and permits the Board to monitor the impact of its policy on financial markets. The Board fully expects that it will, after review of the initial impact of its policies, be adopting guidelines designed to reduce further the volume and incidence of daylight overdrafts and other uses of intra-day credit.

Moreover, the policy statement continues,

[i]t should be noted that the Board has purposely set the recommended caps to be associated with each category at relatively high levels so that institutions and their examiners can gain experience with caps while maintaining a margin of flexibility for most institutions. The Board will evaluate these caps continuously, and expects to have enough data on their impact to recommend new, lower cap levels by March, 1987.

The Board is now proposing for comment lower cap levels in accordance with its previously stated intention.

The Board's Division of Research and Statistics has prepared a study, Proposals for Daylight Overdraft Cap Reductions, De Minimis Caps, and Frequency of Self-Assessment Ratings (Nov. 1986), that forms the basis

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<sup>3/</sup> 51 Fed. Reg. 23,829 (July 1, 1986).

of the proposal on which the Board is requesting comment. This study contains information on the experience with present cap levels and the possible effects various proposals to reduce cap levels could have. Copies of this study are available free of charge from the Secretary of the Board at the address noted above, or from the Daylight Overdraft Liaison Officer of each Federal Reserve Bank. The Board encourages all parties interested in commenting to obtain a copy of the staff study as it contains background information that may enable them more readily to understand the Board's proposal.

PROPOSAL

The Board proposes to reduce the current cap levels by 25 per cent, effective June 18, 1987. Under the proposal, the dual sender net debit cap levels would be as follows:

<u>Cap Class</u>	<u>Dual Sender Net Debit Cap</u>	
	<u>Two-Week</u> <u>Avg.</u>	<u>Plus</u> <u>Single-</u> <u>Day</u>
High	1.5	2.25
Above Average	1.125	1.875
Average	0.75	1.125
No Cap	0.0	0.0

Institutions with negative adjusted primary capital or that have recently improved to a slight positive adjusted primary capital position

0.375\*4/

0.375\*4/

If the Board adopts the proposal effective June 18, 1987, it intends to review the impact of the cap

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4/\*Applied to unadjusted primary capital.

reductions at the end of 1987, and will consider further cap reductions at that time.

Board of Governors of the Federal Reserve System,  
December 10, 1986.

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William W. Wiles  
Secretary of the Board

FEDERAL RESERVE SYSTEM

[Docket No. R-0589]

Request for Comment on Proposals Regarding  
Risks on Large-Dollar Transfer Systems  
"De Minimis" Caps

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board is proposing to amend its policy statement "Reducing Risks on Large-Dollar Electronic Funds Transfer Systems" to provide for a "de minimis" cap category in addition to the sender net debit cap provided for in the original policy. This cap would be available only for those institutions whose boards of directors approved the de minimis cap. Institutions coming under the new cap category would not have to undergo the periodic self-evaluation required to select a sender net debit cap. The de minimis cap would be the lesser of 10 per cent of the institution's adjusted primary capital or \$500,000. As under the present policy, an institution's Federal Reserve Bank could prohibit the use of Fedwire daylight overdrafts, and its primary supervisor continues to have authority to restrict the use of daylight credit that is not consistent with safe and sound banking. The Board also seeks comment on whether the de minimis cap should be available only



to those institutions that incur overdrafts up to the de minimis level no more than twice per biweekly monitoring period.

DATE: Comments must be received by February 9, 1987.

ADDRESS: Comments, which should refer to Docket No. R-0589 should be addressed to the Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551, Attention: Mr. William W. Wiles, Secretary; or delivered to Room B-2223 between 8:45 a.m. and 5:15 p.m. Comments received may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m., except as provided in § 261.6(a) of the Board's Rules Regarding Availability of Information, 12 C.F.R. § 261.6(a).

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director (202-452-3368), Matthew D. Gelfand, Economist (202-452-3634), Division of Research and Statistics; Elliott C. McEntee, Associate Director (202-452-2231), Division of Federal Reserve Bank Operations; Oliver I. Ireland, Associate General Counsel (202-452-3625), or Joseph R. Alexander, Senior Attorney (202-452-2489), Legal Division; Board of Governors of the Federal Reserve System, Washington, D.C. 20551. For the hearing impaired only: Telecommunications Device for the Deaf (202-452-3544), Earnestine Hill or Dorothea Thompson.

SUPPLEMENTARY INFORMATION:

This is one of a series of proposals regarding payment system risk that the Board is issuing for public comment today. The others concern the book-entry securities (Docket No. R-0587), reducing cap levels for institutions filing self-assessment ratings (Docket No. R-0588), pricing of daylight overdrafts (Docket No. R-0592), monitoring of daylight overdrafts of affiliated institutions on a consolidated basis (Docket No. R-0590), and treatment of payments processed through automated clearing houses (Docket No. R-0591). The Board encourages all interested parties to comment on each of these proposals.

The Board urges that in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each. This procedure will facilitate the Board's processing and analysis of the comments on these complex proposals, and will ensure that each comment is quickly brought to the attention of those responsible for analysing the proposal.

BACKGROUND

In May, 1985, the Board announced its policy to reduce the risks that large-dollar payments systems present to the Federal Reserve, to depository institutions using them, to the banking system, and to other sectors of the economy. 50 Fed. Reg. 21,120 (May 22, 1985). As a principal element of that

policy, each depository institution or other entity (such as an Edge corporation or U.S. branch of a foreign bank) participating on private large-dollar networks or incurring daylight overdrafts on Fedwire (hereafter "institution") were strongly encouraged to adopt a "sender net debit cap" (a ceiling on the aggregate cross-system net debit position that it incurs during a given interval) and file it with its district Federal Reserve Bank. For most participants, the sender net debit caps are computed as a multiple of adjusted primary capital.<sup>1/</sup> An institution selects a cap after undergoing a self-assessment, including review by its board of directors, following guidelines developed by the Board.

