

ARE THERE RISKS TO REGULATING BANK RISKS?  
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"Are There Risks to Regulating Bank Risks?" could be the springboard for a broad-ranging philosophical discussion of the costs and benefits of bank regulation. However, at the risk of disappointing some and, I hope, on the chance of keeping more awake, I am not inclined to take that tack this evening, at least in a broad sense. Rather, I would like to address a specific regulatory matter that has a direct bearing on many of you-- the soon-to-be-implemented voluntary policy to reduce daylight overdrafts--and its ramifications, some of which might be considered risks.

It was not too long ago that the term "daylight overdraft" was probably unknown to bank lending and credit officers; if they had heard the term, they undoubtedly thought of it as simply an operational matter. However, the role of large dollar electronic funds transfer systems--CHES, Cashwire, CHIPS, PRESS and Fedwire--has become increasingly important in both the domestic and international dollar payments process. Intraday risks associated with such systems have increased commensurately. On Fedwire and the private systems combined, daylight overdrafts of participating financial institutions have grown to as much as an estimated \$110-120 billion! In other words, at certain times during the day, typically between 10 a.m. and 2 p.m., a group of financial institutions have sent out about \$100 billion more in same-day funds, in the aggregate, than they actually have in collected balance accounts at the Fed.

Clearly, the manner in which these transfer systems and their participants operate contributes to individual credit risk and collective systemic risk. Sudden large changes in the condition of either a system participant or one of its debtors could have effects well beyond the viability of the institution itself. In the worst case, they could lead to serious disruption in both commercial activity and financial markets at large. The failure of one participant in the system to settle could lead to the failure of others to settle and so on. What's more, rumors about who might be affected could extend the effects well beyond those institutions who are actually involved.

How, then, do daylight overdrafts and the Fed's voluntary policy affect each of you? Many transfers are made on behalf of corporate clients. While these transfers are a bank service which is largely taken for granted, they can result in daylight overdrafts in the customer's account and possibly in the institution's reserve account at the Fed as well. In other words, they contribute to both individual credit and systemic risk. The purpose of the Fed's daylight overdraft policy is to make the institution focus on extensions of credit arising in this manner. In this connection, many banks are establishing daylight overdraft limits for their corporate customers and including these in their credit instruments.

I suspect your reactions to this policy might be mixed. On the one hand, you might welcome this move to reduce risk in the banking system because of the significant interbank credit exposure that exists on an ongoing basis. On the other hand, your own daylight overdrafts, as I mentioned, arise in large part as the result of wire transfers made for your

corporate clients. Inability to provide these wire transfer services could jeopardize an entire corporate relationship; in addition, you could be placed in the position of attempting to discipline your corporate clients.

I must say, I had much the same mixed emotions a couple of years ago when greater regulation of the U.S. Government securities market was first being discussed; at that time, I was in your shoes. Problems in the market had arisen principally as a result of the activities of certain unregulated secondary dealers. The ability of the Fed to get at these dealers was limited. However, by having voluntary capital requirements formally applied to the primary dealers and then by requiring them, in turn, to apply the requirements to the secondary dealers, the Fed was able to have some impact. While the secondary dealers certainly did not have the leverage that your corporate customers do, a regulated group was being used as a conduit for disciplining the real "offenders."

As a newcomer to the regulatory arena, I am still developing a philosophy for approaching regulation. However, there is at least one conclusion that I am prepared to draw now. That is, if the problem you are looking at could lead to a breakdown of a fundamental financial mechanism, whether it be the payments system or the U.S. Government securities market, a regulator must look to what can be done relatively quickly and not just to what might be ideal. Operating through an existing regulatory framework may be the only viable option in the short run. Of course, cost/benefit trade-offs must be considered; however, when systemic risk hangs in the balance, the tolerance of costs is higher than otherwise might be the case.

Let me first briefly describe how the daylight overdraft policy works; then, I would like to consider some of its ramifications. It is important to note that the policy is voluntary--that is, each institution plays an important role in determining its own capacity to incur daylight overdraft exposure.

