WILLIAM H. WALLACE
FIRST VICE PRESIDENT
AND CHIEF OPERATING OFFICER

FEDERAL RESERVE BANK
OF DALLAS

DALLAS, TEXAS 75222

June 26, 1990

Circular 90-41

TO: The Chief Executive Officer of each member bank and others concerned in the Eleventh Federal Reserve District

SUBJECT

Modifications to the Payments System Risk Reduction Program

DETAILS

As part of its payments system risk reduction program, the Federal Reserve Board has adopted a policy governing daylight overdraft caps, including measures of capital, for U.S.-chartered depository institutions. The Board also has adopted a policy to reduce the risks to the Federal Reserve arising from daylight overdrafts associated with transfers of book-entry securities on Fedwire. The payments system risk reduction policy also has been modified to allow certain U.S. agencies and branches of a foreign bank to incur an uncollateralized daylight overdraft cap equal to their cap multiple times a U.S. capital equivalency equal to 10 percent of the bank's worldwide capital, provided the foreign bank's home country supervisor adheres to the Basle Capital Accord. The Board's modified policy will be effective on January 10, 1991. In addition, the Board has requested public comment on a proposed risk reduction policy prohibiting certain institutions from incurring overdrafts on Fedwire. Comment is requested by July 31, 1990.

ATTACHMENTS

A copy of the Board's notice appearing in the Federal Register is attached.

MORE INFORMATION

For more information, please contact Donna Matthews at (214) 651-6646, Virginia Rodriguez at (214) 698-4228, or James Smith at (214) 651-6140. For additional copies of this circular, please contact the Pubic Affairs Department at (214) 651-6289.

Sincerely yours,

William H. Wallace

FEDERAL RESERVE SYSTEM

[Docket No. R-0693]

RIN 7100-AA76

Proposal To Modify the Payments System Risk Reduction Program; Bankers' Banks, Edge Corporations, and Zero-Imposed Cap Institutions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: As part of its payments system risk reduction program, the Board is requesting comment on a proposed risk reduction policy that would prohibit bankers' banks and Edge corporations from incurring funds or book-entry overdrafts on Fedwire. Under the proposed policy, Reserve Banks would assess a penalty fee when these or other institutions with imposed zero caps incur inadvertent daylight or overnight overdrafts on Fedwire.

DATES: Comments must be submitted on or before July 31, 1990.

ADDRESSES: Comments, which should refer to Docket No. R-0693, may be mailed to the Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551, Attention: Mr. William W. Wiles, Secretary; or may be delivered to Room B-2223 between 8:45 a.m. and 5 p.m. All comments received at the above address will be included in the public file and may be inspected at Room B-1122 between 8:45 a.m. and 5:15 p.m.

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director, Division of Research and Statistics (202/452-3368); Bruce J. Summers, Associate Director (202/452-2231) or Florence M. Young, Assistant Director (202/452-3955), Division of Federal Reserve Bank Operations; Oliver I. Ireland, Associate General Counsel (202/452-3625) or Stephanie Martin, Attorney (202/452-3198), Legal Division; for the hearing impaired *only*: Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: In April 1985, the Board adopted a policy to reduce the risks that large-dollar payments systems, including Fedwire, presented to the Federal Reserve Banks, to the depository institutions [1] using them, to the banking system, and to other sectors of the economy (50 FR 21120, May 22, 1985). This policy, in effect, established a maximum amount of intraday funds overdrafts, or intraday credit exposure, that depository institutions are permitted to incur over both Fedwire and private large-dollar payments systems [2]. The maximum, or cap, is a multiple of a depository institution's capital [3] and is based on the depository institution's self-assessment of its own creditworthiness, credit polices, and operational controls. The guidelines for performing the self-assessment were established by the Board, and the documentation supporting each depository institution's rating is reviewed by the institution's primary supervisory agency examiners. In July 1987, the Board adopted a number of modifications to its daylight overdraft policy, including a two-step, 25 percent reduction in the cross-system net debit caps, thus reducing the maximum daylight overdraft permitted to an individual depository institution (52 FR 29255, August 6, 1987).

As published in Docket #R-0669, elsewhere in today's **Federal Register,** the Board has adopted modifications to its risk reduction program that bring overdrafts resulting from book-entry securities transactions within an institution's cap. Under the Board's book-entry policy, depository institutions with positive caps that frequently exceed their cap by material amounts solely due to book-entry securities activity must collateralize their overdrafts attributable to book-entry securities activity. In addition, financially healthy depository institutions with positive caps may choose to collateralize all or part of their book-entry overdrafts, even if they do not exceed their caps, and such secured book-entry overdrafts shall not be included with those funds or uncollateralized book-entry overdrafts measured against the cap. Moreover, depository institutions that are prohibited by Reserve Banks from incurring overdrafts because of their risk class (or for any other reason other than lack of access to the discount window) may incur book-entry overdrafts, but must provide collateral to the Reserve Bank sufficient to cover book-entry overdrafts of *any* size of frequency. Institutions that have not filed for a cap that incur frequent and material overdrafts due to book-entry transactions will be requested by their Reserve Bank to file for a cap. (Such institutions are not permitted to incur funds overdrafts, even with collateral.) Those depository institutions that do not have access to the discount window will not be allowed to incur funds or book-entry overdrafts, regardless of collateral.

The Board is proposing a separate policy for bankers' banks and corporations organized under section 25(a) of the Federal Reserve Act (12 U.S.C. 611-631) or having an agreement or undertaking with the Board under section 25 of the Federal Reserve Act (12 U.S.C. 601-604a) ("Edge corporations"). Generally, these entities do not have access to the discount window.

Bankers' banks are statutorily exempt from reserve requirements and are excluded from discount window access, although the Board has permitted such

[1] References to depository institutions include trust companies.

[2] Assuming settlement finality is adopted on the Clearing House Interbank Payments System ("CHIPS"), the cap will apply to Fedwire overdrafts only as of January 10, 1991 (see Docket #R-0668, elsewhere in today's Federal Register).

[3] The cap is currently based on adjusted primary capital, but as January 10, 1991, the cap will be a multiple of risk-based capital (see Docket #R-0668, elsewhere in today's Federal Register).

institutions to have access to the discount window if they choose to hold reserves. Some bankers' banks, however, are required by the Federal Reserve to hold clearing balances as a condition of obtaining Federal Reserve payments services. In order to prevent such an institution's Fedwire activity from resulting in an overnight overdraft, the Federal Reserve has imposed a zero cap on bankers' banks.

Edge corporations, like bankers' banks, do not have access to the discount window, but current policy permits Edge corporations to establish a cap and to incur overdrafts within that cap, provided that they post collateral. Historically, Edge corporations and bankers' banks have not incurred book-entry overdrafts of any significant size or frequency. During a four-week sampling of data in August 1989, only two bankers' banks incurred book-entry overdrafts, while only three Edge corporations incurred either a funds or a book-entry overdraft. No Edge corporation exceeded its cap due to book-entry overdrafts.

Nevertheless, their lack of access to the discount window suggests that both bankers' banks and Edge corporations should be made subject to the same policy: prohibition of both funds and book-entry overdrafts. The Board realizes that inadvertent overdrafts, particularly book-entry overdrafts, can occur and may possibly become overnight overdrafts. The Board believes that its policy toward such institutions should include a penalty charge for inadvertent overdrafts that would provide an incentive to bankers' banks and Edge corporations to avoid them.

In this regard, the Board proposes that, should a bankers' bank or an Edge corporation incur an inadvertent daylight overdrft due to either a funds or a book-entry transaction, the Reserve Bank would, absent unusual circumstances, charge the institutions an amount equal to the overnight overdraft penalty fee, levied against the maximum daylight overdraft level. If the daylight overdraft is not fully repaid by the end of the day, an additional amount equal to the overnight overdraft penalty fee would be levied against the overnight overdraft and would be charged to the bankers' bank or Edge corporation. In addition, Edge corporations would be required to hold excess reserves on subsequent days to make up for the reserve shortfall, and, likewise, those bankers' banks that are required to hold clearing balances with the Federal Reserves would be required to hold excess balances on subsequent days. For those bankers' banks that do not hold clearing balances, in addition to the overnight overdraft penalty fee, the bankers' bank would have to hold a clearing balance on subsequent days to offset the deficit to its zero balance account. Reserve Banks would have the ability to waive the daylight and overnight charges, as well as the holding of excess balances, as they do now for overnight overdrafts if, for example, the overdraft results from a Reserve Bank error.

Under the Board's proposal, both bankers' banks and Edge corporations would have to pre-fund their funds *and* book-entry securities activity. This proposal differs from the current policy, which requires bankers' banks to pre-fund their funds transfers but not their receipt of book-entry securities transfers against payment, and does not require Edge corporations to pre-fund at all. The Board is requesting public comment on this change in policy and on the proposals for penalty charges described above.

The Board also requests comment on whether certain other entities should be subject to the same policy as bankers' banks and Edge corporations. For example, a depository institution may have a zero cap imposed by a Reserve Bank because the institution presented the Reserve Banks with excessive risk or because the institution has not complied with the risk reduction program. As noted above, under the Board's policy on book-entry overdrafts, depository institutions with imposed zero caps that have access to the discount window would be able to incur book-entry overdrafts if collateral were posted. Book-entry overdrafts are prohibited for institutions with imposed zero caps and no discount window access. Funds overdrafts are prohibited for all institutions with imposed zero caps.