Under the Board's current policy, formal caps apply to all institutions in the cap classification category, regardless of the size of their relative or absolute daylight overdrafts. This part of the policy has proved difficult to administer. In any two-week period, almost half of the 3,400 institutions

<sup>1/</sup> "Primary capital" includes common stock, perpetual-preferred stock, surplus, undivided profits, contingency and other capital reserves, qualifying mandatory convertible instruments, allowances for possible loan and lease losses (exclusive of any allocated transfer risk reserves), and minority interests in equity accounts of consolidated subsidiaries, but excludes limited-life preferred stock. "Adjusted" primary capital is defined as the sum of these primary capital components less all intangible assets and deferred net losses on loans and other assets sold. Adjusted primary capital for thrift institutions includes any capital assistance provided by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation in the form of net worth certificates pursuant to 12 U.S.C. §§ 1729(f) or 1823(i). U.S. branches and agencies of foreign banks have a cap based on a "U.S. capital equivalency;" "capital equivalency" follows the deposit requirements applied to federal branches and agencies by § 4(g) of the International Banking Act of 1978, 12 U.S.C. § 3102(g).

incurring an overdraft have either not filed a cap or have filed a cap of zero. These 1,600 institutions are mainly small and account for about 0.4 per cent of all funds overdrafts. The managements of these institutions find either the self-evaluation or the absolute avoidance of overdrafts very burdensome, and many Reserve Banks have found the resources required to monitor and counsel these institutions to be unusually high relative to the risk exposure involved.

In order to alleviate the burdens and costs both to the Federal Reserve and the institutions involved, the Board is proposing to establish a "de minimis" cap category. This proposal is based on a paper prepared by the Board's Division of Research and Statistics, Proposals for Daylight Overdraft Cap Reductions, De Minimis Caps, and Frequency of Self-Assessment Ratings (Nov. 1986). Copies of this study are available free of charge from the Secretary of the Board at the address noted above, or from the Daylight Overdraft Liaison Officer of each Federal Reserve Bank. The Board encourages all parties interested in commenting to obtain a copy of the staff study as it contains background information that may enable them to understand the rationale for the Board's proposals more readily.

#### PROPOSAL

The Board is proposing to create a de minimis cap category as follows:

1. Any institution, regardless of size, could incur total cross-system daylight overdrafts up to the de minimis level. That level would be the lesser of 0.1 times the institution's adjusted primary capital or \$500,000. This cap would be applied on a daily basis.

2. Institutions would not have to undergo the self-assessment required for selecting a sender net debit cap under the existing Board policy. Nevertheless, for an institution to be in compliance with the Board's policy, its board of directors would have to approve the use of daylight credit up to the de minimis level. A copy of the board of director's resolution approving the use of daylight credit would have to be filed annually with the institution's Reserve Bank.

3. As under the present policy, an institution's Federal Reserve Bank could, at any time, prohibit an institution from incurring daylight overdrafts if the Reserve Bank believes that the institution's use of daylight credit exposes the Reserve Bank, other depository institutions, or the payments system to excessive risk. Further, an institution's primary supervisor would continue to have the authority to restrict or prohibit the use of daylight credit that is not consistent with safe and sound banking.

4. The Board also seeks comment on whether the de minimis cap should be available only to institutions that

incur overdrafts up to the de minimis level no more than twice per biweekly monitoring period.

5. Any institution that incurred a daylight overdraft for the first time and that the Reserve Bank judges to be financially sound would be assigned a de minimis cap. If, after 90 days, the institution did not file with its Reserve Bank a copy of its board's resolution adopting a de minimis cap or a positive sender net debit cap under the Board's guidelines, the Reserve Bank would drop the institution's cap to zero.

6. Reserve Banks will vigorously counsel institutions that chronically violate their de minimis or zero caps, and will prohibit Fedwire overdrafts to any institution that violates these caps and does not respond to Reserve Bank counseling. Overdrafts may be denied either through real-time monitoring or by taking the institution "off-line."

The Board intends that the de minimis cap policy take effect on June 18, 1987, unless the public comments raise substantial issues.

Board of Governors of the Federal Reserve System,  
December 10, 1986.

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Williams W. Wiles  
Secretary of the Board

FEDERAL RESERVE SYSTEM

[Docket NO. R-0590]

Request for Comments on Proposals Regarding

Payment System Risks

Limits on Inter-Affiliate Fedwire Transfers

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for Comment.

SUMMARY: The Board is proposing to amend its policy statement, "Reducing Risks on Large-Dollar Electronic Funds Transfer Systems," by limiting inter-affiliate Fedwire transfers at originating depository institutions and other entities that incur daylight overdrafts. The Board requests comment on whether the policy should be amended to either (1) permit transfers of funds over Fedwire among affiliated institutions that create a pattern of daylight overdrafts up to the sending institution's net debit cap provided certain conditions are met, or (2) prohibits such transfers.

DATE: Comments must be received by February 9, 1987. The Board proposes to make the new policy effective on June 18, 1987.

ADDRESS: Comments, which should refer to Docket No. R-0590, should be addressed to the Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551, Attention: Mr. William W. Wiles, Secretary; or delivered to Room B-2223 between 8:45 a.m. and 5:15 p.m. Comments



received may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m., except as provided in § 261.6(a) of the Board's Rules Regarding Availability of Information, 12 C.F.R. § 261.6(a).

