FEDERAL RESERVE BANK
OF DALLAS

TONY J. SALVAGGIO
FIRST VICE PRESIDENT

November 10, 1994

DALLAS, TEXAS
75265-5906

Notice 94-116

TO: The Chief Operating Officer of each financial institution in the Eleventh Federal Reserve District

SUBJECT

Modification to the Policy Statement on Payment System Risk

DETAILS

The Board of Governors of the Federal Reserve System has approved a modification to its Policy Statement on Payment System Risk regarding net debit caps. Specifically, the Board has approved a doubling of the multiple associated with the de minimis net debit cap from 20 to 40 percent of risk-based capital.

In addition, the Board approved administrative counseling flexibility for institutions that continue to exceed their net debit caps due to the posting of non-Fedwire transactions. Under this flexibility, the Reserve Banks will work with affected institutions on ways to avoid daylight overdrafts, but will not subject these institutions to routine counseling for daylight overdrafts.

The modification became effective October 13, 1994.

ATTACHMENT

A copy of the Board's notice (Federal Reserve System Docket No. R-0806) is attached.

MORE INFORMATION

For more information, please contact Donna Gonzalez at (214) 922-5584 or James Smith at (214) 922-5585. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely,

FEDERAL RESERVE SYSTEM

[Docket No. R-0806]

Policy Statement on Payment System Risk

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice

SUMMARY: The Board of Governors of the Federal Reserve System (Board) has approved a modification to its Policy Statement on Payment System Risk regarding net debit caps. Specifically, the Board has approved that the multiple associated with the de minimis net debit cap be doubled from 20 to 40 percent of risk-based capital. In addition, the Board approved administrative counseling flexibility for institutions that continue to exceed their net debit caps due to the posting of non-Fedwire transactions. Under this flexibility, the Reserve Banks will work with affected institutions on means of avoiding daylight overdrafts, but will not subject these institutions to routine counseling for daylight overdrafts.

EFFECTIVE DATE: October 13, 1994.

FOR FURTHER INFORMATION CONTACT: Jeffrey C. Marquardt, Assistant Director (202/452-2360), Paul Bettge, Manager (202/452-3174), Division of Reserve Bank Operations and Payment Systems, Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: The Board has established a Payment System Risk Policy Statement pursuant to its authority under the Federal Reserve Act. 12 U.S.C. 221 et seq. In October 1993, the Federal Reserve implemented a set of intraday posting rules for debits and credits affecting depository institution accounts with Reserve Banks. The posting rules provide for the posting of non-Fedwire transactions at specific times during the day, in addition to the posting of Fedwire funds and securities transfers as they occur throughout the day. In contrast, according to the posting rules that were in effect prior to last October, non-

Fedwire payments for each depository institution were netted and, if a net credit resulted, the amount was posted to the institution's Federal Reserve account as of the opening of business and, if a net debit, as of the close of business.

Prior to implementation of the new posting rules, about 200 institutions, on average, exceeded their daylight overdraft caps during any given two-week reserve maintenance period. Immediately following implementation of the new posting rules, this number increased to between 1200 and 1500 institutions per period. In anticipation of this increase, the Board adopted a "transition period" for routine administrative counseling in order to provide institutions with a period of time to implement changes to their Federal Reserve account management procedures in order to reduce the incidence of daylight overdrafts in excess of daylight overdraft caps. Following nearly one year of "transition," about 750 to 800 institutions per period still typically exceed their caps.

The new posting rules were intended, in large part, to support the assessment of daylight overdraft fees, which began on April 14, 1994. The posting rules were developed by the Board over a three-year period and included two separate requests for public comment.

In developing the new posting rules, four general principles were established. First, the intraday posting rules were designed not to generate intraday float. The old posting rules typically created approximately $30 billion in intraday float. Second, the new posting rules were to permit depository institutions to anticipate precisely when transactions would be posted to their account. Under the old posting rules, an institution would not know until after the close of business whether the net of all non-Fedwire activity was a credit or a debit and, accordingly, whether the netted amount would be posted as of the opening or closing of business. Third, the posting rules were designed to be consistent with the legal rights and responsibilities of depository institutions. Under this principle, check debits would not be posted to an institution's

account prior to presentment of the checks. Finally, the new posting rules were intended to be competitively neutral. That is, neither the Reserve Banks nor private sector providers of correspondent banking services should be artificially advantaged by the new posting rules.