The Board requests comment on whether the proposed policy for imposed-zero-cap institutions, including trust companies with a zero cap, should be consistent with the policy applied to Edge corporations and bankers' banks. Applying penalty charges to imposed-zero-cap institutions, even those with access to the discount window, would provide an incentive for those institutions to avoid overdrafts, similar to the incentive the Board proposes to impose on Edge corporations and bankers' banks. Under such a policy, Reserve Banks would charge the overnight overdraft penalty fee for (1) the maximum inadvertent daylight funds overdraft incurred by any institution with an imposed zero cap and access to the discount window [4] and, as indicated above, (2) the maximum inadvertent daylight funds *or* book-entry overdraft incurred by any institution with an imposed zero cap and no discount window access.[5] As with Edge corporations and bankers' banks, if the daylight overdraft of an institution with an imposed zero cap is not fully extinguished by the end of the day, the Reserve Bank would charge an additional amount equal to the overnight overdraft penalty fee levied against the overnight overdraft, and the institution would also be required to hold excess reserves on subsequent days to make up for the reserve shortfall. The Reserve Bank would be able to waive the daylight and overnight charges, as well as the balance requirements, at its discretion.

Competitive Impact Analysis

Under its competitive equity policy, the Board assesses the competitive impact of changes that have a substantial effect on payments system participants.[6] The Board believes these modifications to its payments system risk reduction program will have no adverse effect on the ability of other service providers to compete effectively with the Federal Reserve Banks in providing similar services. These modifications place controls on the use of the Federal Reserve Banks' funds and book-entry transfer services, which are consistent with controls used in private clearing and settlement systems.

By order of the Board of Governors of the Federal Reserve System, May 24, 1990.

William W. Wiles,

Secretary of the Board.

[FR Doc. 90-12555 Filed 5-30-90; 8:45 am]

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[Docket No. R-0669]

RIN 7100-AA76

Modifications to the Payments System Risk Reduction Program; Book-Entry Securities Transfers

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy statement.

SUMMARY: As part of its payments system risk reduction program, the

[4] These institutions could incur unlimited collateralized book-entry overdrafts without fees.

[5] Posted collateral would be irrelevant for the fees charged to these institutions.

[6] These assessment procedures are described in the Board's policy statement entitled "The Federal Reserve in the Payments System" (55 FR 11648, March 29, 1990).

Board is adopting a policy to reduce the risks to the Federal Reserve arising from daylight overdrafts associated with transfers of book-entry risk reduction program are:

• Overdrafts arising out of wire transfers of funds and book-entry securities will be combined for purposes of measuring the institution's daylight overdraft against its cap.

• Depository institutions should not exceed their daylight overdraft caps for purposes of funds transfers, but financially healthy institutions with positive caps are permitted to exceed their caps due to book-entry securities activity.

• Depository institutions with positive caps that frequently (more than three occasions in two rolling two-week intervals) exceed their caps by material amounts (in excess of 10 percent or more) solely due to book-entry securities transactions must collateralize their Fedwire overdrafts attributable to such transactions.

• Financially healthy depository institutions with positive caps may choose to collateralize all or part of their book-entry overdrafts, even if they do not exceed their caps, and such secured overdrafts shall be excluded from the calculation of overdrafts subject to the cap.

• Depository institutions should have flexibility in determining the type of collateral to pledge to secure book-entry overdrafts.

• Depository institutions that are assigned a cap of zero by Reserve Banks because of their risks class (or for any other reason other than lack of access to the discount window) may incur book-entry overdrafts but must provide collateral to the Reserve Bank sufficient to cover book-entry overdrafts of *any* size or frequency. Institutions that have not filed for a cap that incur frequent and material overdrafts due to book-entry transactions will be requested by their Reserve Bank to file for a cap. (Such institutions are not permitted to incur funds overdrafts, even with collateral.) Those depository institutions that do not have access to the discount window will not be allowed to incur funds or book-entry overdrafts, regardless of collateral.

EFFECTIVE DATE: January 10, 1991.

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director, Division of Research and Statistics (202/452–3368); Florence M. Young, Assistant Director (202/452–3955) or Lisa Hoskins, Senior Financial Services Analyst (202/452–3437), Division of Federal Reserve Bank Operations; Oliver I. Ireland, Associate General Counsel (202/452–3625) or Stephanie Martin, Attorney (202/452–3198), Legal Division; for the hearing impaired only: Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452–3544).

SUPPLEMENTARY INFORMATION:

Background

The Board's payments system risk reduction program establishes a maximum amount of intraday overdrafts that depository institutions are permitted to incur over both Fedwire and private large-dollar payments systems.[1] The maximum, or cap, is a multiple of a depository institution's capital [2] and is based on a self-assessment of a depository institution's creditworthiness, credit policies, and operational controls. Since the initiation of the policy in 1986, the daylight overdrafts on Fedwire associated with book-entry securities transfers have been exempt from the cap limits, pending development of procedures to bring these intraday credit exposures faced by Reserve Banks within the ambit of the policy.

In June 1989, the Board requested comment on proposed modifications to its payments system risk reduction program, including a proposal to include book-entry related overdrafts in the program (54 FR 26090, June 21, 1989). The Board's proposals were designed to protect the Reserve Banks, while continuing to provide flexibility to depository institutions engaged in clearing U.S. Government securities and other book-entry securities over Fedwire. Specifically, the Board proposed:

• To combine book-entry overdrafts with funds overdrafts to create a combined Fedwire overdraft within the existing cap structure;

• To require depository institutions that frequently exceed their Fedwire cap by material amounts solely because of book-entry securities transfers to collateralize their total Fedwire exposure;

• To use discount window collateral not in use for that purpose held either by the Reserve Bank or the depository institution as the first preferred source of collateral and other asset pools held by the depository institution as the second preferred source of collateral; and

• To use as a final source of collateral, book-entry securities being transferred, in the interim marked on the depository institution's own books, and, in the long run, segregated and valued in real time on the books of the Reserve Bank.

Daylight overdrafts related to the transfer of book-entry securities are growing in size, yet are concentrated in a few depository institutions. The average daily amount of book-entry overdrafts has grown from peak levels of almost $60 billion in early 1988 to almost $90 billion in 1990. The Board believes that this growth in overdrafts may be related to the growth in dealer repurchase activity over the same period. If this assumption is correct, it is unlikely that steps being taken by the industry, such as netting services by the Government Securities Clearing Corporation, will succeed in reducing overdraft levels. Repurchase trading is done for same-day delivery and return early the next morning, and, in the near term, technical difficulties prevent such same-day trades from being netted by the Government Securities Clearing Corporation. Therefore, absent reductions in repurchase trading, larger peak book-entry overdrafts are likely to continue.

Currently, ten depository institutions account for 80 to 85 percent of total book-entry overdrafts, with nearly 75 percent of that total attributable to the three major book-entry clearing banks. The Board believes, therefore, that a policy requiring collateralization of book-entry overdrafts for those depository institutions that exceed their caps due to book-entry overdrafts would affect only a small number of depository institutions engaged specifically in the business of clearing book-entry securities for primary dealers in those securities. This assumption has been borne out by two Federal Reserve surveys in which data on overdrafts were collected during a two-week period in February 1988 and a four-week period ending August 23, 1989. These surveys also support the Board's expectation that combining book-entry overdrafts with funds overdrafts will not measurably reduce the intraday flexibility of the vast majority of depository institutions with positive caps.

Amount of Overdraft

The Board has adopted its proposal that a depository institution's funds and book-entry overdrafts be combined for purposes of determining an institution's

[1] Assuming settlement finality is adopted on the Clearing House Interbank Payments System ("CHIPS"), the cap will apply to Fedwire overdrafts only as of January 10, 1991 (see Docket #R–0668, elsewhere in today's **Federal Register**).

[2] The cap is currently based on adjusted primary capital, but as of January 10, 1991, the cap will be a multiple of risk-based capital (see Docket #R–0668, elsewhere in today's **Federal Register**).

compliance with its cap. To determine whether an institution exceeds its cap due solely to book-entry securities activity, Treasury and government agency book-entry interest payments will be credit to an institution's funds "account" as of the opening of the business day. The net effect of new Treasury issues and Treasury and government agency redemptions will be credited or debited to the institution's book-entry "account" at the opening of the book-entry day. New issues of government agency securities will be reflected in the book-entry "account" as the securities are delivered over Fedwire. Credits and debits from transfers of book-entry securities will be applied to the institution's book-entry "account." If an institution's book-entry "account" is in a net credit position, these credits will be applied to the institution's funds "account." If the book-entry "account" is in a net debit position, a "book-entry overdraft" will be counted as having occurred.

The Board received 83 comments on the issue of combining funds and book-entry overdrafts for purposes of measurement under the cap structure. Eighteen commenters, including the Board's Large-Dollar Payments System Advisory Group, supported the proposal. These commenters generally believed that the overdrafts arising from book-entry securities transfers are an extension of credit and that all extensions of credit by Reserve Banks should be subject to controls.

