FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **10301**
June 28, 1989]

PROPOSED CHANGES IN THE PAYMENTS SYSTEM RISK REDUCTION PROGRAM

Comment Invited by November 17, 1989

To the Chief Executive Officers of All Depository Institutions in the Second Federal Reserve District, and Others Concerned:

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System announcing a series of proposed modifications to its Payments System Risk Reduction Program designed to further reduce the risks associated with large-dollar payments.

The Federal Reserve Board has issued for public comment proposed changes to its Large Dollar Payment System Risk Policy designed to reduce risk to the Federal Reserve and the payments system in general.

Comments must be submitted to the Board by November 17, 1989.

The requests for comment are detailed in three dockets.

• Docket No. R-0668 contains proposals that would provide for a fee of 25 basis points (annual rate), phased in over three years, for consolidated funds and book-entry securities average daily Fedwire overdrafts in excess of a deductible of 10 percent of risk-based capital.

To accommodate pricing, the Board is also proposing various changes to the posting and cap procedures, including a proposal that will exempt depository institutions with a low level of overdrafts from filing for a cap or performing a self-evaluation. In view of the proposed deductible and cap exemption, the Board anticipates that a relatively small number of depository institutions would be subject to either pricing or caps.

• Docket No. R-0669 requests comment on a proposed policy to include both book-entry and funds overdrafts in a combined Fedwire overdraft measurement under the existing cap structure. Unlike the pricing proposal, which deals with average Fedwire overdrafts, the caps continue to apply to peak overdrafts.

The proposal would require depository institutions that frequently or routinely exceed their Fedwire cap by material amounts solely because of book-entry transfers to collateralize their total Fedwire exposure. The proposal sets guidelines on the types of collateral preferred and how collateral should be identified, and would also establish guidelines for Reserve Banks to implement the policy.

• Docket No. R-0670 requests comment on a proposed risk reduction policy that would require collateralization of the total amount of Fedwire overdrafts (funds and book-entry) of foreign banks operating through U.S. agencies and branches if such overdrafts exceed the Fedwire cap.

Printed on the following pages is the text of the Board's proposals, which have been reprinted from the *Federal Register* of June 21. Comments thereon must be submitted by November 17, 1989, and may be sent directly to the Board of Governors, as set forth in the Board's notices, or to Richard J. Gelson, Vice President, who is the daylight overdraft liaison officer at this Bank.

E. Gerald Corrigan,
President.

[Docket No. R-0668]

RIN 7100-AA76

Proposals To Modify the Payments System Risk Reduction Program; Pricing, Overdraft Measurement, and Caps

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board is requesting comment on proposed changes to its payments system risk reduction program. The proposals would provide for a fee of 25 basis points, phased in over three years, for average daily consolidated funds and book-entry Fedwire overdrafts in excess of a deductible of 10 percent of risk-based capital. To accommodate pricing and reduce the administrative burden to depository institutions, the Board is also proposing various changes to the procedures used for measuring daylight overdrafts and the current cap structure. These proposals are being issued in conjunction with the other requests for comment and policy statements regarding the payments system risk reduction program published elsewhere in today's Federal Register.

DATES: Comments must be submitted on or before November 17, 1989.

ADDRESSES: Comments, which should refer to Docket No. R-0668, 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 5:00 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 Summers, Associate Director (202/452-2231) or Florence Young, Assistant Director (202/452-3926), 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: This is one of three proposals regarding payments system risk that the Board is issuing for public comment today. The others concern daylight overdrafts related to book-entry securities transfers (Docket No. R-0669) and the daylight overdraft policy for foreign banks with U.S. branches and agencies (Docket No. R-0670). The Board encourages all interested parties to comment on each of these proposals. The Board urges that, in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each. This procedure will facilitate the Board's processing and analysis of the comments on these proposals by ensuring that each comment is quickly brought to the attention of those responsible for analyzing each specific proposal. In addition, the Board encourages entities that plan to submit identical comments, such as affiliated institutions within a holding company, to consolidate their efforts; the Board will give equal consideration to one letter signed by a number of commenters as it would to numerous identical letters submitted by those commenters. Comments are due November 17, 1989, and the Board does not intend to extend the comment period beyond that date.

In addition to its requests for comment, the Board is also issuing today three risk-related policy statements regarding private delivery-against-payment systems (Docket No. R-0665), offshore clearing and netting systems (Docket No. R-0666), and rollovers and continuing contracts (Docket No. R-0667).

Background

The Board has been concerned for some time about the risks associated with large-dollar payments systems. The Federal Reserve Banks would face direct risks of loss in the event that Fedwire users are unable to cover their intraday overdrafts by the end of the business day. Moreover, on a private large-dollar network that permits its participants to transmit payment messages throughout the day with settlement of net positions at the end of the day, the inability or unwillingness of a participant to settle its net debit position would expose the banking system to systemic risk. Systemic risk occurs when institutions unable to settle on private large-dollar payments networks cause their creditors on those networks, in turn, to be unable to settle their own commitments. As a result, serious repercussions could spread to other participants in the network, to other depository institutions not participating in the private network, and to the nonfinancial economy generally. In such circumstances, the Federal Reserve would bear an indirect risk if it sought to avoid or limit this systemic risk. Finally, on both private wire systems or Fedwire, depository institutions will face risk by permitting their customers, including other depository institutions, to make transfers against uncollected or insufficient balances in anticipation of their coverage before the end of the day.

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 (50 FR 21120, May 22, 1985). This policy, in effect, established a maximum amount of intraday funds overdrafts, or intraday credit extensions, that depository institutions and other entitites, such as Edge corporations and foreign banks with U.S. branches and agencies (hereafter "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-evaluation of its own creditworthiness, credit policies, and operational controls. The guidelines for performing the self-evaluation 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).

The Board's policy was designed to be binding only on depository institutions with the largest overdrafts, and, even after the reduction of caps that was effective in 1988, the use of intraday credit by virtually all depository institutions remained generally unconstrained. Only a very small number of the depository institutions required to file a cap incur overdrafts that amount to as much as 80 percent of their caps. However, overdraft levels have remained relatively stable, and overdrafts as a percentage of the dollars transferred over Fedwire have declined. Moreover, management of individual depository institutions and the Board's Large Dollar Payments System Advisory Group have indicated that, as a result of the Board's policy, senior managers of depository institutuions have focused on intraday credit risks. Reportedly, they have taken steps to eliminate many of the payment practices that had presented risk to depository institutions, the Federal Reserve, and the banking and payments systems in general.