The procedure is as follows:

First, the management of financial institutions using Fedwire or a private wire system performs a self evaluation based on their own institution's creditworthiness, operational controls and credit policies. These evaluations are combined into a single overall assessment which corresponds to various net debit caps ranging from average to high.

The caps express, as a multiple of capital, the extent to which the institution will permit itself to be exposed as a net sender using electronic funds transfer systems. There is both a daily and a two-week average cap. For example, an institution which assesses itself as "Average" would have a daily cap of 1.5 times capital and a two-week average cap of 1.0 times capital. This means that, at any point in time, the institution would be willing to incur a net debit position in wire transfer systems equal to one and a half times its capital. The permitted two-week average exposure would be less.

Finally, the self-assessment process and resulting caps must be approved by the institution's board of directors. This is an important aspect of the policy because it forces directors to consider the risks the institution is incurring in an area that may be quite unfamiliar to

them. To the extent that many of these directors are also corporate executives, this step may have the effect of educating some of the "offenders" and at the same time of raising the level of sensitivity to bank risk in general. Frankly, regulators cannot hope to deal with reducing risk without having management, including boards of directors, concerned about the problem and, in their own interests, taking steps to address it.

Before moving on, I should clarify the term "voluntary." First, an institution must submit its approved voluntary caps to the Fed. If these seem inappropriate, the Fed will consult with the institution's management. In addition, in the course of conducting normal examinations, the institution's primary regulator will audit the process used in doing the self assessment and setting the caps. Finally, on an ongoing basis, the Fed will consult with participants who incur daylight overdrafts in excess of their caps. It is hoped that, in this fashion, significant progress can be made in reducing daylight overdrafts without the need for more specific regulation.

For the last couple of months, members of our staff have been working with financial institutions to prepare for implementation of the program on March 27. Generally speaking, banks have been conservative in their self assessments, and boards of directors have been even more conservative. We know of situations where, although an institution would qualify for a higher cap based on its self assessment, its board of directors has deliberately reduced the cap to limit further the institution's risk.

In one respect, this move is not surprising; the caps have been initially set at "liberal" levels in order to minimize the risk of gridlock in the payments system. This situation could arise if all banks decide to send funds transfers only after they receive incoming transfers--that is, "hoard" their ability to create daylight overdrafts for special customers or unforeseen circumstances. In some sense, it would be like the old junior high school dances where no one wanted to be the first couple on the dance floor--as a result, the band played, but no one danced. However, because of the liberal caps, this is unlikely to happen. In fact, it is anticipated that, over time, the caps will be reduced once institutions have adapted to operating with them at present levels.

In addition, financial institutions are likely to take other steps which will minimize the possibility of gridlock. In managing their reserve accounts, many institutions who purchase Fed funds overnight on an ongoing basis return them at the open of business the next day. Rather than do this, they might go to term purchases of funds, either on an open or fixed basis; this would eliminate the need to wire funds out in the morning, only to receive them back before the close of the business day. In addition, they might purchase overnight Fed funds earlier in the day than at present, particularly if they anticipate large daylight overdrafts.

Some people have even talked about the emergence of an intraday Federal funds market whereby institutions with excess reserve balances would sell funds for, say, several hours during the day to others who might incur daylight overdrafts in excess of their caps. Of course, this might be somewhat self-defeating in that it would create more traffic on the wire system and could increase institutional interdependencies and exposure.

Also, it deals with the symptoms and not the cause of the problem. However, among a handful of large institutions, such a Fed funds market might result in a better intraday distribution of reserves.

Another possibility is that institutions decide to maintain larger excess reserve balances in order to provide a cushion against the possibility of daylight overdrafts. This, of course, would increase costs and might ultimately affect how institutions charge for wire transfer services. The question of pricing also comes up in the context of credit risk--specifically whether institutions are at present adequately compensated for incurring a daylight overdraft as a result of making an uncovered transfer on behalf of a customer. However, there is no indication at this point that banks will make surcharges in these circumstances. Certain banks are, on the other hand, indicating to clients how much of an overdraft they would be willing to incur; they are, in effect, setting a limit and considering the overdraft as an extension of credit on the chance that it may not be covered by the close of business.