Sixty-five commenters opposed combining book-entry securities transfers and funds transfers for daylight overdraft measurement purposes. Tweny-nine commenters indicated that the risks associated with funds and book-entry securities overdrafts are different and, therefore, should be treated more flexibly than proposed. Many of these commenters argued that a funds transfer represents the transfer of an asset, but a book-entry securities transfer represents the exchange of assets. Several commenters supported a position taken by the Public Securities Association ("PSA") that the risk presented by book-entry overdrafts is qualitatively different from the risk presented by funds overdrafts, as book-entry overdrafts are fully secured by the underlying securities to which the overdrafts relate. In a joint response, four large clearing banks stated that the risk represented by funds overdrafts is the absolute dollar value of the resulting overdraft, but the risk in book-entry securities deliveries arises from either interest rate volatility or from questions regarding the security interest the Federal Reserve Banks could obtain in such securities. These clearing banks argued that the Board's approach of combining funds and book-entry overdrafts creates serious mismatches between real and perceived risk. Another commercial bank also supported this argument, stating that for banks with moderate to heavy clearing activities, the combination of book-entry and Fedwire overdrafts would overstate the Federal Reserve's true level of risk.

The Board believes, however, that, while the collateralized position of a clearing bank vis-a-vis its customers helps protect that bank against risk, the bank's collateralized position does not necessarily translate into a higher degree of protection for the Reserve Bank. For the Reserve Bank, the risks that intraday exposures may require discount window funding are similar regardless of the type of overdraft or the collateral the clearing bank has taken. Thus, measurement of the total overdraft against the institution's cap is appropriate.

Many commenters argued that another significant distinction between book-entry securities and funds transfers is that receivers of book-entry transfers have no control over the timing of the debit to their account. Because of the sender driven nature of the securities transfer system, the commenters stated that it is virtually impossible for depository institutions to control the level of their overdrafts.

The Board recognizes that the timing of many book-entry overdrafts is uncontrollable, but that intraday book-entry overdrafts, like funds overdrafts, have the potential to become overnight overdrafts. As discussed below, the Board's policy exempts collateralized book-entry overdrafts from cap limits because of the sender-driven nature of the book-entry system and the Board's sensitivity to the markets it supports. The collateralization aspects of the policy are designed to protect Reserve Banks from the very large exposures that can result from the book-entry business.

Several commenters submitted a copy of comments prepared by the Association of Reserve City Bankers, which stated that, in addition to not having any control over the timing of the debit, the availability of real-time information on combined securities and funds overdrafts is limited for smaller banks, making it difficult for them to manage a combined account position. While the statement focuses on the impact to smaller banks, opposition to this aspect of the proposal was received from all types and sizes of book-entry participants. Fifty commenters expressed concern that the costs for depository institutions to develop procedures and computer systems to monitor funds and book-entry overdrafts simultaneously in a real-time environment would be disproportionate to the amount of risk reduction that might be obtained. Many commenters suggested that resources that would otherwise be directed to improving and expanding products and services would likely be reallocated to internal accounting enhancements. One bank holding company stated that additional cross-system monitoring, with the corresponding internal competition for cap resources, could force a bank to address its own funding needs at the expense of its customers' funds movement needs.

Overall, concern was expressed that the Board had underestimated the number of depository institutions that would be affected by this proposal, particularly due to the need to perform intraday tracking of both book-entry and funds positions. Some commenters suggested that the Board should specifically target its proposal to those depository institutions that are directly responsible for the majority of book-entry overdrafts.

Based on its 1988 and 1989 surveys, the Board believes that the policy it has adopted for book-entry overdrafts is narrowly tailored and will effect only a relatively small number of depository institutions. The surveys showed that most institutions are rarely in danger of exceeding their cap, even including book-entry overdrafts. Therefore, additional overdraft tracking should not be necessary for most institutions. Morever, those institutions that do exceed their caps would be able to collateralize their book-entry overdrafts, as discussed below. The Board believes that the policy adopted will allow institutions to minimize internal accounting systems changes. If clearing banks prefer to pledge in-transit securities to the Federal Reserve as collateral for their book-entry overdrafts, as they indicate they will, it should not be difficult for institutions to keep their book-entry business and book-entry collateral operationally separate from their funds business. Should operational or other problems necessitate an institution's borrowing from the discount window to avoid an overnight overdraft, overdrafts arising from the funds business could be coverd separately with available discount window or other pools of collateral, while book-entry overdrafts could be secured with in-transit securities. On an intraday basis, this approach could result in some amount of over-collateralization, but it should not be operationally costly or cumbersome.

Twenty-nine commenters expressed concern that the integration of book-entry overdrafts into the existing cap structure may ultimately have an adverse effect on daily Fedwire traffic because the size of those overdrafts is so substantial. Several commenters asserted that the analysis did not adequately recognize the interdependencies of the various securities markets (as well as the participants in those markets) and, therefore, did not address the problems connected with differences in settlement times. In addition, 13 commenters suggested that the proposal created an incentive for large banks to reject incoming transfers arbitrarily to avoid an overdraft.

The Board does not believe that combining book-entry and funds transfers under one cap will have significant adverse effects on Fedwire operations. Very few depository institutions have high cap utilization rates, even after the inclusion of book-entry overdrafts. For the handful that do, their ability to incur collateralized book-entry overdrafts in excess of cap, as discussed below, should prevent serious settlement timing delays in the various securities markets. The Reserve Banks will continue to monitor the book-entry transfer system and will take action to discourage arbitrary rejections by book-entry recipients and other abuses of the system.

Collateralization Requirement

The Board has adopted a modified version of its proposed policy on collateralization. Financially healthy depository institutions with positive caps that frequently exceed their cap by material amounts solely due to book-entry transfers will be required to collateralize all of their book-entry overdrafts, rather than their total funds and book-entry overdrafts as initially proposed. The Board has defined "frequently" to mean more than three occasions in two rolling two-week intervals and "material amounts" to mean in excess of 10 percent or more of cap. For example, a depository institution that meets the "frequent" and "material" tests and has a $50 million cap and a $70 million overdraft—$30 million due to funds transfers and $40 due to book-entry securities transactions—will be required to collateralize the entire $40 million of book-entry overdrafts.

In addition, all financially healthy depository institutions with positive caps may choose to collateralize all or part of their book-entry overdrafts, even if they have not exceeeded their caps, and such secured overdrafts shall not be included with those overdrafts measured against their caps. For example, a financially healthy depository institution with a $50 million cap and a $30 million overdraft—$15 million due to funds transfers and $15 million due to book-entry securities transfers—would ordinarily have excess cap of $20 million. Such an institution may increase its excess cap by $15 million by collateralizing all of its book-entry overdrafts (or may increase its excess cap by less than $15 millin by collateralizing some portion of its book-entry overdrafts). Such an institution may not increase its cap of $50 million by over-collateralizing its book-entry overdrafts or by collateralizing any part of its funds overdraft.

The Board received 75 comments on its proposal requiring depository institutions that frequently exceed their Fedwire caps by material amounts solely due to book-entry transactions to collateralize their total Fedwire exposure. Seventeen commenters supported the proposal. The Large-Dollar Payments System Advisory Group agreed with the proposal and suggested that it represented a positive step in meeting some of the primary goals of the payments system risk reduction program, such as encouraging the development to changes in market practices designed to reduce risk and providing adequate protection to the individual Reserve Banks for the risk posed by book-entry transactions.

Fifty-eight commenters strongly opposed the requirement that the total Fedwire exposure be fully collateralized by depository institutions that exceed their caps due to book-entry activity. One-third of these commenters, the clearing banks in particular, argued that collateralization of total funds transfer and book-entry daylight overdrafts represents an unfair burden. The New York Clearing House Association stated that the cap represents the level of risk that the Federal Reserve has judged prudent for it to accept on an unsecured basis during the day and that those institutions whose business requires them to exceed their caps regularly should not be required to forego the benefit of unsecured credit up to the cap.

Although the clearing banks may have sufficient collateral in a stable pool, PSA and the clearing banks stated that the total collateralization requirement would place an unfair burden on the funds transfer business of depository institutions that choose to be clearers of securities on a large scale vis-a-vis those institutions that provide funds clearing services only. These commenters stated that securities clearing banks would have to bear the burden of collateralizing the total overdraft, including both the book-entry securities portion and the funds portion. Many of these commenters suggested that, if the Board pursued the consolidated cap approach to monitoring and controlling daylight overdrafts, collateralization should be imposed only on that portion of the overdraft that is in excess of the cap.

The Board recognizes that some commenters perceived that proposed policy to be restrictive and discriminatory, given the large unsecured funds exposures permitted to some depository institutions with large caps, albeit because of their capital, that would be unaffected by the proposed book-entry program. Because of the importance of maintaining a liquid and efficient government securities market, the Board wished to adopt a policy that could generally be supported and implemented by clearing banks. Therefore, the Board has revised its proposal and adopted a policy to require collateralization of only the book-entry portion of an institution's overdraft.