In 1987, the Board's Payments System Policy Committee requested two studies to assist in its consideration of future payments system risk reduction policies. The Board's Large Dollar Payments System Advisory Group was specifically asked to propose policy recommendations, and a Federal Reserve System staff task force was asked to review options but to make no policy recommendations. Both reports were published by the Board in August 1988.[1]

To test the impact of pricing, posting rules, and cap changes, the Board used data from a survey for the two weeks ending February 10, 1988. This survey provided detailed transactions data for all depository institutions. Cap multiples in force in 1989 were applied to survey cap categories. The normal data flow for monitoring daylight overdrafts is reported only for depository institutions incurring overdrafts under present daylight overdraft measurement procedures and includes only summary level information on transactions processed. During the comment period, the Reserve Banks will provide individual depository institutions with information on their own overdraft profiles under both the current and proposed posting procedures as well as information on any fees that would be assessed to that each depository institution can determine for itself how the proposals would affect its position.

After reviewing the Advisory Group's and the staff's reports as well as the survey data, the Board developed a series of proposals to reduce the aggregate level of payments system risk further. These proposals assume private sector systemic risk will be reduced by the implementation of settlement finality on the New York Clearing House's Clearing House Interbank Payments System ("CHIPS") network and that other sources of systemic risk will be controlled by policy statements regarding private-sector delivery-against-payment systems and offshore netting and clearing arrangements (see Docket Nos. R–0665 and R–0666, elsewhere in today's **Federal Register**). Against this background, the Board's proposals seek to shift a higher proportion of risk to the private sector, reducing the share of such risk borne by Reserve Banks. Presented in this docket are proposals to establish a program for pricing the daily average value of all Fedwire overdrafts in excess of a deductible, to facilitate pricing by revising the defintion and measurement of daylight overdrafts, to exempt from caps those depository institutions with relatively small overdrafts, and to exclude from the cross-system net debit cap net debits on CHIPS after settlement finality is adopted on CHIPS.

Other proposals issued for comment today would apply the existing cap structure to all overdrafts, including Fedwire book-entry overdrafts, and would require collateral for all Fedwire overdrafts for (1) any depository institution whose total Fedwire overdrafts frequently and materially exceed its Fedwire cap solely because of book-entry overdrafts and (2) any foreign bank with a U.S. agency or branch whose Fedwire overdrafts exceed its cap multiple times its U.S. capital equivalency. (See Docket Nos. R–0669 and R–0670, elsewhere in today's **Federal Register**.)

As indicated above, all of these proposals should be evaluated in the context of settlement finality on CHIPS and the adoption of systemic risk-reducing policies on private-sector delivery-against-payment systems for securities activity, netting arrangements, and offshore dollar clearing systems. Moreover, proposed revisions in the rules on finality for automated clearing house ("ACH") transactions processed by the Reserve Banks should also be considered (see the Board's request for comment on ACH finality, 54 FR 8822, March 2, 1989). Proposals regarding daylight overdraft pricing, posting, and caps are discussed in detail below.

Pricing Fedwire Overdrafts

The Board is requesting public comment on a change in its payments system risk reduction policy that would provide for a fee of 25 basis points, phased in over three years in increments of 10, 10, and 5 basis points, for average daily consolidated funds and book-entry Fedwire overdrafts in excess of a deductible of 10 percent of risk-based capital. Explicit fees or charges for Fedwire daylight credit are expected to create incentives for depository institutions to reduce Fedwire overdrafts, thereby reducing direct Federal Reserve risk and contributing to economic efficiency. The Board expects that payments system participants as a result of the market incentives established by the combination of Fedwire daylight overdraft pricing and settlement finality on CHIPS, will lower the level and more efficiently allocate the distribution of Fedwire and private sector intraday credit flows.[2]

Application of Pricing to Total Fedwire Overdrafts. The Board is proposing that pricing apply to book-entry related overdrafts as well as funds overdrafts. The Board is requesting comment in a separate docket on the inclusion of book-entry securities in the total measure of overdrafts (see Docket No. R–0669). As in the case of funds overdrafts, pricing book-depository institutions to reduce these overdrafts. Moreover, failing to price book-entry overdrafts while pricing funds overdrafts would create incentives to avoid charges for funds overdrafts through manipulation of book-entry transfers. For example, depository institutions in funds overdraft could deliver book-entry securities to another depository institution in order to receive a credit from the Federal Reserve to offset their priced funds overdrafts. If book-entry overdrafts were not priced, the receiver of the securities would incur a book-entry overdraft that is free (but, perhaps, requiring the posting of collateral with the Reserve Bank) and could charge the sender of the securities any rate below the Federal Reserve charge on funds overdrafts. The loan

[1] *A Strategic Plan for Managing Risk in the Payments System: Report of the Large Dollar Payments System Advisory Group to the Payments System Policy Committee of the Federal Reserve System* (Washington, 1988) and *Controlling Risk in the Payments System: Report of the Task Force on Controlling Payments System Risk to the Payments System Policy Committee of the Federal Reserve System* (Washington, 1988) are available from the Secretary of the Board at the address noted above or from the Daylight Overdraft Liaison Officer of each Federal Reserve Bank.

[2] The Board believes that settlement finality and other risk-constraining steps on existing and evolving U.S. and offshore clearing and settlement systems will partially offset pricing-induced shifts of payments away from Fedwire and will reduce overall systemic risk. See Docket Nos. R–0665 and R–0666 elsewhere in today's Federal Register.

could be secured by the securities being transferred.

Pricing of book-entry overdrafts is unlikely to disrupt the U.S. government securities market, to constrain open market operations, or to increase the cost of Treasury financing. Each 10 basis points of overdraft charge amounts to only $2.70 per million per day, and, on average, each dollar of book-entry overdrafts is associated with six or seven dollars of transfers. The increase in the cost of the average transfer of less than $10 million is thus consideably smaller than the traditional minimum market bid-ask spread for Treasury securities, which is 1/64th of a percentage point or about $165 per million dollars transferred.

Average Overdrafts. The Board is proposing that pricing be applied to the average level of total Fedwire overdrafts. Overdrafts would be measured at equally-spaced intervals throughout the day, and the average overdraft would be the sum of all of the overdraft measurements divided by the number of intervals.[3] Average overdraft pricing more closely reflects the Federal Reserve credit actually used during the day by individual depository institutions. Average overdraft pricing is also likely to induce depository institutions to focus on managing their overdraft positions more or less continuously over the day rather than concentrating on only the time periods when overdrafts are at or close to their peak. Average overdraft pricing also permits more flexibility to the depository institution in managing overdraft levels, a particularly important advantage if book-entry related overdrafts are priced because the overdrafting depository institution will not be able to control when securities are delivered and when such overdrafts occur with the same precision as is possible with funds overdrafts.