Under these principles, the debit to an institution for any payment is posted at the same time as the credit is posted to the account of the counterparty to the transaction. The exception to this guideline is for check transactions where, by virtue of the nature of check processing, it is not possible to match debits and credits on a transaction-by-transaction basis throughout the day. In addition, because checks should not be debited prior to presentment, a single time for all check debits and credits would necessarily be later in the day than many depository institutions believed appropriate. Therefore, debits for checks presented to depository institutions are posted on the next clock hour at least one hour following presentment, beginning at 11:00 a.m., Eastern Time. Credits for check deposits are either posted (1) at a single, float-weighted posting time or (2) at multiple times throughout the day, beginning at 11:00 a.m., Eastern Time, using a set of fractions that are based upon Reserve Bank check collection experience. For check credits, depository institutions are permitted to select either option, based upon which alternative best meets their needs. Currently, the earliest float-weighted posting time (Option 1), which enables an institution to have full use of check deposit credits, is 11:45 a.m. Eastern Time.

On average over a day, these check posting rules result in a minimal amount of intraday check float. At specific points in time during the day, however, the check posting rules appear to be giving rise to as much as $20 billion in "credit float," whereby the Reserve Banks have posted debits to depository institution accounts prior to providing corresponding credits on check transactions to other institutions. The impact of this float, and the measured daylight overdrafts it creates, appears

to be falling primarily on smaller depository institutions.

Under the old posting rules, smaller institutions seldom incurred significant daylight overdrafts and, thus, were able to make use of the "exempt from filing" or "de minimis" daylight overdraft caps without incurring a significant number of cap breaches. Under the new posting rules, however, on average over four recent reserve maintenance periods, 600 of the 775 total institutions with daylight overdrafts in excess of their caps were institutions that had "exempt from filing" or "de minimis" daylight overdraft caps. An additional 159 institutions with a zero net debit cap had cap breaches.

The "exempt from filing" cap permits an institution to incur daylight overdrafts up to the lesser of $10 million or 20 percent of risk-based capital. The exempt cap does not require any action by the board of directors of the depository institution or the filing of any documentation with its Reserve Bank. As additional flexibility, an exempt-from-filing institution may incur up to two daylight overdrafts in two consecutive two-week reserve maintenance periods before it is in violation of the Board's payments system risk (PSR) policy.[1] In order to incur higher daylight overdrafts, an institution may file a resolution of its board of directors requesting a de minimis cap, which permits daylight overdrafts up to 20 percent of risk-based capital. To be permitted even larger amounts of intraday credit, up to 2.25 times risk-based capital on a single day, the institution must undertake a self-assessment of creditworthiness, intraday funds management and control, and customer credit policies and controls to support a higher daylight overdraft cap.

An institution that regularly exceeds its cap is subject to progressively higher levels of administrative

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[1]For institutions with other net debit cap categories, any daylight overdraft that exceeds the net debit cap would be subject to administrative counseling by the Reserve Banks.

counseling by its Reserve Bank. Under current guidelines, a depository institution that continues to exceed its daylight overdraft cap ultimately may be assigned a zero cap and be placed on the real-time monitor. In this situation, a depository institution will be prevented from originating Fedwire funds transfers that would cause, or increase, a daylight overdraft.

The Board's policy on daylight overdraft caps is intended to address intraday risk to the Federal Reserve arising from daylight overdrafts. However, most non-Fedwire activity poses primarily interday, rather than intraday, risk. Escalated counseling, including real-time monitoring, for non-Fedwire-caused daylight overdrafts may be of limited usefulness in reducing these overdrafts. In addition, most of the daylight overdrafts caused by implementation of the new posting rules would not result in the assessment of daylight overdraft charges, owing to the deductible permitted in computing such charges.