Under the policy adopted by the Board, financially healthy depository institutions would be allowed to exceed their cap with collateralized book-entry overdrafts. The major risk addressed by requiring collateral is that the institution may experience an operational outrage. Operational problems can cause book-entry overdrafts to increase dramatically, but the incoming securities that cause these exposures can be pledged to Reserve Banks to cover the overdraft. Operational problems related to funds transfers, on the other hand, usually prevent an institution from sending payments. As a result, funds transfer overdrafts tend to decline when operational problems occur. Thus, a Reserve Bank will be able to protect itself fully against most operational risks if it requires collateral only for book-entry overdrafts.

This policy assumes that, while a book-entry operational problem is occurring, the normal reserve position management function of the clearing bank remains unaffected and funds overdrafts are extinguished as usual. In the event this does not happen, the Reserve Bank may experience exposures that are not fully secured. This problem will be addressed in an ad hoc way, however, by allowing Reserve Banks to increase the amount of collateral held for discount window purposes over current, already sizeable, amounts. In practice, institutions usually keep sufficient collateral at Reserve Banks to cover their funds overdrafts. Given current levels of discount window collateral, it is likely that Reserve Banks would have the same amount of collateral available when it is actually needed under either the proposed or the final policy.

Twenty-one commenters indicated that the vagueness of the proposal's criteria, "frequently exceeds" and "material amounts," could result in different treatment of depository institutions across Federal Reserve districts. Many commenters were concerned that the proposal would be administered differently by each of the Reserve Banks resulting in an unlevel playing field. The Large-Dollar Payments System Advisory Group strongly recommended that the Board work with the Reserve Banks to develop more specific guidelines as to the patterns of overdrafts that would trigger the collateralization requirements, and more importantly, to ensure consistent administration of the policy across all depository institutions. Although the likelihood of differences in application among Reserve Banks is small, the Board has set definitive standards for these levels. The Board has defined "materiality" as 10 percent or more in excess of cap due to book-entry overdrafts and has defined "frequent" overdrafts to be those experienced on more than three days in any rolling 20-day period (two 2-week intervals).

Forty-one commenters indicated that the costs associated with collateralizing the combined overdraft would be substantial and would have an adverse impact on depository institutions' profitability. Many depository institutions would incur direct expenses for the development of new collateral monitoring systems as well as indirect expenses related to acquiring and pledging the required collateral.

Both custodian banks and clearing banks were generally concerned that the proposal would ultimately affect their ability to raise funds. The custody banks argued that they would have to acquire new collateral or divert portfolio securities (used for repurchase agreements or as collateral for public funds) to provide the necessary collateral for daylight overdraft purposes. The clearing banks, on the other hand, were concerned about the potential reaction in credit markets to the use of major blocks of the clearing banks' own assets to collateralize a single line of business (e.g., book-entry securities transfers). Overall, commenters argued that such costs would be passed on to depository institution customers and, ultimately, to the Treasury. Approximately 28 percent of these commenters believed that the Board's proposal would result in some form of "tax" on Treasury securities.

The Board believes that the burden of providing collateral is limited, as collateral routinely available for discount window purposes by the affected institutions would more than cover their funds transfer overdrafts as measured under the current policy. Thus, the cost impact of the new policy will likely be low, given that a large part of the book-entry portion of total Fedwire overdrafts can be collateralized by book-entry securities in transit.

Generally, the commenters supported collateralizing those overdrafts that result directly from book-entry transfers, because this approach builds on existing systems and business practices. As an alternative proposal, several commenters supported allowing depository institutions, at their option, either: (1) To combine both funds and book-entry exposures under their existing caps and agree to operate within those caps, or, (2) to collateralize the book-entry overdraft (no matter how large or frequent), continue to exempt this collateralized book-entry overdraft from measuring compliance with the cap and, as now, use the unsecured cap overdraft amounts solely for their funds businesses.

Under the policy adopted by the Board, all depository institutions, not just those with book-entry overdrafts above their caps, may choose to collateralize all or part of their book-entry overdrafts. Any collateralized book-entry overdrafts would be removed from consideration against the cap, thereby leaving those institutions' funds transfer flexibility unchanged. This policy allows institutions to gain cap headroom through collateralization of book-entry overdrafts, even when those institutions are not engaged in large-scale book-entry clearing businesses.

Collateralization Procedures

The Board has adopted a policy that will give depository institutions flexibility as to the specific type of collateral that must be pledged to secure book-entry overdrafts. The Reserve Banks will not give preference, as proposed in June 1989, to a particular type of collateral, such as securities in transit, discount window collateral, or stable pools of collateral, unless such preference is desired by the depository institution. All collateral must be acceptable to the Reserve Bank.

Many commenters were critical of the preferences indicated in the proposal as to the type of collateral, and to the ways in which intraday pledges of book-entry securities would be made. The proposed order of priority reflected both the desire first to take collateral in which interests can be perfected most easily, and the fact that earlier Board book-entry proposals had been criticized because of a stated unwillingness to use stable pools of collateral.

Although several commenters supported the proposal's flexibility in allowing the Reserve Banks to customize each depository institution's collateral requirements, many more were concerned about the possibility of inconsistent treatment of depository institutions across districts. One large commercial bank stated that customizing a mixed collateral program on a case-by-case basis would be difficult to implement without fostering trade-offs between the business needs of the depository institution and the need to protect its Reserve Bank.

Several commenters expressed reservations about using a stable pool of collateral as the preferred method of securing daylight overdrafts. The custody banks were generally concerned because most of their portfolio securities are already pledged for other purposes and remaining securities activity is composed of a substantial amount of custodial and fiduciary transactions, which involve non-pledgeable customer securities.

It was not the intent of the proposal to be as rigid as it was interpreted by commenters. It was the Board's desire to work with each depository institution to determine the best mix of types of collateral for that institution. The Board has clarified its policy to indicate a willingness to start the collateralization identification process with book-entry securities in transit, and to fill in with other collateral, such as discount window collateral and other stable pools, where in-transit collateral is not adequate.

Of the 49 commenters that discussed the pledge of book-entry securities in-transit, 39 supported the use of incoming book-entry securities as collateral. Few of these commenters, however, agreed with the Board's interim procedures for marking book-entry securities collateral on the depository institution's own books. Commenters stated that the proposal did not identify the types of records, the frequency, or the level of detail to be kept by the depository institution.

PSA argued that the clearing banks already have established control mechanisms to minimize the risk exposure to themselves arising from book-entry overdrafts and to collateralize the repayment of advances. The Board's proposal would, in effect, superimpose another collateral system at the clearing bank level. To avoid this "duplicative" effort, PSA and the clearing banks suggested a system under which the Reserve Bank would take an assignment of the clearing bank's secured extension of credit to each dealer. The "additional layer of controls" presented in the proposal was of concern to most of the primary dealers because of the potential that one dealer-customer's securities might be used as collateral for an overdraft caused by another customer ("horizontal risk") or as a result of the clearing bank's own activities ("vertical risk").

Under the system suggested by PSA, however, the Reserve Bank would not have a better position than the clearing bank vis-a-vis dealer/customer securities delivered against payment. The Reserve Bank's interest in the dealer's proprietary securities or fully-paid customer securities would be limited to the amount of clearing credit extended by the clearing bank. Moreover, if there were some defect in the clearing bank's security interest or the dealer or its customer had some defense against the clearing bank, that defect or defense could be raised against the Reserve Bank.

The Board believes this approach has the potential to impose substantial risk on a Reserve Bank. That risk could be reduced only by intrusion into the clearing bank-dealer/customer relationship. The Board also believes that there are steps, such as agreeing to use collateral sources other than in-transit securities as a cushion against cross-collateralization, that could be taken to reduce risk of cross-collateralization to dealers.

Twenty-three commenters representing a variety of book-entry participants were concerned about the legal obstacles involved with pledging certain customer-owned securities. Although many commenters suggested that the underlying securities might be the most appropriate form of collateral for book-entry overdrafts, it was clearly recognized that the development of systems capabilities to segregate customer securities received but not yet paid for will take a long time. Furthermore, roughly 15 percent of all commenters suggested that the Board encourage the implementation of Treasury's TRADES regulations, which would provide the Reserve Banks with a "super lien" on book-entry securities in transit.

Under the policy adopted by the Board, securities in transit that are being pledged to Reserve Banks to collateralize depository institution overdrafts are, in the interim, to be marked on the books of the depository institution. The Federal Reserve is working with the major clearing banks and dealers, the Treasury, and the Public Securities Association in formulating a pledge agreement covering securities in transit that will address the concerns raised by the commenters without imposing substantial risk on the Reserve Banks or intruding into the relationships between clearing banks, dealers, and their customers.

The in-transit pledge on the institution's own books is an interim step until better automation capabilities are available to allow such pledges to be recorded on Reserve Bank books. The Federal Reserve is currently studying alternatives to deal with book-entry risk on an operational basis, and plans to implement a new system by the mid-nineties.

Other Book-Entry Issues

Currently, there are many depository institutions with small (*de minimis*) caps, zero caps imposed by Reserve Banks because of the institution's financially troubled status or because of Board policy, zero caps adopted at the request of the institution, or no cap as a result of not filing for a cap. Under the old policy, none of these institutions have had a prohibition or limit on book-entry overdrafts, but, under the newly-adopted policy, about 125 of them would exceed their zero or small caps, wholly or in part, due to book-entry overdrafts on at least one day.