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director (202-452-3368), Division of Research and Statistics; Elliott C. McEntee, Associate Director (202-452-2231), Division of Federal Reserve Bank Operations; Oliver I. Ireland, Associate General Counsel (202-452-3625), or Joseph R. Alexander, Senior Attorney (202-452-2489), Legal Division; Board of Governors of the Federal Reserve System, Washington, D.C. 20551. For the hearing impaired only: Telecommunications Device for the Deaf (202-452-3544), Earnestine Hill or Dorothea Thompson.

SUPPLEMENTARY INFORMATION: This is one of a series of proposals regarding payment system risk that the Board is issuing for public comment today. The others concern book-entry securities (Docket No. R-0587), pricing of daylight overdrafts (Docket No. R-0592), cap levels (Docket No. R-0588), "de minimis" caps (Docket No. R-0589), and treatment of payments processed through automated clearing houses (Docket No. R-0591). The Board encourages all interested parties to comment on each of these proposals.

The Board urges that in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each.



This procedure will facilitate the Board's processing and analysis of the comments on these complex proposals, and will ensure that each comment is quickly brought to the attention of those responsible for analysing the proposal.

#### BACKGROUND

The Board's policy statement "Reducing Risks on Large-Dollar Electronic Funds Transfer Systems" establishes intra-day net debit limits for depository institutions and other entities (such as Edge corporations and U.S. branches of foreign banks; hereafter, all will be referred to as "institutions") on an individual entity basis. The 1985 staff report to the Board, from which the policy statement was drawn, recommended that the private-sector Large-Dollar Payments System Advisory Group study the possibility of allowing institutions affiliated through holding company ownership to treat all of the affiliates as a single entity for purposes of the Board's daylight overdraft policy. The Federal Reserve's staff also studied the issue.

After reviewing the consolidation issues, the Board has determined that the current prohibition on consolidation of affiliates for daylight overdraft monitoring purposes should be retained. Permitting holding company organizations to consolidate their funds transfer activity for daylight overdraft monitoring purposes would result in an increase in either Federal Reserve Bank credit risk or systemic risk to depository institutions. Consolidation could also

significantly increase the maximum permissible level of daylight overdrafts for the lead institution in a holding company organization. Without enforceable guarantees to the Reserve Bank from the affiliates of the lead institution covering this additional overdraft level, the Reserve Bank's credit exposure would increase. If, however, enforceable guarantees were provided, reliance by the Reserve Bank on them in the event of a default could endanger other institutions in the holding company organization.

One of the arguments advanced in favor of modifying the policy statement to permit monitoring on a consolidated basis is that holding company organizations can approximate consolidation through daily Fedwire transfers, concentrating at one lead institution funds equal to their subsidiaries' caps. For example, a holding company could arrange for all of its depository institution subsidiaries to transfer funds up to their individual sender net debit caps to the lead bank; each of the sending affiliates would then have used all the daylight credit available to them under the Board's policy to provide the lead bank with a large net credit position against which the lead bank's payments could be made. The effect would be to consolidate the caps of all institutions in the holding company in the one subsidiary, giving that subsidiary a much higher cap than would be available to it if it stood alone under the Board's policy.

The Board believes that such de facto consolidation practices may be inconsistent with the principle of monitoring daylight overdrafts on a separate-entity basis. Accordingly, the Board is requesting comments on two alternative amendments to its policy statement: one would permit institutions within a holding company system to simulate consolidation through inter-affiliate funds transfers that result in daylight overdrafts so long as certain conditions were met; the second would prohibit such transfers.

Further background material regarding these proposals may be found in the staff paper, Consolidated Daylight Overdraft Monitoring of Affiliated Depository Institutions (Nov. 1986). Copies of this study are available free of charge from the Secretary of the Board at the address noted above, or from the Daylight Overdraft Liaison Officer of each Federal Reserve Bank. The Board encourages all parties interested in commenting to obtain a copy of this staff paper as it contains background information that may enable them to understand more readily the rationale for the Board's proposal.

#### PROPOSAL

The Board requests public comments on the following alternative proposals for dealing with inter-affiliate transfer practices:

1. Under the first alternative, the Board's policy would continue to permit depository institutions to transfer funds to their affiliates, even if such transfers cause the originating institutions to incur overdrafts up to their net debit caps, provided that each institution's board of directors specifically approves each year the extension of credit to specified affiliates and sends a copy of its resolution to its Reserve Bank. Further, the institution's primary supervisor, during the examination process, will review the transfer in the context of the institution's overall credit relations with the affiliates for consistency with standards of safety and soundness, and confirm that the originating institution continues to exercise independent credit judgment in deciding each day whether or not to make the transfers and maintains adequate internal controls to do so. The Federal Reserve Banks, of course, retain the right unilaterally to require collateral or to prohibit any Fedwire transfer that, in the opinion of the Reserve Bank, exposes the Reserve Bank to excessive risk.

2. Under the second alternative, the Board would modify its policy statement to prohibit inter-affiliate transfers that create a pattern of daylight overdrafts at the sending institutions in order to enable one or more institutions of a holding company system to obtain the benefits of a higher net debit cap than they would be entitled to in the absence of such transfers. To ensure that institutions do not

engage in such practices, funds transfer activities among affiliates will be monitored by Reserve Banks and through the examination process.

Board of Governors of the Federal Reserve System,  
December 10, 1986.