Current alternatives available to a depository institution to address the situation where it routinely exceeds its daylight overdraft cap include: (1) filing for a "self-assessment" cap, (2) shifting funding patterns or delaying the origination of funds transfers, (3) selecting the "fractional" check posting option in order to begin receiving some check credits earlier than the single, float-weighted posting time, (4) having check debits posted to the account of a correspondent bank, or (5) transferring payment processing business to a private correspondent bank. It should be noted that filing for a self-assessment cap is an alternative available only to financially healthy institutions and presents an increased administrative burden to these institutions. In addition, many of the small institutions adversely affected by the posting rules have a limited amount of Fedwire funds transfer activity. Thus adjustments to such Fedwire activity may have a minimal impact on such institutions' level of daylight overdrafts. Similarly, a correspondent bank may be unable to provide funding to respondents earlier in the day without adversely affecting its

own daylight overdraft position.

ALTERNATIVES: The Board considered three alternatives to address cap breaches attributable to the changes in the intraday posting rules for non-Fedwire activity: (1) increasing the size of the multiples associated with daylight overdraft net debit caps, (2) adopting, on a permanent basis, counseling flexibility for daylight overdrafts caused by non-Fedwire activity, or (3) changing the posting rules. Each of these alternatives is discussed below.

Caps

The Board analyzed various scenarios to determine whether the level of exempt-from-filing or de minimis cap categories could be increased without materially increasing risk to Reserve Banks. An increase in the exempt-from-filing daylight overdraft cap category would require no action on the part of a depository institution, with a potentially substantial percentage increase in intraday credit to be granted to that depository institution by the Federal Reserve. The Board believes that any increase in the size of caps, without a self-assessment, should be made in the de minimis cap, which requires the filing of a board of directors' resolution. This approach will ensure that senior bank management and directors are aware of the potential amount of credit that may be obtained by the depository institution from the Federal Reserve during the day.

In studying increases in cap levels, the Board was mindful of the existing structure of cap categories that require a self-assessment. For example, an "average" cap permits daylight overdrafts, on average over a reserve maintenance period, up to 75 percent of an institution's risk-based capital. In order not to diminish the relevance of an "average" cap, which can be obtained by an institution only after conducting a full self-assessment, the Board believes the cap multiple for the de minimis cap should not approach 75 percent.

At a level of 40 percent of risk-based capital,

however, between 85 and 90 percent of cap breaches by institutions that currently have exempt or de minimis caps would be eliminated, assuming certain exempt-from-filing institutions file a board of directors' resolution adopting a de minimis cap. Diminishing reductions in cap breaches by institutions with exempt and de minimis caps are achieved with cap levels beyond 40 percent, with an associated lessening of the relative benefits of a self-assessed cap. Cap levels below 40 percent do not yield a sufficient reduction in cap breaches to warrant any increase at all in the level of the de minimis cap.

It should be noted that any increase in the size of net debit caps, in addition to providing capacity to cover current cap breaches caused by the posting rules, would also increase the intraday capacity for daylight overdrafts resulting from irrevocable Fedwire funds and book-entry securities transfers. The Board believes that, for the most part, institutions with a de minimis net debit cap have a relatively limited amount of Fedwire activity and an increase in daylight overdraft capacity will likely not increase significantly the risk exposure of the Reserve Banks. Moreover, Reserve Banks have special procedures in place for dealing with risks posed by depository institutions in poor or deteriorating financial condition. The Board has, therefore, approved an increase in the multiple associated with the de minimis net debit cap from 20 percent to 40 percent of risk-based capital.

Counseling

As noted above, the Reserve Banks administratively counsel depository institutions that exceed their caps. For cap categories other than the exempt-from-filing category, any daylight overdrafts in excess of a depository institution's cap are subject to counseling by the Reserve Banks. For institutions with an exempt cap, however, only when an institution incurs three or more daylight overdrafts in excess of its cap within a four-week period would it be subject to counseling. The Board reviewed this frequency measure to determine whether an increase

may be feasible.

By increasing the number of permissible daylight overdrafts in excess of the exempt cap from two in two consecutive two-week reserve maintenance periods to four in two consecutive two-week reserve maintenance periods, 79 percent of the institutions with exempt-from-filing caps that had cap breaches would not be subject to counseling by their Reserve Banks. A significant concern with increasing the permissible occurrences of cap breaches, however, is that there is currently no size limitation on the size of those cap breaches. The Board also believes that increases in the number of non-counselable daylight overdrafts effectively increases the amount of intraday credit that may be used by an institution. Should the Federal Reserve decide to increase the amount of intraday credit to be extended to depository institutions, the Board believes it would be preferable to identify such an increase clearly through an increase in the size of a cap, rather than an increase in the number of permissible excess daylight overdrafts.