Because the timing of book-entry overdrafts and, hence, their size, are beyond the control of the depository institution incurring the overdraft, and given the current policy that requires collateral from weak depository institutions, the Board has developed a separate policy for those institutions currently prohibitied from funds overdrafts or restricted to small cap levels. The Board will allow those institutions with zero caps that have access to the discount window to continue to incur book-entry overdrafts, but will require collateralization even if such overdrafts are infrequent and modest. (The Board has requested comment on penalty fees for inadvertent overdrafts incurred by institutions with imposed zero caps. See Docket #R-0693, elsewhere in today's **Federal Register**.) Institutions that have not filed for a cap that incur frequent and material overdrafts due to book-entry transactions will be requested by their Reserve Bank to file for a cap. (Such institutions are not permitted to incur funds overdrafts, even with collateral.) Those depository institutions that do not have access to the discount window will not be allowed to incur funds or book-entry overdrafts, regardless of collateral.

Competitive Impact Analysis

Under its competitive equity policy, the Board assesses the competitive impact of changes that have a substantial effect on payments system participants.[3] The Board believes these modifications to its payments system risk reduction program will have no adverse effect on the ability of other service providers to compete effectively with the Federal Reserve Banks in providing similar services. These modifications place controls on the use of the Federal Reserve Banks' funds and book-entry transfer services that are consistent with controls used in private clearing and settlement systems, and, if anything, would have a positive impact on competitors in these services.

By order of the Board of Governors of the Federal Reserve System, May 24, 1990.

William W. Wiles,

Secretary of the Board.

[FR Doc. 90-12553 Filed 5-30-90; 8:45 am]

BILLING CODE 6210-01-M

[Docket No. R-0668]

RIN 7100-AA76

Modifications to the Payments System Risk Reduction Program; Caps and Measures of Capital for U.S. Chartered Depository Institutions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy statement.

SUMMARY: As part of its payments system risk reduction program, the Board is adopting a policy governing daylight overdraft caps, including measures of capital, for U.S. chartered depository institutions. Specifically, the policy will:

• For the purpose of calculating maximum permissible daylight overdrafts, replace "adjusted primary capital" with "qualifying" or similar capital measures that include those capital instruments that satisfy risk-based capital standards;

[3] These assessment procedures are described in the Board's policy statement entitled "The Federal Reserve in the Payments System" (55 FR 11648, March 29, 1990).

• Eliminate Clearing House Interbank Payments System ("CHIPS") net debits from the cross-system cap, provided that implementation of settlement finality has been adopted by CHIPS;

• Excuse financially healthy U.S. chartered depository instutitions that rarely incur Fedwire overdrafts in excess of the lessor of $10 million or 20 percent of their capital from filing board-of-directors' resolutions or self-assessements with their Reserve Banks; and

• Create a revised *de minimis* cap category to permit U.S. chartered depository institutions a daily cap equal to 20 percent of capital with a board-of-directors' resolution but no self-assessment.

EFFECTIVE DATE: January 10, 1991.

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director, Division of Research and Statistics (202/452-3368); Bruce J. Summers, Associate Director (202/452-2231) or Florence M. Young, Assistant Director (202/452-3955), Division of Federal Reserve Bank Operations; Oliver I. Ireland, Associate General Counsel (202/452-3625) or Stephanie Martin, Attorney (202/452-3198), Legal Division; for the hearing impaired *only*: Telecomunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-3544).

SUPPLEMENTAY INFORMATION:

Background.

In April 1985, the Board adopted a policy to reduce the risks that large-dollar payments systems, including Fedwire, present to the Federal Reserve, to the depository institutions using them, to the banking system, and to other sectors of the economy (52 FR 21120, May 22, 1985). This policy in effect, established a maximum amount of intraday funds overdrafts, or intraday credit exposure, that depository institutions are permitted to incur over both Fedwire and private large-dollar payments systems. The maximum, or cap, is a multiple of a depository institution's adjusted primary capital and is based on the depository institution's self-assessment of its own creditworthiness, credit policies, and operational controls. The guidelines for performing the self-assessment were established by the Board, and the documentation supporting each depository institution's rating is reviewed by the institution's primary supervisory agency examiners. In July 1987, the Board adopted a number of modifciations to its daylight overdraft policy, including a two-step, 25 percent reduction in the cross-system net debit caps, thus reducing the maximum daylight exposure that an individual depository institution could incur (52 FR 29255, August 6, 1987).

In June 1989, the Board requested comment on further modifications to its payments system risk reduction program (54 FR 26094, June 21, 1989). The Board proposed to: (i) Establish a program for pricing the daily average value of all Fedwire ovedrafts in excess of a deductible, (ii) revise the definition and measurement of daylight overdrafts to facilitate pricing, (iii) exempt from filing for caps those depository institutions with relatively small overdrafts, (iv) use risk-based capital as the factor to which cap multiples would be applied, and (v) exclude from the measurement of cross-system net debit caps net debits on CHIPS after CHIPS implements settlement finality. As described below, the Board has adopted policies, essentially as proposed, regarding caps, capital, and CHIPS net debits for domestically-chartered depository institutions. The Board expects to take action on pricing and overdraft measurement in the near future.

Although the Board originally proposed that changes regarding CHIPS net debits and caps would be conditional on the changes in overdraft measurement, the Board has adopted these changes independently. The CHIPS net debits and cap proposals were generally supported by commenters, ease the burden on depository institutions, and cause only limited increase in Reserve Bank or systemic risk.

In related dockets, the Board's June 1989 proposals included modification to its risk reduction policies concerning book-entry securities (54 FR 26090, June 21, 1989) and branches and agencies of foreign banks (54 FR 26108, June 21, 1989). The final versions of these policies, as well as a request for comment concerning the overdraft policy applicable to bankers' banks and Edge corporations, are discussed elsewhere in today's **Federal Register**.

Capital

The Board has adopted its proposal to replace, for the purpose of calculating maximum permissible daylight overdrafts, "adjusted primary capital" with "qualifying" or similar capital measures that include those capital instruments tht can be used to satisfy risk-based capital standards. Depository institutions that choose to access Fedwire through multiple accounts will continue to be required to allocate their capital for daylight overdraft purposes to each Reserve Bank at which they incur overdrafts, and one Reserve Bank will continue to have overall risk-management responsibilities. (Capital for foreign banks is discussed in Docket No. R-0670, elsewhere in today's **Federal Register.**)

The Board's policy is consistent with the newly-adopted international capital standards (see 54 FR 4186, January 27, 1989). The international risk-based capital guidelines will begin to be phased in at the end of 1990, and the new capital measurement for daylight overdraft cap calculation will become effective Janaury 10, 1991. In 1990, all of the federal financial regulatory agencies will begin collecting, as part of their required reports, data on the amount of capital that can be used for risk-based purposes—"qualifying" capital for commercial and savings banks, "risk-based" capital for savings and loan associations, and total regulatory reserves for credit unions.[1] Other U.S. chartered entities incurring Fedwire overdrafts would have to provide similar data to their Reserve Banks.

Nineteen commenters supported the proposal to use risk-based capital to calculate caps. These commenters indicated that the change appeared to be appropriate given that risk-based capital would be used for other future regulatory purposes. Three commenters suggested moving to risk-based capital at an early stage so that, for those institutions with risk-based capital larger than adjusted primary capital, caps would expanded to "make room" for book-entry overdrafts. Two commenters, however, had reservations about this change. One large commercial bank stated that, for many institutions, risk-based capital will be less than the adjusted primary capital on which caps are based today. The Independent Bankers Association suggested that the risk-based capital system was too new to be used as the basis for calculating caps.

According to a survey taken by the Federal Reserve during a four-week

[1] The minimum ratio of qualifying capital to risk-weighted assets for U.S. chartered commercial and savings banks will be 7.25 percent at the end of 1990 and 8 percent by the end of 1992. The maximum allowance for loan loss included in Tier II capital will decline from 1.5 percent of risk-weighted assets at the end of 1990 to 1.25 percent at the end of 1992. Of the 3.625 percentage points of the Tier I capital requirement at the end of 1990, 3.25 points must be stockholders equity; by the end of 1992, stockholders equity must account for all 4 percent of Tier I capital. Rules for savings and loan associations will be similar with a similar schedule, although a declining amount of supervisory goodwill will be permitted for these institutions until 1995, as mandated by Congress. In contrast to the bank and other thrift risk-based capital, National Credit Union Administration rules permit the inclusions, without limit, of loan and investment loss reserves for credit unions.

period ending August 23, 1989, the impact of the shift to risk-based capital will likely be modest. Most of the 343 domestic depository institutions that would have been subject to caps during the survey period under the Board's new policy would have had their caps raised by the shift to risk-based capital. Approximately 20 percent of the 317 banks and 40 percent of the 26 thrift institutions would have had their caps reduced under the risk-based capital standards. The banks whose caps would have declined, including some of the larger overdrafters, had relatively large loan loss reserves, only a portion of which would be eligible for inclusion in Tier II capital. Most of the negatively affected thrifts were credit unions with modest overdrafts. Four of the 343 depository institutions would have experienced a significant increase in their cap utilization rates, although they would have incurred only modest levels of overdrafts, even with the inclusion of book-entry overdrafts. Given the limited impact of risk-based capital standards on the ability of most depository institutions to incur daylight overdrafts under the Board's cap policy and the scheduled adoption of these standards by the federal financial regulatory agencies, the Board has adopted its proposed risk-based capital standards for cap calculation purposes.