The Board considered but decided against pricing peak rather than average overdrafts. Peak pricing would levy a fee on the Reserve Banks' maximum exposure and would also be consistent with the debit caps applied to peak overdrafts. Peak pricing, however, would be unlikely to provide incentives for depository institutions to reduce their overdraft levels once the peak has been reached, depending on the dynamics of other depository institutions' responses to pricing. In addition, if fees were assessed only for the peak overdraft, the duration of the Reserve Banks' exposure would not be considered.

The Board believes that average overdraft pricing is, on balance, superior to peak overdraft pricing and proposes that the Reserve Banks assess daily fees for average total intraday Fedwire overdrafts. Daily and two-week average debit caps would continue to apply to peak intraday values of such overdrafts in excess of $10 million and 20 percent of capital (as discussed below).

Deductible. The Board proposes that the amount of overdrafts subject to pricing be decreased by a deductible of 10 percent of risk-based capital. The deductible amount would be subtracted from the average intraday total Fedwire overdraft (funds and book-entry) each day to determine the amount of such overdrafts subject to pricing. An important purpose of the deductible would be to provide a certain amount of free Fedwire overdrafts to offset, partially or in full, those overdrafts incurred due to circumstances beyond the control of the depository institution. The deductible would provide some liquidity to the payments mechanism and would address the inevitable lack of synchronization of payments in a complex economy.

The deductible would also offset, in part, the Fedwire charge for overdrafts that may be beyond the control of the depository institution because of a computer problem at a Reserve Bank. The downtime associated with such problems can artificially affect the overdraft of a depository institution as payments cannot be sent or received. Reserve Bank operating problems affect the distribution of daylight overdrafts among institutions, benefitting some and harming others. A fixed deductible, as proposed, provided each day to address unpredictable downtime would likely overcompensate on some days and undercompensate on others. Depository institutions benefitting from a deductible on some days may have to absorb any downtime effects on other days for which a charge might be levied. The Board believes that, on average, depository institutions would not be unfairly charged and that Reserve Banks could make adjustments in exceptional circumstances. The Board proposes that Reserve Banks be permitted to adjust the amount of overdrafts subject to pricing for individual depository institutions on a *ad hoc* basis to deal with unusual circumstances, such as extended operational difficulties. In general, however, the Reserve Banks should assume that the deductible is sufficient to offset all but very lengthy operating outages at Reserve Banks and other unusual events.

The deductible would also offset some of the impact on individual depository institutions of the loss of opening-of-day non-wire net credits under the new posting rules (see discussion below). For example, a deductibe could offset the end-of-day Federal Reserve recognition of credits for checks and commerical ACH, the proceeds of which depository institutions may be required to make available to their customers at the opening of the business day according to the provisions of Regulation CC (12 CFR Part 229) or the guidelines of the National Automated Clearing House Association ("NACHA").

Regulation CC requires depository institutions to make the proceeds of certain categories of checks deposited by 2:00 p.m. available to their customers for withdrawal at the opening of business on the business day following the banking day of deposit. These "next-day availability" checks include Treasury checks, Postal money orders, checks drawn on Federal Reserve Banks and Federal Home Loan Banks, cashier's, teller's, and certified checks, and state and local government checks. Similarly, NACHA guidelines encourage depository institutions to make ACH credit transactions available to consumers for withdrawal by opening of business on the settlement day.

Under the posting proposal, discussed below, depository institutions generally would not receive credit for overdraft measurement pruposes for "next-day availability" checks or for commercial ACH credit transactions by the time that the funds should be available to their customers for withdrawal under Regulation CC and NACHA guidelines. Consequently, these depository institutions may incur an overdraft. The Board believes that these types of overdrafts would be rare, in view of the fact that most of the withdrawals of the proceeds of "next-day availability" checks and commercial ACH credits are likely to be by check or by cash withdrawal. Check withdrawals would not affect a depository institution's intraday balance because the debits for the check presentments would be recognized after the close of Fedwire. Furthermore, cash withdrawls would not affect a depository institution's intraday reserve balance. The proposal would cause depository institutions to incur overdraft costs for these checks and ACH credits only if the proceeds were

[3] Currently, overdraft values are measured at 15-minute intervals for both average and peak overdrafts. Federal Reserve staff is reviewing the feasibility of measuring overdrafts at shorter intervals (e.g., by second or minute) and whether the averaging period should be fixed (e.g., the "normal" hours over which Fedwire is open) or the actual period Fedwire is open at each Reserve Bank.

wired out on the settlement day. For most depository institutions, these overdraft costs would be covered by the deductible.

Another reason for a deductible is to exclude from pricing the large number of mainly smaller depository institutions that incur *de minimis* overdrafts. Among the over 5,000 depository institutions that incurred overdrafts on at least one day during the final quarter of 1988 (measured by the current posting rules), over 90 percent of total Fedwire (funds and book-entry) average overdrafts were incurred by the largest 50 overdrafters. The Board believes that the burden of imposing charges on the 4,500 to 5,000 depository institutions that present ony 1 or 2 percent of the risk exceeds the benefit of reducing this small amount of risk.

Depository institutions that choose to access Fedwire through multiple accounts would be required to allocate their deductible in the same proportion as the allocation of their caps. One administering Reserve Bank would still have overall risk management responsibility, even though each Reserve Bank would administer the charges for each overdrafting account.

The Board considered the impact of various deductibles (based on capital) during the test period. If there were no deductible, all 5,040 depository institutions incurring overdrafts in the test period would have been subject to pricing on their total average overdrafts, which amount to $37.3 billion. (During the same period, these depository institutions' daily peak overdrafts amounted to $120 billion.) A deductible of 10 percent would exempt 4,821 depository institutions from pricing, and only 219 would have been subject to pricing. These 219 depository institutions would have had $34.0 billion of average overdrafts but would have paid fees on only $25.5 billion of overdrafts, the difference being overdrafts at depository institutions subject to pricing that would be exempted by the deductible. The 4,821 totally exempt depository institutions would have incurred $3.3 billion of average overdrafts.

As the deductible rises, the number of depository institutions subject to pricing falls as do both the aggregate overdrafts at depository institutions subject to pricing and the amount of overdrafts actually priced. At a 20 percent deductible, for example, only 118 depository institutions would have been subject to pricing in the test period; these depository institutions would have accounted for almost 80 percent of all average overdrafts, but fees would have been assessed on only 50 percent of all average overdrafts.