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William W. Wiles  
Secretary of the Board

FEDERAL RESERVE SYSTEM

[Docket No. R-0591]

Risks on Large-Dollar Transfer Systems

Automated Clearing House Transactions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board of Governors of the Federal Reserve System ("Board") is proposing several changes related to automated clearing house ("ACH") transactions, which are intended as additional steps in implementing the risk reduction policy adopted by the Board in May, 1985. (See, policy statement, "Reducing Risks on Large-Dollar Electronic Funds Transfer Systems," 50 Fed. Reg. 21120). The changes proposed include:

- A. Modification of the ex post monitor to post ACH debit transactions and check transactions at 1:00 p.m., Eastern Time, on the settlement/presentation date.
- B. Amendment of the Reserve Banks' ACH Operating Circular to modify the time of finality for ACH credit and debit transactions, and to clarify the Reserve Bank's rights with regard to ACH credit transfers.
- C. Efforts to reduce return times and improve procedures for handling large-dollar ACH return items.
- D. Procedures for handling ACH credit transfers when the originating institution is closed during the middle of the week or for a nonstandard holiday.

DATE: Comments must be received by March 16, 1987.

ADDRESS: Comments, which should refer to Docket No. R-0591, may be mailed to the Board of Governors of the Federal Reserve

System, 20th Street and Constitution Avenue, N. W., Washington, D. C. 20551, to the attention of Mr. William W. Wiles, Secretary, or delivered to room B-2223 between 8:45 a.m. and 5:15 p.m. Comments may be inspected in room B-1122 between 8:45 a.m. and 5:15 p.m., except as provided in § 261.6(a) of the Board's Rules Regarding the Availability of Information, 12 C.F.R. § 261.6(a).

FOR FURTHER INFORMATION CONTACT: Elliott C. McEntee, Associate Director (202/452-2231), or Florence M. Young, Adviser, Division of Federal Reserve Bank Operations (202/452-3955); Terrence M. Belton, Economist (202/452-2444), Division of Research and Statistics; Oliver I. Ireland, Associate General Counsel (202/452-3625), or Elaine M. Boutilier, Senior Attorney, Legal Division (202/452-2418), Board of Governors of the Federal Reserve System, Washington, D. C. 20551. For the hearing impaired only, Telecommunications Device for the Deaf ("TDD"), Earnestine Hill or Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: This is one of a series of proposals regarding payment system risk that the Board is issuing for public comment today. The others concern the net debit cap (Docket Nos. R-0588 and R-0589), pricing of daylight overdrafts (Docket No. R-0592), consolidation of affiliated institutions for cap monitoring purposes (Docket No. R-0590), and book-entry securities transfers (Docket No. R-0587). The Board encourages all interested parties to comment on each of

these proposals. The Board urges that in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each. This procedure will facilitate the Board's processing and analysis of the comments on these complex proposals, and will ensure that each comment is quickly brought to the attention of those responsible for analyzing the proposal.

#### Background

On May 22, 1985, the Board published its policy statement, "Reducing Risks on Large-Dollar Electronic Funds Transfer Systems" (50 Fed. Reg. 21120). That statement did not, however, resolve the issues of risks arising from ACH transactions. In a related document, the Board requested comment on issues relating to risk in ACH transfers. (50 Fed. Reg. 21130) Based upon the comments received and further study of the issues, the Board is proposing certain changes related to ACH transactions. The Board anticipates implementing the proposed changes set forth in this document by the fourth quarter of 1987, after consideration of the comments received.

For a complete and detailed discussion of the ACH risk issues considered by the Board, please refer to the Board staff memorandum dated November, 1986, entitled, "Risk Associated with the Automated Clearing House Mechanism." Copies of this memorandum are available from the Daylight Overdraft Officer at each Federal Reserve Bank. (The memorandum also includes a detailed summary of the comments received regarding the May 1985 proposal on these issues.)



While the risks relating to the ACH are small compared with large-dollar funds transfer systems, the Board is concerned that the ACH mechanism exposes individual participants and the Federal Reserve to significant risk in certain cases. One source of this concern is the temporal exposure associated with ACH transactions. Because the ACH is a value-dated mechanism, depository institutions are typically exposed to overnight as well as intra-day credit risk when using the ACH. In the case of ACH credit transactions -- such as payrolls or corporate trade payments -- temporal risk begins one or two days prior to settlement day when the originating depository institution deposits the payments with the processor. At that time, the depository institution is committed to making the payment for its customer even though the customer may not fund its account until close of business on settlement day. About one-half of all ACH credit transactions are processed two days in advance of settlement day. These transactions entail credit risk comparable to a two or three day loan granted by the originating depository institution to its corporate customer. This is significantly longer than the temporal risk associated with wire transfer payments -- where payments are processed and settled on the same day.

ACH debit transactions also entail temporal risk. In this case, however, the risk exists on the days following settlement day when the ACH debit transactions -- like checks

-- may be returned after the collecting corporate customer has already made use of the funds. Five to six days typically elapse before collecting institutions receive ACH return items from payor institutions, so the collecting institutions may be exposed to substantial temporal exposure. Again, this exposure significantly exceeds the temporal exposure associated with wire transfer payments.

In addition to concerns about temporal risk, the Board is concerned that its recently adopted guidelines on daylight overdrafts may create incentives to use the ACH for some types of large-dollar payments that are currently made over wire transfer systems. Accordingly, the Board is proposing changes in the treatment of ACH transactions that fall into four categories: (1) modification of the ex post monitor; (2) amendments to the Reserve Banks' ACH Operating Circular concerning the finality of ACH transactions; (3) efforts to reduce return times for large-dollar ACH return items; and (4) treatment of ACH credit transactions originated by institutions observing a midweek closing or nonstandard holidays.