CHIPS Net Debits

The Board has adopted its proposal to eliminate CHIPS net debits from the cross-system cap, provided that implementation of settlement finality is adopted by CHIPS by January 10, 1991. Effective on that date, if CHIPS settlement finality is in place, an institution's cap will be applied only to total Fedwire overdrafts that are subject to cap.

The New York Clearing House is scheduled to implement settlement finality among CHIPS participants in the third quarter of 1990. Subsequently, should a CHIPS participant be unable to settle its net debit position at the close of a business day, each participant has agreed to cover the failed participant's position on the basis of a pre-arranged allocation formula; collateral will be pledged by each participant to assist in insuring that it will fund this settlement commitment. In short, CHIPS settlement on any day will be assured even if a large participant fails. In addition, this program should give rise to incentives for all CHIPS participants to be more risk-sensitive when they extend intraday credit limits to their CHIPS counterparties because these limits will establish their potential losses should that counterparty fail.

Fifteen commenters, generally large commercial banks, agreed with the exclusion of CHIPS net debits from the determination of compliance with caps. One commenter that supported the change emphasized that CHIPS net debits should be excluded only after settlement finality is adopted because of the likely migration of payments to CHIPS from Fedwire as a result of proposed Fedwire overdraft fees. Another commenter expressed concern about the ability of CHIPS to handle the expanded payments volume.

The proposed pricing of Fedwire overdrafts may cause institutions to shift payments from Fedwire, with it settlement finality, to CHIPS. The systemic risk associated with such a shift, however, is significantly diminished by CHIPS settlement finality, loss allocation, and the resulting enhanced risk sensitivity of CHIPS participants. CHIPS settlement finality is consistent with the Board's goal to induce participants in the payments system to limit their own risk exposures without creating Federal Reserve risk or significant systemic risk. Such actions by payments system participants reduce the necessity for Board policies limiting private daylight credit exposure.

Over 100 (mostly foreign banks) of the 140 CHIPS participants would not benefit from the exclusion of CHIPS net debits from the cap because they do not incur Fedwire overdrafts, have very low net debits, or are net creditors on CHIPS. The policy would benefit 35 large net debtors on CHIPS, that will no longer need to reduce their Fedwire cap by the amount of their CHIPS net debits. The increased Fedwire capacity for approximately 90 percent of these 35 institutions, however, will be less than 10 percent.

Five commenters opposed the change, citing the prudential benefits from greater Federal Reserve supervision and control of total overdrafts under the current system. Information on individual bank positions on CHIPS will continue to be made available on a daily basis to the Federal Reserve, facilitating prudential review of cross-system net debits. On balance, the Board believes that such review will be a sufficient replacement for the current policy after the new CHIPS rules become effective.

Two commenters raised the issue of the unsettled legal status of netting arrangements and requested the Board's assistance in obtaining clarifying legislation. The Board generally supports the concept of multilateral netting, and Federal Reserve staff is currently reviewing proposed netting legislation.

Exemptions

The Board has adopted a policy, as proposed, to excuse financially healthy U.S. chartered depository institutions that only rarely incur Fedwire overdrafts in excess of the lesser of $10 million or 20 percent of their capital from filing board-of-directors' resolutions or self-assessments with their Reserve Banks. This dual test is designed to limit the exclusion to depository institutions that create only low-dollar risks to the Reserve Banks and to those institutions that incur small overdrafts relative to the institution's capital.

Reserve Banks will review the status of exempt depository institutions that incur total Fedwire overdrafts in excess of $10 million or 20 percent of capital on more than two days in any two rolling two-week intervals and will decide if the exemption should be maintained or if the institutions will be required to file for a cap. Even for depository institutions meeting these size and frequency standards, the exemption would be granted at the discretion of the Reserve Bank. The Reserve Bank may choose to limit its own risk exposure by unilaterally imposing collateral requirements and/or a lower cap or a zero cap. A depository institution on which a Reserve Bank has imposed a zero cap, whether or not it has access to the discount window, will be prohibited from incurring funds transfer-related overdrafts. A depository institution with an imposed zero cap that has access to the discount window may incur collateralized book-entry overdrafts, but institutions with imposed zero caps and no discount window access may not incur book-entry overdrafts. Depository institutions with access to the discount window are free to file for a cap if they choose to do so and will be required to do so if they begin to exceed their exemption limits. (The Board has requested comment on penalty fees for inadvertent overdrafts incurred by institutions with imposed zero caps. See Docket #R-0693, elsewhere in today's **Federal Register.**)

There was no opposition to this proposal from the commenters. The proposal was generally viewed by the commenters as a reduction in burden that will not increase payments system risk. The Independent Bankers Association suggested that the Board go further and exempt all banks with assets of less than $500 million because the risk level they create for the Federal Reserve is small. During the August 1989 test period, 120 of the 343 nonexempt institutions had assets of less than $500 million; these institutions accounted for only $510 million of the $109.3 billion of the total Fedwire overdrafts of nonexempt institutions. Despite the modest aggregate risk caused by these 120 institutions, the Board believes they should be subject to self-assessment and caps. Exemptiong entities by size of institution is not indicative of the risk of overdrafts to the individual institution and would be inequitable for larger institutions with similar relative overdraft exposure.

The Board expects that this policy will result in a reduced burden to many institutions with only a marginal increase in direct Federal Reserve risk. During the August 1989 test period, 4,015 of the 4,358 depository institutions' Fedwire overdrafts were within the size and frequency tests established to qualify as exempt from filing a cap, yet those institutions accounted for less than 0.7 percent of aggregate Fedwire overdrafts. No exempt institution exceeded the exemption levels on more than two days during the 20-day test period, and most of the exempt institutions met the exemption criteria on each day of the test period. Moreover, most of the dollars of overdrafts were incurred by depository institutions that exceeded the exemption criteria very often; over 85 percent of the nonexempt overdrafts were incurred by 80 institutions that exceeded the exemption level each day in the test period.

De Minimis Caps

The Board has, as proposed, created a revised *de minimis* cap category, which permits U.S. chartered depository institutions to incur daylight overdrafts equal to 20 percent of capital, if a board-of-directors' resolution is submitted. No self-assessment is required for this cap category. This replaces the pre-existing *de minimis* cap category that imposed, in addition to a percent of capital constraint, both a $500,000 limit and a frequency limit. The Board received 22 comments on the *de minimis* cap proposal, all in support of the proposal.

As in the case of the exempt from filing category, Reserve Banks will have the discretion to limit their own risk exposure from *de minimis* institutions by imposing unilateral collateral requirements and/or a lower cap or a zero cap. *De minimis* institutions will be required to file for a higher cap (and do a self-assessment) if their overdrafts begin to exceed 20 percent of capital. Reserve Banks will review the status of *de minimis* cap institutions that exceed their cap on more than two days in any rolling two-week period and will decide if the *de minimis* cap should be maintained or if the institution will be required to file for a higher cap.

The new *de minimis* cap differs from the exemption category in that, in exchange for a board-of-directors' resolution by *de minimis* depository institutions) not required of exempt institutions), the $10 million limit imposed on exempt institutions will not apply to *de minimis* institutions. Thus, larger institutions that restrain their daily overdrafts to 20 percent or less of their capital will not have to do a full self-assessment.

Competitive Impact Analysis

Under its competitive equity policy, the Board assesses the competitive impact of changes that have a substantial effect on payments system participants.[2] The Board believes these modifications to its payments system risk reduction program will have no adverse effect on the ability of other service providers to compete effectively with the Federal Reserve Banks in providing similar services. These modifications place controls on the use of the Federal Reserve Banks' funds and book-entry transfer services that are consistent with controls used in private clearing and settlement systems.

By order of the Board of Governors of the Federal Reserve System, May 24, 1990.

William W. Wiles,

Secretary of the Board.

[FR Doc. 90-12552 Filed 5-30-90; 8:45 am]

BILLING CODE 6210-01-M

[2] These assessment procedures are described in the Board's policy statement entitled "The Federal Reserve in the Payments System" (55 FR 11648, March 29, 1990).

[Docket No. R-0670]

RIN 7100-AA76

Modifications to the Payments System Risk Reduction Program; U.S. Agencies and Branches of Foreign Banks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy statement.

SUMMARY: As part of its payments system risk reduction program, the Board is adopting a policy that will allow certain U.S. agencies and branches of a foreign bank an uncollateralized daylight overdraft cap equal to their cap multiple times a U.S. capital equivalency equal to 10 percent of the bank's worldwide capital, provided the foreign bank's home country supervisor adheres to the Basle Capital Accord. All other foreign banks will continue to use the current U.S. capital equivalency to determine their uncollateralized caps. All measures of uncollateralized caps are conditioned on U.S. funding capability and potential eligible collateral satisfactory to the administering Reserve Bank. Regardless of their uncollateralized cap, all U.S. agencies and branches of foreign banks may incur collateralized funds overdrafts up to their cap multiple times 10 percent of their worldwide capital, and all may incur unlimited collateralized book-entry overdrafts.

EFFECTIVE DATE: January 10, 1991.