The pricing deductible would be independent and separate from the test for exempotion from filing for a cap (discussed below). The cap exemption deals with intraday peak values and determines which depository institutions would be exempt from filing for a Fedwire net debit cap. The pricing deductible determines the amount of daily average intraday overdrafts subject to fees (if any) by Reserve Banks. A depository institution could be subject to a cap and operate close to its cap level for part of the day and not be subject to fees, depending on its intraday overdraft pattern. Similarly, a depository institution could conceivably be exempt from filing for a cap, but be subject to pricing because it had overdrafts for most of the day above the 10-percent-of-capital pricing deductible, even though its peak overdraft remained below the 20 percent of capital exemption-from-filing-for-cap level.

The Board specifically requests comment on whether deductible schemes other than the one proposed would be appropriate. In addition, the Board requests comment on whether there are any additional actions that could be taken by Reserve Banks or depository institutions to alleviate the problems caused by overdrafts beyond the control of depository institutions. For example, would it be feasible to accelerate lthe posting time, for overdraft measurement purposes, of those "next-day availability" checks that bear unique routing numbers, such as Treasury, Federal Reserve Bank, and Federal Home Loan Bank checks and U.S. Postal Service money orders?

Size of Charge. The Board is proposing an initial Fedwire overdraft charge of 25 basis points (annual rate) to be phased-in over three years, with the effective initial date 12 to 18 months after the Board's final adoption of a program to price Fedwire overdrafts.[4] The Board intends to implement pricing three to six months after new procedures for measuring daylight overdrafts are effective (see below). In setting the level of the Federal Reserve charge for priced Fedwire overdrafts, the Board seeks a price that is high enough to induce risk-reducing changes by depository institutions and their customers. The price should not be so high, however, as to slow payments flows or drastically increase the public's cost of making payments.

According to data collected during the test period, a fee of 25 basis points for daily average Fedwire overdrafts in excess of a 10 percent of capital deductible, before any response on the part of depository institutions to reduce their overdrafts, would result in the 15 largest overdrafters paying almost 90 percent of the total charges. (Sixty percent of the fees would have been levied against the four largest book-entry securities clearing banks.) By the 100th largest overdrafter, the annual fee would be less than $3,000 and by the 150th it would be about $400.

The Fedwire overdraft price will be applied only on business days; the actual annual cost to a depository institution of an explicit price is only a fraction of the annual percentage rate. The number of business days varies each year, but the fraction is approximately 251/365, or about 30 percent lower than an annual rate that levies fees for all calendar days. The actual rate each day is 1/365 of the annual rate fee. The Board requests comment on the level of the proposed fee as well as on the three-step phase-in schedule.

Defining Overdrafts and Application of Caps

Measuring Overdrafts

The Board's daylight overdraft pricing proposal would give funds an intraday value and, therefore, would require precision in measuring intraday overdrafts. Such precision requires fixing the time at which all payment transactions by Reserve Banks are recognized to have occurred for daylight overdraft measurement purposes. The Board proposes that, for purposes of measuring daylight overdrafts, a depository institution's opening balance at the Reserve Bank be adjusted by (1) credits for U.S. Treasury and government agency book-entry securities interest payments; (2) credits for U.S. Treasury and government agency book-entry securities redemption proceeds; (3) credits for U.S. Treasury ACH recurring credit transactions; and (4) debits for new issues of U.S. Treasury book-entry securities. During the day, this adjusted opening balance would be adjusted for Fedwire funds and book-entry securities transactions as they occur. At 2:00 p.m. local time of the Reserve Bank, Treasury direct and special direct investment credits would be reflected. After the close of Fedwire, all non-wire and commercial ACH transactions would be included.

[4] The Federal Reserve will retain its current penalty for overnight overdrafts of 10 percent or the federal funds rate plus 2 percentage points, whichever is higher.

regardless of whether the net of those transactions were a credit or A debit.[5] This overdraft measurement proposal would apply equally to all depository institutions with Reserve Bank accounts, including U.S. chartered banks, foreign banks with U.S. agencies and branches, thrifts, bankers' banks, limited purpose trust companies, nonbank banks, [6] and any other such entities.

The precise measurement of daylight overdrafts requires a set of rules to determine when during the day debits and credits to a depository institution's account at a Reserve Bank are determined to have occurred. "Posting" for the purpose of measuring daylight overdrafts is not necessarily synonymous with the time at which payments become final or the time at which the current rights to receive funds accrue, although finality of payment is one of the criteria the Board used to develop the daylight overdraft measurement rules. The actual timing of entering transactions on the Reserve Banks' books varies depending on operational procedures. Fedwire transactions, whether funds or book-entry transfers, are debited or credited as they are processed and are considered to be final payments when the receiver of funds is advised by the Reserve Bank of the credit. Rules governing non-wire payments transfers, however, generally are provisional for some period of time and refer to a particular "day" as the measuring unit of availability, without indicating the time during the day at which payment participants are either entitled to the use of the funds received or have been relieved of their payments obligation to the Federal Reserve.

Even if the Federal Reserve were not contemplating pricing Fedwire overdrafts, it would be desirable to clarify the time at which the debtor-creditor relationship between a depository institution and its Reserve Bank changes as the result of the recognition of a payment. Independent of overdraft pricing or cap policies in the United States, technology and the globalization of financial instruments and transactions are increasingly causing money, securities, and capital markets to operate on a 24-hour basis. In such an environment, trading in dollar instruments and dollar payments in one part of the world occurs while U.S. markets and Reserve Banks are closed and vice versa. In a 24-hour global market, depository institutions in the United States and abroad need to know more precisely the time of day that dollar payments are recognized to have occurred by the Federal Reserve. Even if such global developmetns were not in progress, a clarificaiton would permit depository institutions to ascertain their intraday rights and responsibilities vis-a-vis Reserve Banks and to evaluate their risks accordingly.

Under the current definition of daylight overdrafts, all non-ACH, non-wire transactions are netted at the end of the banking day; if the net is a credit, and if that net is a debit, the debit is deducted from the end-of-day position. The net of all ACH transactions is posted as if the transactions occurred at the opening of business, regardless of whether the net is a debit or a credit. This *ex post* measure thus allows a depository institution to use all of its non-wire net credits to offset any wire debits during the day, but postpones the need to cover non-wire, non-ACH net debits until the close of the day.

The current, transitional, system of posting debits and credits for daylight overdraft measurement purposes gives the benefit of the doubt to depository institutions. Two drawbacks of this system are that it creates intraday float in the measurement of daylight overdrafts in that depository institutions with net credits can use them before those with net debits are charged and many depository institutions are unable to monitor their overdraft levels effectively during the banking day. Because the Board's payments system risk reduction program is reaching maturity, the Board believes that the initial transaction posting procedures must be modified now.