#### Ex Post Monitoring System

The current ex post monitoring system is designed to monitor depository institutions' compliance with the Board's payment system risk reduction program.<sup>1/</sup> The Board's

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<sup>1/</sup> The time at which transactions are posted to the ex post monitor does not affect the time at which funds become available or final.

analysis suggests that existing procedures for monitoring ACH debit transactions and checks have a number of serious shortcomings. First, ACH debit and check transactions are treated differently even though the intra-day credit risk associated with the two payment forms is similar. Currently, the net of ACH debit transactions is posted at the opening of business for ex post monitoring purposes. By contrast, if the net of check transactions plus all other "off-line"<sup>2/</sup> transactions is a credit, it is posted in the ex post monitor at the opening of business; yet if it is a debit, it is posted at the close of business. It is desirable to treat checks and ACH debit items as similarly as possible in the ex post monitor to avoid artificial incentives to use one over the other. Second, posting ACH debit transactions to receivers' accounts at the opening of business is inappropriate because these institutions do not incur intra-day credit risk and do not impose any risk on the Federal Reserve until after the return deadline.

A final problem with the current ex post monitoring procedures is that they create incentives for depository institutions to originate ACH debit transactions in order to circumvent the Board's large dollar payments system risk reduction program. There are several factors that contribute

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<sup>2/</sup> Off-line transactions include all transactions other than ACH, funds transfer, and book-entry security transfers.

to these incentives. First, ACH transactions entail significantly lower costs than wire transfer payments. Second, ACH payments provide depository institutions greater control over the timing of payments. This is because a collecting institution that receives payments by wire transfer must rely on the payor institution to send funds on a timely basis. By contrast, institutions that collect funds by originating ACH debit transactions currently have these funds posted to their reserve accounts at opening of business on settlement date. This earlier crediting of ACH transactions creates an incentive for collecting institutions near their cap to substitute ACH debit originations for wire transfer payments. By making such a substitution, the collecting institution is able to receive the credit from the transaction at the opening of business in the ex post monitor, and thereby able to use that credit to fund anticipated daylight overdrafts. Payor institutions not near their caps, moreover, may be willing to accommodate this substitution because of the lower costs associated with ACH transactions and their ability to reverse the transaction without risk if the originating institution does not cover its debit with the receiving institution by the end of the settlement day.

After evaluating a number of alternatives, the Board proposes that ACH debit and check transactions be posted to the accounts of collecting (originating) and payor (receiving) institutions, for ex post monitoring purposes, on the

settlement (presentment) date at 1:00 p.m. Eastern Time. This posting time would apply to items processed by the Federal Reserve as well as items processed by private clearers that use the Federal Reserve's net settlement service. Accordingly, these private ACH clearers will be required to segregate their ACH debit transactions from their credit transactions. The proposal would reduce the inequitable impact of current procedures on receivers of ACH debit transactions by providing them some additional time to obtain funds to cover incoming payments. At the same time, the proposal reduces incentives to use the ACH and check collection mechanisms to create intra-day credit in order to circumvent the Board's risk-reduction program. Finally, the proposal acknowledges that the risks associated with ACH debit and check transactions are comparable.

Under existing ex post monitoring procedures, there are approximately 400 depository institutions that incur daylight overdrafts solely from the receipt of ACH debit transactions. The Reserve Banks have excused these institutions from conducting a self-evaluation, pending the Board's review of ACH risk. If the 1:00 posting time for ACH debits is adopted as proposed, there could be approximately 70 depository institutions that might have daylight overdrafts only as a result of ACH debit transactions or checks that will exceed the de minimis cap proposed in a related Board action. (See "Request for Comment on Proposals Regarding 'De Minimis' Caps", Docket No. R-0589). Because the majority of these

institutions should have little difficulty in remaining below their net debit caps under 1:00 p.m. posting, the Reserve Banks will no longer grant exemptions from the risk reduction program to institutions incurring daylight overdrafts solely from ACH transactions or checks.

With respect to ACH credit transactions, the current procedure for posting these transactions to the ex post monitor treats them like funds transfers originated at the opening of business on the settlement day. This procedure is reasonable because the originating depository institutions commit to make the payments when they deposit them with a Reserve Bank. As a result, this procedure accurately measures intra-day credit risk. Furthermore, the current procedures for posting ACH credit transactions to the ex post monitoring system do not create incentives to use the ACH as a substitute for wire transfers because originators' accounts are debited at the opening of business on the settlement day. Therefore, ACH credit transactions will continue to be posted to the accounts of both originating and receiving institutions in the ex post monitor at the opening of business on the settlement day.

In summary, the proposal for the ex post monitoring system is to: (1) post ACH debit and check transactions to the accounts of collecting and payor institutions at 1:00 p.m. Eastern Time; (2) discontinue the exemptions from the risk reduction policy for institutions incurring daylight overdrafts solely from ACH transactions or checks; and (3) continue to

post ACH credit transactions, for ex post monitoring purposes, at the opening of business on the settlement date.

ACH Operating Circular Changes

Most depository institutions treat credit received for ACH credit items as final as of the opening of business on the settlement day. However, the Reserve Banks' ACH operating circular states only that credit given for ACH credit transactions is available for use on the settlement day.<sup>3/</sup> Further, the Reserve Banks reserve the right to reverse transactions if either the originator or receiver is suspended or closed before or during the settlement day. While the Reserve Banks would make a reasonable effort to provide timely notice to receiving institutions when they reverse transactions, reversing entries can be functioned without prior notice.