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director, Division of Research and Statistics (202/452-3368), Charles P. Thomas, Economist, Division of International Finance (202/452-3698); for the hearing impaired *only*: Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-35440).

SUPPLEMENTARY INFORMATION:

Background

In April 1985, the Board of Governors adopted a policy to reduce risk on large-dollar payments systems. This policy, implemented in March 1986, established a maximum amount of intraday funds overdrafts that depository institutions are permitted to incur over both Fedwire and private large-dollar payments systems [1]. The maximum, or cap, for U.S. chartered institutions, is a multiple of the institution's capital [2] and is based on a self-assessment of a depository institution's creditworthiness, credit policies, and operational controls. In July 1987, the Board adopted a number of modifications to the daylight overdraft policy, including a two-step, 25 percent reduction in the cap, thus reducing the maximum daylight overdrafts permitted to individual depository institutions. [3]

Like U.S. chartered banks, foreign banks operating in the U.S. through agencies and branches ("foreing banks") are required to perform a self-assessment and obtain a board-of-directors' resolution to establish a cap

[1] Assuming settlement finality is adopted on the Clearing House Interbank Payments System ("CHIPS"), the cap will apply to Fedwire overdrafts only as of January 10, 1991 (see Docket #R-0670, elsewhere in today's **Federal Register**).

[2] The cap is currently based on adjusted primary capital, but as of January 10, 1991, the cap will be a multiple of risk-based capital (see Docket #R-0668, elsewhere in today's **Federal Register**).

[3] These reductions became effective in January and May 1988. See 52 FR 29255 (August 6, 1987).

multiple. Although foreign banks have been allowed to apply that cap to worldwide capital to establish their cross-system caps (for Fedwire and CHIPS net debits combined) and their collateralized Fedwire caps, their uncollateralized Fedwife funds cap [4] is the product of their cap multiple and their much smaller "U.S. capital equivalency." [5] In 1987, the Board considered and determined not to amend the definition of U.S. capital equivalency.[6] At the request of several foreign banks, however, the Board requested comment again in June 1989 on alternative methods of determining Fedwire caps for foreign banks.[7] Specifically, the Board proposed:

• To continue the policy of allowing uncollateralized Fedwire overdrafts up to a Fedwire cap based on a cap multiple times U.S. capital equivalency, but requested comment on the appropriate measure of U.S. equivalency;

• To broaden the definition of Fedwire overdrafts to include those resulting from book-entry securities transfers as well as funds transfers; and

• To continue the policy of allowing Fedwire overdrafts up to a cap based on the cap multiple times worldwide capital, but to require that the total Fedwire overdraft be collateralized, not just the amount over the Fedwire cap, whenever the overdraft is in excess of the Fedwire cap because of book-entry overdrafts.

The activity of foreign banks on both CHIPS and Fedwire has grown rapidly since 1986 when the Board's daylight overdraft policy was implemented. Foreign banks' net debits on CHIPS account for twice that of U.S. banks, as CHIPS is used mainly for Eurodollar and foreign exchange settlement. Foreign banks account for a much smaller proportion of Fedwire funds overdrafts, in part because of their low Fedwire caps. The overdrafts of foreign banks on both networks are highly concentrated. In 1989, 20 foreign banks accounted for over half of all foreign bank net debits on CHIPS, while five accounted for a similar proportion of the foreign bank overdrafts on Fedwire and 20 accounted for 97 percent of such overdrafts.

In developing its daylight overdraft policy for foreign banks, the Board has taken into consideration the fact that most of a foreign bank's assets and liabilities are located and controlled outside of the United States and are not under supervisory review by U.S. authorities. Moreover, the level of dollar payments of many foreign banks is quite substantial relative to their assets in the U.S., their deposits at the Federal Reserve, and their U.S. money market funding capacity.

Consequently, there appear to be practical limits on the ability of financially healthy and well-supervised foreign banks to raise dollars at very short notice in the U.S. market to meet liquidity needs in the event of credit or operational problems. Moreover, although both U.S. and foreign banks are expected to rely on their own resources or their private market funding capacity to meet liquidity needs, unusual circumstances may require access to the discount window and the provision of adequate eligible collateral.

In short, the geographic location of assets, limited U.S. supervision, the relative size of dollar flows, limits on U.S. funding capacity, and limits on discount window collateral, all played a role in the Board's previous policies to limit Fedwire overdrafts by even well-capitalized foreign banks. At the same time, by basing the cross-system cap on worldwide capital, previous policies provided foreign banks substantial flexibility to function their payments through CHIPS in an institutional framework in which other banks make a commercial judgment about the credit and liquidity capabilities of the foreign bank through imposition of bilateral credit limits and CHIPS-specific debit caps.

U.S. Capital Equivalency and Caps

The Board received 12 responses to its request for comment on the definition of U.S. capital equivalency. Both foreign and U.S. bank commenters stated that the Fedwire caps were set inequitably low. The commenters suggested that the Federal Reserve's policy did not recognize the worldwide strength of foreign banks. Moreover, commenters noted that the Basle Capital Accord, which will be phased in starting late this year, should alleviate the Board's concerns about the capital positions and supervision of those entities whose home-country supervisors adhere to the Accord.

Most of the foreign bank commenters suggested that the uncollateralized Fedwire cap should be based on total worldwide capital, just as it is for U.S. banks. They noted that many U.S. banks hold a considerable proportion of their assets offshore. Some commenters, including the Institute of International Bankers, suggested that 50 percent of worldwide capital be used as a compromise for establishing caps for foreign banks. Others suggested that worldwide capital be scaled by the ratio of U.S. dollar assets (held either in the U.S. or abroad) to total assets. The Board's Large Dollar Payments System Advisory Group recommended that, for those banks whose home country has adopted the Basle Capital Accord, the Board should develop a new formula for U.S. capital equivalency that provides foreign entities improved access to Fedwire without giving them a competitive advantage over U.S. banks.

Foreign banks do not use their current modest Fedwire caps intensively. The foreign bank commenters noted, however, that such low utilization rates are "statistical artifacts" because the Fedwire caps force foreign banks to rely mainly on CHIPS to function their payments. Accordingly, foreign banks argued that they do not try to use Fedwire intensively.

In the future, if the Board imposes an explicit price on Fedwire overdrafts as proposed,[8] foreign banks may prefer to keep most of their payments business on CHIPS, where it appears that CHIPS caps are no more binding for them than for U.S. banks. Despite that possibility, there is support from both U.S. and foreign banks for a more expansive Fedwire cap for financially strong foreign banks, and the Board has determined to provide some relief for these institutions, based on their worldwide capital. A larger cap seems reasonable within a framework of the Basle Capital Accord, provided that due regard is taken of foreign banks' access to both U.S. dollar liquidity and acceptable collateral for discount window loans.

The Board does not believe, however, that caps for foreign banks should be based on total worldwide capital. Just as the yen or sterling business of U.S. chartered banks is a small proportion of their worldwide assets and capital, even with the reserve currency status of the U.S. dollar. As a result, dollar overdraft caps based on worldwide capital for foreign banks would produce caps that are relatively much larger than caps for U.S. banks, although these caps would

[4] Foreign banks have been able to incur Fedwie overdrafts above their uncollateralized cap if collateral is pledged for this excess, so long as their cross-system overdrafts do not exceed their cross-system cap.

[5] U.S. capital equivalency is currently defined as the greater of (1) the sum of the amount of capital (but not surplus) that would be required of a national bank being organized at each branch or agency location or (2) the sum of 5 percent of the total liabilities of each branch or agency, including acceptances, but excluding (a) accrued expenses and (b) amounts due and other liabilities to offices, branches, and subsidiaries of the foreign bank.

[6] 52 FR 29255, August 6, 1987.

[7] 54 FR 26108, June 21, 1989.

[8] 54 FR 26094, June 21, 1989.

be subject to Reserve Bank modification to reflect U.S. funding capability and the availability of eligible collateral. This basis for cap measurement may result in considerably less relative restraint on foreign banks than on U.S. banks.

In addition, allowing foreign banks a cap based on total worldwide capital could cause competitive inequities should the Board adopt pricing of daylight overdrafts over a deductible based on a percentage of capital. Were the Board to allow foreign banks to their caps and deductible on total worldwide capital, foreign banks would be able to avoid most (or all) of the cost incurred by U.S. banks for the same level of overdrafts.

Therefore, the Board has adopted a policy that will allow foreign banks to determine their uncollateralized daylight overdraft capacity by applying their cap multiples to a U.S. capital equivalency equal to 10 percent of worldwide capital, provided the foreign bank's home-country supervisor adheres to the Basle Capital Accord. For all other foreign banks, cap multiples will continue to be applied to the current U.S. capital equivalency. All measures of U.S. capital equivalency are conditioned on Reserve Bank judgment that the U.S. branch or agency of the foreign bank has satisfactory U.S. funding capability and potential eligible collateral for a loan from the discount window, should it be unable to cover its daylight overdraft by the end of the day.