Another approach to minimize the administrative burden of counseling on both depository institutions and the Reserve Banks is to exempt daylight overdrafts caused either by check transactions or all non-Fedwire transactions from counseling. The Board believes, however, that separate treatment under the PSR policy of different types of payment transactions is not desirable. For example, daylight overdrafts caused by book-entry securities transfers and ACH transactions were initially excluded from counseling under the PSR policy. The Board decided in 1992 that all transactions should be treated alike for daylight overdraft measurement purposes. In addition, counseling institutions for some daylight overdrafts and not for others may lead to confusion, both within the Reserve Banks and at depository institutions.

Nonetheless, some degree of counseling flexibility may be appropriate. As noted above, the Reserve Banks have had in place since October 1993 a policy of administering daylight

overdraft counseling on a flexible basis, depending upon whether cap breaches were attributable to the new posting rules. Continued counseling flexibility appears to be desirable largely in dealing with institutions that have a zero daylight overdraft net debit cap as well as relatively small institutions that, by the nature of their business, will continue to exceed a positive net debit cap even after appropriate adjustments have been made. These institutions may have few alternatives for eliminating non-Fedwire daylight overdrafts. The institutions that have zero caps for reasons related to their financial condition are typically already on the real-time monitor in reject or pend mode. In addition, in some cases, zero cap institutions are also required by the Reserve Banks to prefund certain payments or collateralize any daylight overdrafts. Routinely counseling such institutions for overdrafts caused by non-Fedwire transactions lessens the credibility of the daylight overdraft counseling program and appears to do little to lessen the actual risk to Reserve Banks. The Board has approved such administrative counseling flexibility on an on-going basis.

Posting Procedures

Modifications to the intraday posting procedures would be another way to address the frequency of cap breaches by small depository institutions. The Board believes any such modifications should be carefully weighed. The check posting rules were adopted by the Board following a lengthy process involving two requests for public comment and many discussions with the banking industry, as noted above. For example, the principle of the elimination of intraday float for checks was specifically addressed through public comment in 1989. The new posting rules have now been in place about one year and it is possible that institutions may still be adapting to those rules. In addition, changes to these rules after such a short period of time may impose unanticipated costs associated with changing computer programs on a large number of depository institutions.

Further changes to the check posting rules may also lead to the creation of intraday float. As an example, a scheme whereby check credits are posted at 11:00 a.m. Eastern Time and check debits continue to be posted on the clock hour at least one hour following presentment would generate as much as $23 billion in debit float at 11:00 a.m., and an average of $6 billion in float over the course of the day. However, even this radical a change to the posting rules would not eliminate a significant fraction of cap breaches caused by the implementation of the new posting rules. Many non-Fedwire-caused cap breaches would continue due to the posting of ACH debit transactions, at 11:00 a.m. Eastern Time, and net settlement entries from private clearing houses, as determined by the individual settlement arrangements. Many small depository institutions may continue to encounter difficulties in funding these transactions on a timely basis during the day.

Another possible change to the check posting rules would be to shift the first check debiting time from 11:00 a.m., Eastern Time to 11:00 a.m., Local Time. It was initially believed that such an approach might make the fractional check crediting option more feasible for many institutions in the Central, Mountain, and Pacific time zones. Upon further analysis, however, the Board determined that because of the later debiting times in western time zones, the corresponding crediting times would shift later in the day as well, thereby lessening any positive benefit of the delayed check debits.

A final alternative is to establish a new set of posting rules for cap administration different from the posting rules for the assessment of daylight overdraft fees. The Board does not believe such an approach would be desirable, as it would likely lead to more, rather than less, of an administrative burden on small institutions and could create a significant amount of confusion in the banking industry about the focus of

the PSR initiative.

The Board has, therefore, not elected to make any changes to the established intraday posting procedures at this time.

By order of the Board of Governors of the Federal Reserve System, October 27, 1994.

(Signed)

William W. Wiles,
Secretary of the Board.
[FR Doc. 94-00000 Filed 00-00-94; 8:45am]
BILLING CODE 6210-01-P