Because the dollar value of the majority of ACH credit transactions is low, the risk of loss to most receiving depository institutions is also low. In addition, because receiving institutions for credit transactions originated by a single institution are a highly diverse group, the reversal of ACH credit transactions on the settlement day should not result in systemic risk. Nevertheless, the Board believes that receiving institutions would benefit if there were greater

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<sup>3/</sup> Copies of the ACH Uniform Operating Circular are available at each Reserve Bank office.



certainty regarding the time that "small-dollar" ACH credit transactions become final. At the same time, the Board believes that the ACH should not be used as a substitute for large-dollar payments that are currently made via the large-dollar payments network (Fedwire or CHIPS). The Board, therefore, proposes that the Reserve Banks modify their ACH operating circular to provide (1) finality at 1:00 p.m. local time on the settlement date to receivers of ACH credit transactions amounting to \$5,000 or less, and (2) finality for ACH credit transactions over \$5,000 when the Reserve Banks have received actually and finally collected funds. If "small-dollar" ACH credit transactions are reversed, the Reserve Banks would use their best efforts to notify the receiving depository institution before the 1:00 p.m. deadline for finality. In the case of "large-dollar" payments, the Reserve Banks would use their best efforts to notify receiving depository institutions as soon as possible that payments are being reversed.

If ACH credit transactions of \$5,000 or less are treated as final to receivers at 1:00 p.m. local time on the settlement day, the finality accorded these transactions would be closer to the treatment the Board believes that the majority of ACH users believe is currently accorded to ACH credit transactions. Treating ACH credit transactions in amounts over \$5,000 as provisional until the Reserve Banks have received actually and finally collected funds would clearly



differentiate the ACH mechanism from Fedwire. It would also create the inducement for receiving institutions to be particularly cautious about making funds received via "large-dollar" ACH transactions available to their customers on the settlement date.

Under the Reserve Banks' ACH operating circular, ACH debit transactions may not be reversed by a Reserve Bank acting on its own initiative after the opening of business on the banking day following the settlement date. Transactions reversed as a result of the receiver exercising his right of return, however, need not be dispatched by the receiver until midnight of the banking day following the settlement (presentment) day. With regard to check services, the Reserve Banks reserve the right indefinitely to charge back the amount of an item for which credit was given subject to receipt of payment in actually and finally collected funds. (12 C.F.R. § 210.13) While the treatment accorded ACH debit transactions and checks should be comparable, the language in the ACH operating circular may be misleading to users of ACH services. The Board, therefore, proposes that the Reserve Banks modify their ACH operating circular to indicate that credit given for an ACH debit item, like that for checks, is not final until the Reserve Bank has received payment in actually and finally collected funds.

To protect the Reserve Banks from risk associated with handling ACH transactions for institutions experiencing

financial problems, another modification to the Reserve Banks' ACH operating circular is proposed. For institutions experiencing financial difficulties, procedures will be established to monitor at individual institutions the cumulative balance of all ACH credit transactions originated by settlement date.<sup>4/</sup> The operating circular would be modified to explicitly permit Reserve Banks, (1) to require advance funding or collateral for ACH credit transactions originated by problem institutions, and (2) to reject credit transactions if there is a question about the originating institution's ability to cover the payments.

#### ACH Return Items

Currently, five to six days, on average, elapse before return items reach depository institutions originating ACH debit transactions. A number of factors contribute to the delays, including the fact that a large proportion of return items are submitted to the Reserve Banks in paper form, necessitating the use of ground transportation for delivery. In addition, dispatch by the returning depository institution by the midnight deadline does not coincide with processing cycles at Reserve Banks and contributes to delays in items being returned to depository institutions.

The Board believes that meaningful reductions in ACH

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<sup>4/</sup> A task force will be established to develop specific procedures for monitoring ACH debit and credit transactions.

risk could be realized by reducing return times and improving procedures for providing advices of large-dollar returns. The Board, therefore, requests comment on the following questions:

- ° Should the ACH return deadline for debit transactions amounting to \$2,500 and above be changed from dispatching return items by midnight of the banking day following the settlement date or the day of receipt, whichever is later, to depositing them for processing at the nighttime deposit deadline on the banking day following the settlement date or day of receipt, whichever is later?
- ° If the ACH return deadline for debit transactions amounting to \$2,500 and above were changed, the deadline for paper returns would be changed to a range of 5:00 p.m. to 8:00 p.m. Eastern Time so that paper returns could be processed during the nighttime operating cycle. To facilitate a change in the paper return deadline, it is envisioned that the Reserve Banks would offer a telephone return service to institutions that are unable to present paper return items by the paper return deadline. It is anticipated that the fee for the proposed telephone return service would be about \$6.00 per return item, which is comparable to the fee the Reserve Banks charge for off-line funds transfer requests.
- ° If the return deadline for ACH debit transactions were changed, should all institutions returning ACH debit transactions amounting to \$100,000 or more be required to send to the originator of the transaction a notice that the item is being returned by 3:00 p.m. Eastern Time the banking day following the settlement date or the day of receipt, whichever is later? Would a higher or lower dollar cut-off for required advices be preferable? If such a requirement is adopted, the Reserve Banks would assess fees for this notification service that would be comparable to the fees assessed for the check notification service, that is, \$2.25 for an on-line notice and \$4.25 for an off-line notice.
- ° The Reserve Banks could segregate ACH return items and transmit them to originators at the opening of

business on the day following processing, rather than intermingling them with original transactions as is currently the practice. Would institutions originating ACH debit transactions be interested in using such a service?