In developing a proposal to establish the time at which non-wire transactions would be recognized for daylight overdraft measurement purposes (herein after referred to as "posting changes"), the Board was guided by a desire to eliminate intraday float and to keep the posting rules simple and easy to use. The Board believes that measurement procedures shoud not provide intraday float to payments system participants. Thus, the processing of a payment transaction should not result in a reduction of one depository institution's measured overdraft (or an increase in its credit balance) before another depository institution's overdraft is increased (or its credit balance reduced).

The principle of eliminating aggregate Federal Reserve intraday float is independent of the credit risk arising from the transactions. For example, there may be only minimal Federal Reserve risk resulting from granting early-in-the-day credit for checks collected through the Federal Reserve, even though the Reserve Banks do not charge paying institutions until late on the presentment day. However, by providing early-in-the-day credit to the collecting institution without an offsetting debit to the paying institution, the Federal Reserve would be permitting the collecting institution to use Federal Reserve credit without regard to that depository institution's cap, deductible, or any Reserve Bank fee. Furthermore, if explicit fees for overdrafts are adopted, and if the timing of debits and credits for each transaction were not nearly simultaneous at Reserve Banks, depository institutions would have an incentive to create float by writing each other checks to create free overdraft capacity. As intraday credit begins to have value, either through pricing or the evolution to 24-hour global markets, intraday Federal Reserve float becomes a taxpayer subsidy. Similar concerns were one reason that the Congress mandated, in Section 11A of the Federal Reserve Act, that Federal Reserve Banks should charge for float.

In addition, the new daylight overdraft measure should be simple to understand and to use in controlling intraday overdrafts. If depository institutions are to be charged a fee for incurring a Fedwire overdraft, the procedures for measuring overdrafts should facilitate their ability to control their positions and determine their intraday balances accurately. Measures that would include transactions retroactively after the transaction day is complete do not meet this test.[7]

Treasury transactions. The proposed opening-of-day credits and debits for certain U.S. Treasury transactions reflect Treasury obligations and the mechanics of the book-entry system. Interest and redemption payments on the debt are due at the opening of

[5] Generally, credit for, and repayment of, discount window loans for healthy depository institutions would be included among the non-wire transactions posted for daylight overdraft measurement purposes at the end of the day. This treatment would assure that the discount window loans were not used to fund same-day daylight overdrafters and would make the discount rate a price for a 24-hour credit and, hence, more relevant for monetary policy purposes in conjunction with a 24-hour federal funds rate.

[6] The posting changes would not affect the overdraft restrictions for nonbank banks established by the Competitive Equality Banking Act of 1987.

[7] The Large Dollar Payments System Advisory Group noted that the inability of depository institutions to control their overdraft positions accurately would be inconsistent with a program of either binding caps or overdraft pricing.

business on the payment date. Similarly, institutions purchasing Treasury securities receive title to the securities at the opening of business on the settlement date and should pay for the securities upon receipt.

Treasury Department regulations for recurring ACH payments require depository institutions to make federal government direct deposit ACH payments available to consumers at the opening of business on the payment date, and the Board has provided for such credits to depository institutions in the proposal. Reserve Banks would modify their accounting systems to separate Treasury and commercial ACH credit transactions. Because the Treasury's account will be debited for ACH credit transactions at the same time that depository institutions will be credited for those transactions, this posting rule will not create intraday float. Treasury ACH payments can be distinguished from certain next-day availability checks, discussed above, which are also required by regulation to be made available for withdrawal by the opening of business. Unlike the Treasury ACH payments, posting the next-day availability check credits at the opening of the day would create intraday float because the checks will not have been presented to the paying institutions the opening of the day.

Under the Treasury's direct and special direct investment programs, excess balances are placed with designated depositories that pay interest on the deposits to the Treasury from the day of receipt until the day of withdrawal. Because depository institutions must pay interest from the transfer date, they should receive credit for the transafer early enough to be able to invest the funds that day without incurring an overdraft. Some depositories are advised of direct investments the day before the deposits are received, and others are advised on the day of deposit. While it might be feasible to grant credit for deposits known in advance at the opening of business, it is generally not possible to grant credit for same-day deposits until 2:00 p.m. local time. Because one posting time would be less complex and should not disadvantage depository institutions, the Board believes the credits for Treasury direct and special direct investments should be posted at 2:00 p.m. local time of the Reserve Bank. The repayment of these investments is effected by Treasury calls, and the Board proposes that debits for calls be posted after the close of Fedwire on the day of the Treasury call. To ensure that no intraday float is created, the Treasury's account would be debited or credited for book-entry, ACH, and direct investment transactions at the same time that depository institutions receive the corresponding debit and credit entries in their accounts.

Other Non-wire Transactions. For purposes of measuring daylight overdrafts, the Board proposes that all other non-wire and commercial ACH transactions be posted simultaneously, which eliminates the creation of intraday float, after the close of Fedwire. In addition to eliminating float, posting non-wire transactions at the end of the day would assure that the depository institutions on either side of a transaction would have complete information as to the amount and account to be debited or credited and that depository institutions would not incur daylight overdrafts subject to charges and caps that are due to debits that are only provisional and may not be binding if the institution fails.

The Board considered and rejected various other arguments for posting non-wire debits and credits earlier in the day. For example, although commercial ACH credit transactions are generally known in advance of settlement day and both the debit and credit for these transfers could be posted at the opening of business, the Board did not propose such a rule, in part because the opening-of-day debit might disadvantage originators that no longer obtain opening-of-day net credit for other non-ACH, non-wire transfers. Moreover, consumers typically withdraw cash or write checks on the proceeds of commercial ACH credit payments on settlement day, which, unlike funds transfers, would not affect a depository institution's intraday reserve balance. Thus, crediting receiving depository institutions at the close of Fedwire should not create significant costs.

Posting check transactions to the collecting and paying depository institutions' accounts after the close of Fedwire on the availability date is consistent with the elimination of intraday float and providing banks with information to enable them to manage their accounts. Although Reserve Banks present most checks to paying depository institutions in the morning, they present some checks as late as 2:00 p.m. for same-day payment. If an earlier posting time were established, paying depository institutions in the western time zones (Alaska, Hawaii, and the West Coast) might be debited before checks were presented to them and, therefore, before they were aware of the amount of the debit. Further, to avoid intraday float, if check debits and credits were to be recorded earlier than after the close of Fedwire, the time established must be a standard time nationwide. If the timing of the credits and debits were based on the local time of the Reserve Bank holding the depository institution's account, float would be created due to time zone differences. In addition, it is not operationally feasible to credit some checks, i.e., those that have been presented to paying depository institutions, earlier than other checks that are presented later in the day.