At the extreme, the daylight overdraft policy could affect discount window borrowing. With the possible changes in the Fed funds market I have already mentioned, borrowing patterns could be affected as well, particularly as institutions become more attuned to policing their intraday exposures. In effect, the spread relationship between the discount rate and the Fed funds rate, which is presently associated with an expected level of borrowings, might change.

Exploring these ramifications of the daylight overdraft policy takes us back to the question, "Are there risks to regulating bank risks?" Clearly there are; they arise principally out of the uncertainties associated with modifying financial market behavior in a very dynamic system. However, we have already seen a decline in overdrafts, both daylight and overnight, as we move toward implementation of this policy. This is simply as a result of increased sensitivity to the problem. Moreover, because the policy is voluntary, and the caps have initially been set at liberal levels, there is certainly ample room for the system to adjust. On the other hand, I would not pretend for a minute that all aspects of behavior in such a dynamic system can be anticipated. Accordingly, there will be a high premium on watching and communicating as we move through the adjustment process.

One aspect of this policy which is of particular interest to me as a monetary policymaker is its effect on the Fed funds market, excess reserves and discount window borrowings. All of these are watched closely in connection with day-to-day implementation of policy. Changes in these could conceivably send confusing signals to financial markets and policymakers alike. If my past experience is any guide, my guess is that market practitioners are not apt to focus on "possible implications;" instead, they will wait until the policy is implemented and some early, seemingly peculiar effects have been observed. However, the desk at the New York Fed is certainly aware of these possible implications.

In closing, given that I am on the topic, I might just take this opportunity to make a few brief comments on monetary policy. I view

monetary policy as having been quite accommodative for some time and as continuing to be so at present. I say this not to suggest that I consider this bias inappropriate. On the other hand, I do balk at calls for further easing of policy to respond, for example, to signs of current weakness in the economy or to offset the alleged restrictive effects of Gramm-Rudman budget cuts. First of all, while there are some conflicting data, the economy has been doing quite well; certainly the outlook for this year of 3-4% real growth is in line with the economy's long-range potential. Second, the effects of an accomodative policy over the last nine or 10 months will be felt with a long lag--for example, I am not at all sure that the effects of declining interest rates and rising financial asset values have been fully reflected as yet; nor have the effects of declining oil prices been truly felt. Third, the Gramm-Rudman cuts so far have been minimal--only \$11.7 billion; in my opinion, the promised future, larger cuts are far from assured.

Financial markets may rally based on the apparent will of Congress to cut deficits, notwithstanding the constitutionality of Gramm-Rudman, but I do not think monetary policy can allow itself to get caught up in the same euphoria. Further, inflation is not dead, despite the favorable impact that lower oil prices will have on price indices. The lower dollar in foreign exchange markets will increase the cost of imported goods over time and permit competing domestic industries to raise their prices as well. In addition, the employment rate is at an all-time, post World War II high, which could imply labor market shortages and inflationary wage increases. This could particularly be so against the backdrop of the poor productivity gains we have seen in the last year. And there is already some evidence of wage pressures in the service industries.

Finally, expectations of future inflation linked to a perception of an overly-expansive monetary policy could be particularly damaging in foreign exchange markets. A rapid decline in the value of the dollar arising out of such expectations could change foreigners' willingness to reinvest in dollar assets at current interest rate levels. Yet we continue to be very dependent on those foreign capital flows to finance our budget deficit and private investment. Happily, the recent discount rate cut, made in light of similar cuts by the Germans and Japanese, apparently did not carry with it these possible adverse effects on psychology.

I could continue, but let me stop at this point. I appreciate your attention and would be happy to answer a few questions. Thank you.