#### Midweek and Nonstandard Holiday Closings

In November 1985, the Board requested public comment on a proposal to modify the procedures used by the Reserve Banks to recover the cost of ACH float caused by depository institutions that close during the middle of the business week and on nonstandard holidays. (50 Fed. Reg. 47752) In May of this year, the Board approved procedures for recovering the cost of such float generated by ACH debit transactions, but deferred action on procedures associated with ACH credit transactions until the ACH risk study was completed. (51 Fed. Reg. 21421, June 12, 1986)

In November 1985, the Board proposed that float caused by the closing of depository institutions during the middle of the business week or on nonstandard holidays be recovered by debiting the institutions on the preceding business day and compensating them for the early debit by means of an as-of adjustment. The Board now proposes to modify that proposal so that originating depository institutions would be charged, as though they were open, for ACH credit transactions that settle on days that they are closed. This policy would apply to both voluntary and mandatory holidays because the depository institutions are aware of their obligation in advance.

The Reserve Banks have adopted a standard holiday

schedule that, with one exception -- the observance of Mardi Gras Day at the New Orleans Branch -- eliminates the observance of nonstandard holidays. For depository institutions located in the New Orleans zone and originating credit transactions for settlement on Mardi Gras Day, it is proposed that they be charged at the close of business on the preceding business day and be compensated for the early debit through an as-of adjustment.

Board of Governors of the Federal Reserve System,  
December 10, 1986.

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Williams W. Wiles  
Secretary

FEDERAL RESERVE SYSTEM

[Docket No. R-0515]

Policy Regarding Risks on Large-Dollar Wire Transfer Systems  
Amendment

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy statement; amendment.

SUMMARY: This document amends the Board's policy statement, "Reducing Risks on Large-Dollar Electronic Funds Transfer Systems," to provide that depository institutions and other entities (such as foreign banks) that undergo a self-assessment to establish levels for their sender net debit caps need do so only once each year, rather than every six months as provided for in the original policy statement. The original policy statement was published in the Federal Register on May 22, 1985 (50 Fed. Reg. 21,120).

EFFECTIVE DATE: December 10, 1986.

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director (202-452-3368), or Matthew D. Gelfand, Economist (202-452-3634), Division of Research and Statistics; Elliott C. McEntee, Associate Director (202-452-2231), Division of Federal Reserve Bank Operations; Oliver I. Ireland, Associate General Counsel (202-452-3625), or Joseph R. Alexander, Senior Attorney (202-452-2489), Legal Division; Board of Governors of the Federal Reserve System, Washington, D.C. 50551. For the hearing impaired only: Telecommunications Device for the Deaf (202-452-3544), Earnestine Hill or Dorothea Thompson.

SUPPLEMENTARY INFORMATION: The Board's policy on reducing risks on large-dollar wire transfer systems strongly urges each depository institution or other entity (such as an Edge corporation or U.S. branch or agency of a foreign bank) that participates on a private large-dollar network or incurs daylight overdrafts on Fedwire (hereafter "institution") to adopt a sender net debit cap. The cap is to be adopted by the institution's board of directors after a self-evaluation according to Board guidelines of the institution's creditworthiness, credit policies, and operational controls and procedures. The Board's policy currently provides that this self-evaluation should take place at least once every six months, or more frequently if conditions warrant.

In order to reduce the burden on institutions of complying with the risk reduction policy, the Board is amending the policy statement to provide that institutions need update their self-assessment ratings and cap level selections only once during each twelve month period. Any institution that chooses to adopt a new self-assessment rating at shorter intervals in order to revise the existing cap may do so. In any event, any institution that experiences a material adverse change in its condition should conduct a new self-assessment and establish a new cap as soon as practical after discovery of the change. All institutions should submit renewals of board of director certifications of self-assessments at the time of their new filings.

The following change is made in Docket No. R-0515, appearing on page 21,120 in the issue of May 22, 1985, and in the Board's release of May 17, 1985:

On page 21,122, in the first full paragraph of the third column (the first full paragraph of page 11 of the Board's release), the last sentence is amended to read: "The process of self-evaluation, with board of director review, should be conducted at least once in each 12 month period."

Board of Governors of the Federal Reserve System,  
December 10, 1986.

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William W. Wiles  
Secretary of the Board



FEDERAL RESERVE SYSTEM

[Docket No. R-0592]

Risks on Large-Dollar Transfer Systems

Request for Comments on Proposal  
Regarding Pricing Daylight Overdrafts

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comments.

SUMMARY: The Board is exploring the concept of instituting a charge or fee on daylight overdrafts in lieu of, or as a complement to, lowering the cap levels on daylight overdrafts. The Board is therefore requesting comment on the concept of pricing daylight overdrafts.

DATE: Comments must be received by April 13, 1987.

ADDRESS: Comments, which should refer to Docket No. R-0592, may be mailed to the Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N. W., Washington, D. C. 20551, to the attention of Mr. William W. Wiles, Secretary, or delivered to room B-2223 between 8:45 a.m. and 5:15 p.m. Comments may be inspected in room B-1122 between 8:45 a.m. and 5:15 p.m., except as provided in § 261.6(a) of the Board's Rules Regarding the Availability of Information, 12 C.F.R. § 261.6(a).