In addition, the Board believes it is important to establish a time at which a paying depository institution becomes obligated for a debit. Regulation J (12 CFR Part 210) requires a depository institution to pay for checks presented by a Reserve Bank by the close of the banking day on which the checks are presented. Debiting the paying depository institution for checks presented at an earlier time during the day might require a depository institution to pay for checks before they have been presented and before the depository institution has had an opportunity to verify the charge. Moreover, private sector collecting depository institutions are often not able to obtain same-day payment for checks presented to paying depository institutions without payment of a presentment fee; in some cases they are unable to do so even if presentment fees are offered. For these reasons, the Board does not believe that debiting institutions for checks presented earlier than the close of business would be an equitable solution for either paying or collecting depository institutions.[8]

The new posting rules are intended to

[8] In April 1988, the Board published for comment a same-day payment concept, which would enable private sector collecting depository institutions to receive payment for checks presented to paying depository institutions prior to 2:00 p.m. in same-day funds, without the imposition of presentment fees. Adoption of the concept would provide private collecting depository institutions with the same presentment abilities Reserve Banks currently have (53 FR 11911, April 11, 1988). Board staff is currently analyzing the comments received and reviewing alternatives suggested by several commenters. If a viable alternative is developed and proposed for public comment, it could incorporate payment options, chosen at the discretion of the paying depository institution, that would provide for payment to the collecting bank after the close of Fedwire on the day of presentment. Thus, paying depository institutions would not be obligated to pay for checks presented by private collecting depository institutions earlier in the day than they would be debited for checks presented by Reserve Banks. The Board could also propose a similar change to Regulation CC regarding the timing of payment by a depositary bank for returned checks.

facilitate pricing of Fedwire overdrafts by allowing depository institutions to determine with certainty their account balance at the Reserve Bank at any time during the day. The Board does not anticipate that these posting rules will significantly increase the pricing burden on depositor institutions, particularly given the deductible equal to 10 percent of risk-based capital, which will provide some compensation for overdrafts directly caused by the new positing rules.

The Board recognizes that it is common practice for depository institutions to extend credit to creditworthy corporate customers by permitting them to use non-wire credits, such as check credits, on the availablility/settlement date to cover funds transfers during the day. In such cases, depository institutions have determined that their customers are sufficiently creditworthy to recover any funds should the non-wire transactions be returned or not paid. Under the proposal, most depository institutions will have the option to continue their current practices of providing credit to customers in anticipation of later cover or collection of final funds. A small number of depository institutions, however, may incur a cost in the form of a Federal Reserve fee on average overdrafts above a deductible amount for using intraday Federal Reserve credit to finance the transactions. As discussed above, given the 10 percent pricing deductible proposed by the Board, the incidence of that higher cost is likely to extend to very few depository institutions.

In view of the lack of finality of most non-wire payments and the goals to eliminate Federal Reserve float and to provide depository institutions with an accurate measurement of their overdraft position throughout the day, the Board requests comment on whether it would be desirable to post certain non-wire transactions, such as commercial ACH, local clearinghouse, or other transactions earlier in the day.

Application of Cap

The Board is proposing that the current cap system continue, with certain modifications that would exempt small depository institutions from the requirement to file for a cap and make the *de minimis cap* more useful for some larger institutions. In addition, the Board proposes that CHIPS net debits be excluded from the cross-system debit cap once settlement finality is implemented on CHIPS. These changes are intended to facilitate compliance with the Board's overall risk policy. In a related proposal issued for comment today (see Docket No. R–0669 elsewhere in today's **Federal Register**) the Board has proposed that book-entry overdrafts be included within the current debit caps. While the Board believes that pricing should reduce Fedwire overdrafts significantly, until more experience is gained, it would be premature to remove caps or the self-evaluation process for depository institutions.

Exemption of small overdrafters. The Board proposes that depository institutions that only very rarely incur daily total peak Fedwire (funds and book-entry) overdrafts in excess of the lesser of $10 million or 20 percent of their risk-based capital be excused from performing self-evaluations or filing board-of-director's resolutions with their Reserve Banks. This exemption would, however, be granted at the discretion of each Reserve Bank. Reserve Banks would be expected to take the necessary steps (e.g., coordination and consultation with supervisory personnel within the Reserve Bank and at other agencies) to limit their risk exposures to those depository institutions under financial duress or in any other way presenting unusual risk to the Reserve Banks. This risk-exposure control could include real-time monitoring and imposition of lower caps or zero caps. Depository institutions, of course, would continue to be free to file for a cap if they chose to do so and would be required to do so if they began to exceed the exemption limits.

Currently, a depository institution that incurs Fedwire funds overdrafts infrequently is only required to file an annual board-of-directors resolution with the Reserve Bank authorizing the depository institution to incur occasional Fedwire overdrafts up to $500,000 or 20 percent of capital, whichever is less (the *de minimis* cap). All other depository institutions wishing to incur Fedwire overdrafts must conduct an annual self-evaluation, based on Federal Reserve criteria, obtain their board's resolution of approval, and maintain supporting files for examiner review. These procedures have focused director and senior management attention on the risks of daylight credit exposure and the need to adopt prudential internal control procedures and policies. A number of observers within and outside the Federal Reserve System, however, have questioned the need to apply the policy to all overdrafters.

The Board does not believe it would be prudent to excuse depository institutions with a small absolute level of overdrafts from the limits of the overdraft policy if the overdrafts are large relative to the depository institution's capital. Similarly, from a Federal Reserve risk perspective, large overdrafts should not be excluded from the policy just because such overdrafts are a small portion of the depository institution's capital. Both the prudential and Reserve Bank risk concerns could be addressed by a dual test that considered both the size of the overdraft and its relationship to the capital position of the depository institution incurring the overdraft.

Of the 5,040 depository institutions that would have incurred an overdraft under the proposed posting procedure in the February 1988 test period, about 4,600 had overdrafts that were both less than $10 million and 20 percent of the depository institution's capital. These overdrafts were neither large relative to the depository institution's capital nor to the risk exposure of Reserve Banks. These 4,600 depository institutions accounted for only $1.7 billion of Fedwire overdrafts, less than 1.5 percent of the total.[9] This exemption greatly reduces the administrative burden of the Board's payments system risk reduction policy, with only marginal increases in potential direct Federal Reserve risk.

De Minimis Cap. Under the current *de minimis* cap, a depository institution may incur overdrafts up to the lesser of 20 percent of adjusted primary capital (or "U.S. capital equivalency" for foreign banks' overdrafts on Fedwire) or $500,000, so long as the institution does not incur daylight overdrafts on a regular basis. The depository institution must file a board-of-directors' resolution with its Reserve Bank approving its use of a *de minimis* cap but need not engage in a full self-evaluation process. The Board is proposing a new *de minimis* cap category with no frequency or dollar-limit tests, but still requiring a board-of-directors' resolution to obtain the 20 percent of capital cap.