The Board believes the new definition of U.S. capital equivalency will provide a significant increase in the capacity for uncollateralized Fedwire overdrafts for most foreign banks. Lower ratios, such as 5 percent of worldwide capital, would reduce Fedwire overdraft capacity, especially among the largest foreign bank Fedwire users. A new U.S. capital equivalency for foreign banks based on 10 percent of worldwide capital appears not only to provide significant increases in overdraft capacity for virtually all foreign banks, but also to provide them with the capability of shifting all of their CHIPS business (in most cases) to Fedwire—an unlikely event, especially if Fedwire overdrafts are priced. Higher capital equivalencies would not only be redundant but would, with Fedwire overdraft pricing and deductible based on U.S. capital eqivalency, sharply reduce the Fedwire cost to these banks, giving them a competitive advantage over U.S. banks.

In addition to competitive equity and prudential concerns with the use of total worldwide capital by foreign banks, the Board believes its concern about the late-in-the-day funding capacity of foreign banks in the U.S. money market is still a significant factor, should those banks be unable to fund their Fedwire overdrafts due to operational or other reasons. The need in such circumstances to provide an overnight discount window loan is obvious, and satisfactory collateral for such loans is required by statute. Thus, the Board's policy takes into account the access of foreign banks to U.S. dollar liquidity.

When implementing the new U.S. capital equivalency measure, in the absence of contrary information, the Reserve Banks will presume that all banks chartered in G-10 countries (the Basle Capital Accord signatories) have met the acceptable prudential capital/supervisory standards, and will consider any band chartered in any other nation that adopts the Basle Capital Accord standards (or requires capital at least as large and in the same form as called for by the Accord) eligible for the Reserve Banks' review for meeting acceptable prudential capital/supervisory standards. Banks from G-10 countries, as well as those from other nations that adhere to the Basle Capital Accord, that otherwise meet Reserve Bank capital/supervisory standards will be authorized to file for an uncollateralized cap based on a U.S. capital equivalency equal to 10 percent of worldwide capital, subject to Reserve Bank adjustments for funding capabilities and potential eligible collateral. All other banks will be authorized to file for an uncollateralized cap based on the current U.S. capital equivalency.

The administering Reserve Banks will review the caps submitted by all U.S. branches and agencies of foreign banks and may modify the institution's overdraft capacity using the following guidelines:

(1) Uncollateralized Fedwire capacity should be consistent with the demonstrated ability of the branch or agency to access dollar liquidity in the U.S. market, and, if it is not consistent, Fedwire capacity should be reduced by the Reserve Bank to a level consistent with that ability, regardless of any collateral that the foreign bank has pledged (or is willing to pledge) to the Reserve Bank.

(2) Uncollateralized Fedwire capacity also should be consistent with the demonstrated ability of the foreign bank to provide, under stressful market conditions, acceptable discount window collateral for the full potential exposure to the Federal Reserve.

(3) In no case should the uncollateralized Fedwire capacity exceed the smaller of the cap multiple times the appropriate U.S. capital equivalency, the U.S. funding capacity of the branches and agencies, or what the Reserve Bank believes to be eligible discount window collateral.

The ability of Reserve Banks to modify overdraft capacity will permit Reserve Banks to limit their own risks on a case-by-case basis and assure that caps are consistent with both a foreign bank's access to the U.S. money market and its ability to fund itself under stressful conditions, including discount window access.

The adjustment to each foreign bank's overdraft capacity could well become the basis for the deductible, should pricing be adopted. In order to avoid large deductibles for pricing linked to relatively small effective caps, the amount on which the deductible is based could be reduced if the cap is reduced by the Reserve Bank and might be equal to the lower of the U.S. capital equivalency or the cap.

Further, the changes in measuring daylight overdrafts for U.S. chartered institutions, including combining funds and book-entry securities overdrafts, requiring collateral for book-entry overdrafts exceeding caps, and excluding net debits on CHIPS (assuming CHIPS implements settlement finality) [9] will also be applied to foreign banks. All foreign banks will maintain their market-determined access to CHIPS, unfettered by the Board's daylight overdraft policy.

In addition, the Board's policies on exemptions from cap (Fedwire overdrafts less than $10 million and 20 percent of the appropriate U.S. capital equivalency) and the *de minimis* cap (Fedwire overdrafts less than 20 percent of the appropriate U.S. capital equivalency) are applicable to foreign banks to the same extent as they apply to U.S. institutions.[10] Moreover, home-country supervisors of banks with U.S. branches and agencies will be advised by the administering Reserve Bank of the Fedwire capacity of banks under their jurisdiction, as well as of other pertinent conditions about their caps. Home-country supervisors requesting information on the Fedwire overdrafts of their banks will be provided that information on a regular basis.

Collateralized Overdrafts in Excess of Caps

In its June 1989 request for comment, the Board proposed to require collateralization of a foreign bank's entire Fedwire overdraft if the bank exceeded its Fedwire cap due to book-

[9] See Docket #R-0669, elsewhere in today's **Federal Register.**

[10] See Docket #R-0668, elsewhere in today's Federal Register

entry overdrafts. The proposal was motivated by the desire both to assure sufficient collateral for the entire overdraft should a discount window loan be required and to strengthen the Reserve Bank's interest in the collateral should the bank fail before the overdraft was extinguished.

Fourteen commenters explicitly addressed the issue of full collateralization of overdrafts. Of these, three agreed with the proposed policy while eleven disagreed with it.

One commenter noted that, as with the definition of U.S. capital equivalency, the proposed policy on collateralization would encourage foreign banks to participate more in available netting practices Another commenter supported the proposal as a matter of equity, stating that, if domestic institutions are to be subject to collateral requirements and to a Fedwire cap based on their capital, then foreign institutions' branches and agencies should be subject to similar, if not the same, types of risk controls.

Those that objected to the proposed policy did so for a variety of reasons. Most of those objecting to the policy thought it was unfair to apply full collateralization to only those U.S.-based institutions that frequently and materially exceed their Fedwire cap because of book-entry security overdrafts, but to require all foreign-based banks to fully collateralize their overdrafts when they exceed their Fedwire caps.

Another foreign bank commented that, under the proposed policy, the collateral required to support its existing and anticipated Fedwire payments volume exceeds its available collateral now in the United states and thought that it might prove more economical to route Fedwire payments through the large U.S. banks than to incur the administrative overhead associated with collateralizing overdrafts. The commenter noted that this would require it to share information about its payments flows with competitors. Several commenters thought that the proposed policy would increase the risk to the U.S. payments system by reducing the presence of some very strong foreign institutions and by further concentrating the U.S. payments system.

One commenter supported the complete collateralization requirement but expressed concern about the model set by the U.S. policy for developments in foreign payments system practices. The commenter saw this policy initiative as an opportunity for the Board to promote the principle that assets used to support payment activities need not be located in that particular country. The commenter urged the Board to consider using assets denominated in the home currency as a secondary source of collateral. The commenter proposed that these assets could be held at the home-country central bank or supervisory authority and pledged to its Reserve Bank. Similarly, two foreign banks suggested that U.S. Treasury securities booked in the name of non-U.S. offices be accepted as collateral because their book-entry form made it possible for the Reserve Banks to perfect an interest in that collateral.

A domestic bank recommended that the Board abandon altogether the collateralization requirement for overdrafts of foreign bank branches and agencies and instead focus its attention on the financial strength of institutions seeking to base their caps on worldwide capital. It suggested that, in cases where the likelihood of default by an institution is equivalent to that posed by an equally sound U.S. bank, worldwide capital be used for setting caps without collateralization of any part of the overdraft and that, in other cases, the institution's cap should be based on U.S. capital equivalency.

The Board has adopted a policy to permit all foreign banks, regardless of their uncollateralized cap, to incur funds overdrafts up to an amount equal to their cap multiple times 10 percent of their worldwide capital (as long as the amount of the overdraft above the uncollateralized cap is collateralized) and unlimited collateralized book-entry overdrafts. This policy offers all foreign banks, under terms that reasonably limit Reserve Bank risk, a level of overdrafts based on the same proportion of their worldwide capital. Under the policy, banks chartered in countries that follow the Basle Accord with demonstrated collateral and funding capacity will not receive a larger cap than they already have (the cap multiple times 10 percent of worldwide capital), and except for book-entry overdrafts, will not be permitted to incur overdrafts above that cap, even with collateral. All other foreign banks may incur overdrafts to the same extent as banks from Basle Accord countries, i.e., up to their cap multiple times 10 percent of their worldwide capital, provided that sufficient collateral is posted for any overdrafts in excess of the cap based on their U.S. capital equivalency. As discussed in Docket #R-0669, elsewhere in today's **Federal Register**, foreign banks may choose to collateralize their book-entry overdrafts, even if they do not exceed their caps, and such secured overdrafts shall not be included with those overdrafts measured against the cap.

Competitive Impact Analysis

Under its competitive equity policy, the Board assesses the competitive impact of changes that have a substantial effect on payments system participants.[11] The Board believes these modifications to its payments system risk reduction program will have no adverse effect on the ability of other service providers to compete effectively with the Federal Reserve Banks in providing similar services. These modifications place controls on the use of the Federal Reserve Banks' funds and book-entry transfer services, which are consistent with controls used in private clearing and settlement systems.

By order of the Board of Governors of the Federal Reserve System, May 24, 1990.

William W. Wiles,

Secretary of the Board.

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FEDERAL RESERVE BANK OF DALLAS
STATION K
DALLAS, TEXAS 75222

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