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director, Division of Research and Statistics (202/452-3368); Elliott C. McEntee, Associate Director, Division of Federal

Reserve Bank Operations (202/452-2231); or Oliver Ireland, Associate General Counsel, Legal Division (202/452-3625), Board of Governors of the Federal Reserve System, Washington, D. C. 20551. For the hearing impaired only, Telecommunications Device for the Deaf ("TDD") Earnestine Hill or Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: This is one of a series of proposals regarding payment system risk that the Board is issuing for public comment today. The others concern the net debit cap (Docket Nos. R-0588 and R-0589), book-entry security transfers (Docket No. R-0587), consolidation of affiliated institutions for cap monitoring purposes (Docket No. R-0590), and treatment of payments processed through automated clearing houses (Docket No. R-0591). The Board encourages all interested parties to comment on each of these proposals. The Board urges that in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each. This procedure will facilitate the Board's processing and analysis of the comments on these complex proposals, and will ensure that each comment is quickly brought to the attention of those responsible for analyzing the proposal.

On May 22, 1985, the Board of Governors of the Federal Reserve System published its policy statement, "Reducing Risks on Large-Dollar Electronic Funds Transfer Systems." (50 Fed. Reg. 21120) In that statement, the Board announced its

intention to adopt additional guidelines in the future "to reduce further the volume and incidence of daylight overdrafts and other uses of intraday credit." At present, overdrafts are not explicitly priced. However, the Board is exploring the concept of levying a charge or fee for daylight overdrafts that occur in accounts maintained with the Federal Reserve in lieu of, or as a complement to, lowering the level of net debit caps.

The system of net debit caps now in place likely would continue to be the Federal Reserve System's primary risk reduction policy tool, but pricing daylight overdrafts could be used as a supplement to net debit caps. Such pricing would provide additional incentives for users to reduce overdrafts below the caps and would charge those depository institutions who continue to use daylight credit and generate payments system risks. In addition, it would compensate the Federal Reserve for assuming credit risk and providing finality of all Fedwire payments.

Caps have reduced the level of overdrafts from what they otherwise would be. While the growth of payments' value over large dollar networks continues to be greater than 15 percent a year, the level of cross-system overdrafts has remained relatively flat since caps have been in place. Pricing Fedwire daylight overdrafts would continue this trend by encouraging banks to reduce overdrafts below the caps. Pricing daylight overdrafts is expected to provide incentives for payments network participants to use and develop further a

number of institutional changes for reducing overdrafts. Such changes could result in both a reduction in the daily value of payments sent over external wire transfer networks and an elimination of the current gap in processing time between totally or partially offsetting payments. Some examples of changes in payments practices that could reduce overdrafts are:

- (1) Rollovers where the same amount of maturing overnight (or longer) funds borrowing is renegotiated with the same seller. No funds move over the wire networks except the initial borrowing and the final repayment. Importantly, there is no time gap between daily repayment of borrowed funds and receipt of borrowings for the next time period. As a result, the value of payments over wire networks is reduced, the time gap is eliminated, and associated daylight overdrafts fall;
- (2) Continuing contracts where differing amounts of daily funds borrowings are renegotiated with the same sellers but only the net change in the position (including interest) is sent over the wire. The value of the single net transfer is less than either the early in the day full repayment of the gross funds borrowed or the later in the day full reborrowing of an altered gross amount for the next period. The value of payments made is thus reduced and the time gap between the two gross flows eliminated, so overdrafts fall;
- (3) Term funds where longer term borrowings are substituted for overnight funding. Overdrafts fall due to the lower average daily value of funds sent and returned over the wire network, as well as the now more infrequent daily time gap between return of borrowed funds and subsequent reborrowing;
- (4) Intraday funding where excess funds are sold and sent to other payments participants for portions of the day to fund, for a price, what otherwise would be daylight overdrafts at the purchasing institution; and,

- (5) Netting by novation where gross bilateral payment obligations between depository institutions are legally netted using contracts among the parties prior to the value or settlement date. Legal exposure from payment obligations is reduced from gross to net positions so that payments satisfying these obligations over the wire are reduced. Even though a time gap may remain, both measured overdrafts and risk decrease.

Although there are a number of advantages to pricing of daylight overdrafts, such pricing would represent a significant modification of current policy. Accordingly, public comment is invited on the general concept of pricing daylight overdrafts. In addition, comment is requested on the following specific questions:

1. If daylight overdrafts that occur in accounts maintained with the Federal Reserve are priced,
  - (a) How should the price be determined?
  - (b) Should the overdraft value assessed be the maximum overdraft incurred during the day or some average value?
  - (c) Should the price vary according to the duration of the overdraft? If so, how much should the price be adjusted for overdraft duration?
  - (d) Should daylight overdrafts lasting less than, say, one hour be excluded in order to allow for computer outages and other operational difficulties? Similarly, should some portion of the measured overdraft, be exempt from pricing for the same reason?
  - (e) What operational improvements or changes in institutional practices would depository institutions contemplate in response to pricing? (Examples of such improvements and changes include better control over third party payments that are not time-critical, rollovers of overnight funding, shifting

from overnight to term federal funds, and payment netting by novation arrangements.)

- (f) Would depository institutions attempt to pass overdraft charges through to customers in order to encourage them better to control payments that do not have to be made immediately? Are there other means of improving an institution's control over the timing of payments made?
  - (g) Should the proceeds of the overdraft charges be placed in a special reserve fund for possible Federal Reserve losses from providing payment finality? Should it be used to make improvements in Fedwire?
  - (h) Would pricing induce a private sector market for intraday funds?
  - (i) What operational problems are anticipated with pricing? How might they be alleviated?
2. Would pricing be a suitable substitute for further cap reductions from their current levels?
  3. What are the anticipated problems with pricing compared with a policy of lowering caps without pricing?

Suggestions of any other alternatives for pricing daylight overdrafts are welcome.

Board of Governors of the Federal Reserve System,  
December 10, 1986.

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Williams W. Wiles  
Secretary