A small number of depository institutions would benefit if the existing *de minimis* cap were modified to remove the $500,000 limit and the frequency test, retaining only the 20 percent of capital constraint. This

[9] Indicative of the large number of very small overdrafters, the number of depository institutions does not change significantly as the $10 million overdraft threshold is increased to $25 million (4,635), or decreased to $5 million (4,544). Similarly, changing the capital ratio has modest impact at the same dollar level: at a $10 million overdraft level, a 10 percent overdraft-to-capital ratio would exempt 4,383 depository institutions and a 50 percent ratio would exempt 4,708 depository institutions.

modified cap category would differ from the exempt category in two ways: (1) While retaining a 20 percent of capital constraint, it would have no $10 million limit, and, hence, would be of value only to larger depository institutions; and (2) it would, like the present *de minimis* cap, require board-of-director filing, but not a self-evaluation. The modified *de minimis* cap would be a useful transition grouping for larger depository institutions between the proposed exempt-from-cap-filing category and the lowest cap requiring self-evaluation and board-of-directors' resolutions.

Exclusion of CHIPS Net Debits. Provided that settlement finality is implemented on CHIPS, the Board proposes that the cross-system sender net debit cap be eliminated, with the current cap multiples applied only to total Fedwire overdrafts. Under current procedures, Fedwire caps are reduced by any net debit on CHIPS. When these procedures were adopted, they were intended to control not only the use of Federal Reserve intraday credit, but also to serve as a check on systemic risk. With reasonable means of assuring settlement finality, the system risk associated with the potential failure of a CHIPS participant to settle should be reduced significantly. Each participant would have an increased incentive to be cautious in setting bilateral net credit limits for other participants. Moreover, shifts of Fedwire payments to CHIPS to avoid Fedwire overdraft fees would be likely to result in expanded exchanges of payments among the few largest CHIPs participants. If this assumption is correct, net debit positions subject to cross-system caps should not change significantly as participants both receive and send more on CHIPS. Finally, elimination of the cross-system cap would be consistent with the policy statement on private book-entry systems that the Board issued today (see Docket No. R–0665, elsewhere in today's Federal Register), which does not impose the cross-system cap on those systems that adhere to the policy statement on risk control and settlement finality.

CHIPS serves almost 140 participating banks. Twenty-two of these participants are settling banks, i.e., at the end of the day, they settle the day's transactions on a net basis both for their own account and as correspondents for non-settling participants. Settlement is effected at the end of the day when Fedwire payments by those settling depository institutions in debit position are made to a settlement account at the New York Reserve Bank, followed by Fedwire transfers from the settlement account to all settling depository institutions in net credit position.

The payments volume on CHIPS, more than three-quarters of which is associated with foreign exchange and Eurodollar transfers, is somewhat larger than Fedwire funds transfers (about $700 versus about $660 billion per day in the fourth quarter of 1988). However, the average aggregate peak intraday net debit position on CHIPS is smaller than Fedwire funds daylight overdrafts (about $45 billion per day versus $60 to $65 billion per day). Although less than Fedwire, the net daylight credit exposure on CHIPS still represents a potential major systemic risk should a CHIPS participant be unable to settle its net debit position.

To reduce the systemic risk on CHIPS, the Board in recent years has encouraged the NYCH to adopt risk-reducing measures. Thus, in 1984, the NYCH implemented a system of network bilateral credit limits, and in 1985 established CHIPS-specific sender net debit caps. The former requires each participant to make an assessment of the creditworthiness of its counterparty, and the latter establishes a limit on the total exposure any one bank can create on CHIPS.

Despite these steps, if a participant is unable to settle its debit position at the end of the day, the CHIPS rules provide that payments to and from that participant be "backed out" of the settlement and new net positions calculated for the remaining participants; the calculation of the new net positions could continue until settlement is achieved. Despite this potential for revised settlement, participants permit most of their customers to use credits for CHIPS payments during settlement day, while reserving the right to charge back such credits if the transferring bank does not settle its CHIPS position. Simulations of the impact of a CHIPS participant's inability to settle suggest that such failures to settle could drastically change the net position of other participants, inducing a series of failures to settle by them. Thus, the current CHIPS rules and the practices of participants could lead to the systemic failure of depository institutions and/or pressure on the Federal Reserve to provide liquidity assistance while losses and solvency problems are determined.

The Federal Reserve has encouraged the NYCH to adopt settlement finality for CHIPS. Settlement finality would assure that CHIPS payments will be settled each day, even if one large, or several smaller, participants are unable to settle. Thus, liquidity pressures will be dealt with immediately, while allocation of losses can be resolved at a later time. In response to these concerns, the NYCH has developed a plan to implement settlement finality in late 1990 or early 1991 based on the netting of payments and a formula for sharing the risk of the remaining uncovered net debits.

Settlement finality on CHIPS does not eliminate private direct credit risk. Under the NYCH plan, specified CHIPS participants must cover the net debit of the failed participant, but that share is of a size unlikely to cause the failure of any one of them. Although the NYCH plan would provide for settlement finality on the day of a participant's failure to settle, there is some uncertainty as to whether the calculated multilateral net positions are legally binding obligations. The Federal Reserve is encouraging the NYCH to explore means of assuring that certainty, but even with uncertainty, the proposed CHIPS settlement finality will produce a substantial reduction of systemic risk.

In addition, because of the added settlement obligation aspects of the NYCH plan for settlement finality on CHIPS, CHIPS bilateral credit limits may be reduced and some small participants can be expected to withdraw from CHIPS. The number of transactions and the dollar volume of payments on CHIPS is likely to decline only moderately after settlement finality, as long as those depository institutions leaving CHIPS can find correspondents willing to conduct business for them. In fact, volume could increase with shifts from Fedwire if Fedwire overdrafts are priced.

The exclusion of CHIPS net debits from caps would benefit the 35 CHIPS participants that have large net debits on that system. Elimination of the cross-system cap would increase their ability to conduct Fedwire activity within their cap. The CHIPS activity of the remaining 105 participants does not generally result in a high cross-system cap utilization rate, and thus elimination of the cross-system cap would not affect these institutions.

The approximately 50 foreign banks that incur net debits on CHIPS would be virtually unaffected by the elimination of cross-system caps. Currently, foreign banks are allowed to incur Fedwire overdrafts up to the amount of their Fedwire cap (based on U.S. capital equivalency), regardless of CHIPS debits. Foreign banks cross-system debit caps are based on world-wide capital, and they are permitted to incur Fedwire overdrafts above their Fedwire caps (up to their cross-system caps) by posting collateral for the amount of such overdrafts in excess of their Fedwire caps. Under the proposed revisions to the foreign bank overdraft policy, however, foreign banks exceeding their Fedwire cap woudl have to collateralize the entire amount of their Fedwire overdraft, not just the amount over their Fedwire cap. Under the proposal, foreign banks could have Fedwire overdrafts up to the amount of their cap multiplied by their world-wide capital if all of those overdrafts were collateralized. (See Docket No. R–0670, elsewhere in today's **Federal Register.**)

Capital

The Board proposes, for the purpose of determining caps, that all domestic depository institutions use the same definition of "capital" that bank supervisors will require U.S. commercial banks to use for meeting their risk-based capital requirements. Depository institutions that choose to access Fedwire through multiple accounts would continue to be required to allocate their capital for debit cap purposes to each Reserve Bank at which they incur overdrafts: one administering Reserve Bank would still have overall risk-management responsibilities.

If CHIPS overdrafts are excluded from caps, foreign banks would be relieved of reportiing worldwide capital for the purpose of computing their cross-system debit cap. Under the proposal, the only foreign bank overdrafts subject to cap would be Fedwire overdrafts based on U.S. capital equivalency. If, however, the foreign bank overdraft policy is changed as discussed above, foreign banks would be required to report their wordwide capital if they wished to incur collateralized Fedwire overdrafts, which would be limited to their cap multiplied by their world-wide capital. In that case, those foreign banks whose home countries participated in the Basle Accord might, in the name of reduced burden, be given the option of reporting either their lower (but easier to report) world-wide equity capital for cap purposes or their capital in accordance with the Basle Accord as applied by home country supervisors.

The "capital" concept that has been used in the payments system risk reduction policy to determine the maximum permissible overdrafts (the cap multiple times capital) is primary capital less certain intangible assets. This "adjusted" primary capital concept for commercial banks is refined for other types of depository institutions to be consistent with the bank concept, given any special institutional characteristics of these depository institutions.[10]

In the past year, the U.S. bank supervisory agencies have adopted new risk-based capital requirements consistent with the Basle Accord. (See 54 FR 4186, January 27, 1989.) The new requirements will be phased in from 1990 through 1992. For consistency, it would be desirable if the capital base used for the Board's daylight overdraft policy were the same as that used for certain other supervisory purposes, such as the computation of risk-based capital.

The new international risk-based capital standard divides capital into two tiers. Tier I is composed of "pure equity" less goodwill.[11] Tier I alone would be smaller than adjusted primary capital for all depository institutions. Tier II (which cannot exceed Tier I) is composed of certain forms of hybrid capital, preferred stock, subordinated debt (up to 50 percent of Tier I capital), and loan loss reserves (up to 1.25 percent of risk-weighted assets).[12] For most banks, the sum of the two tiers exceeds their adjusted primary capital, as the inclusion of subordinated debt and hybrid capital in Tier II exceeds the reduction due to the limited inclusion of loan reserves now fully included in primary capital. The ratio of estimated risk-based capital to adjusted primary capital at the 286 U.S. chartered banks that, in the February 1988 test period, had overdrafts of sufficient size to require filing for a cap suggests, on average, that risk-based capital for U.S. banks incurring overdrafts subject to cap would be about 15 to 25 percent higher than adjusted primary capital, increasing maximum permissible overdrafts by that amount.

The Administration's proposal to address the thrift problem and to modify the regulatory structure of the thrift industry would apply bank capital standards to thrift institutions, other than credit unions, by 1991. In the test period, only 13 thrifts (excluding credit unions) incurred overdrafts above the exemption level. As might be expected, some of these entities would face larger increases in capital requirements than banks. About half of them, however, would have no increase in capital for overdraft purposes because most of the regulatory accounting adjustments are already eliminated from adjusted primary capital for thrifts.[13] In the aggregate, the 60 thrifts (including credit unions) with Fedwire overdrafts in excess of the exemption level incurred only about $300 million of overdrafts in the February 1988 test period, about 0.2 percent of total Fedwire overdrafts.

Impact of Proposal on Cap Utilization

According to the data collected during the February 1988 survey, under the current posting procedure, excluding book-entry overdrafts and with no exemptions or exclusions, 3,414 depository institutions with $92.7 billion of intraday peak overdrafts subject to cap would be covered by the current daylight overdraft policy. If book-entry overdrafts were added to the amount subject to cap assuming the current overdraft measurement methodology and no exemptions of small overdrafters or exclusions of CHIPS net debits, the number of overdrafters would have risen by only 100 or so depository institutions, but the amount of overdrafts subject to cap could have increased by over $40 billion to $133.6

[10] "Primary" capital for commercial banks is common stock, perpetual preferred stock, surplus, undivided profits, contingency and other capital reserves, cumulative foreign currency transaction adjustments, qualifying mandatory convertible instruments, allowance for possible loans and lease loses (exclusive of any allocated transfer risk reserves), and minority interest in equity accounts of consolidated subsidiaries. Intangible assets are subtracted from this total to obtain "adjusted" primary capital. (Equity capital of Edge corporation subsidiaries is also subtracted from the parent's capital if the parent permits the subsidiary to incur its own overdrafts).

For savings and loan associations and federal savings banks, "primary" capital is composed of perpetual preferred stock, permanent reserves or guaranty stock, contributed capital, qualifying mutual capital certificates, net worth certificates, income capital certificates, retained earnings, and all general valuation allowances. From this total are deducted deferred net losses on loans and other assets sold, goodwill, and other intangible assets to obtain "adjusted" primary capital. Mutual savings banks' capital measures are similar.

[11] Common Stock, surplus, undivided profits, capital reserves, cumulative foreign currency translation adjustments, and the minority interest in consolidated subsidiaries. While goodwill is deducted, in general, mortgage servicing rights and other identifiable intangible assets are not.

[12] More specifically, hybrid capital is the sum of net equity contract notes and equity commitment notes; preferred stock must be noncumulative perpetual preferred, subordinated debt is the sum of limited life preferred and subordinated notes and debentures, and loan loss reserves must be general provisions and not for specific assets.

[13] Deferred net losses on loans and assets sold and goodwill are deducted from both current and proposed capital; risk-based capital would generally permit the inclusion of mortgage servicing rights and other intangibles (existing goodwill is grandfathered through 1992, and then excluded), while all forms of intangibles are now excluded from adjusted primary capital; net worth and income capital certificates are included in adjusted primary capital but would be excluded from the new capital standard; FSLIC and FDIC notes could serve to raise capital under both standards.

billion. The proposed modification of posting procedures would have raised the total number of depository institutions with overdrafts by almost 1,600 depository institutions to 5,097,[14] and would have raised the aggregate level of overdrafts an additional $17 billion to $150.8 billion. This latter increase in overdrafts and overdrafters reflects the shift of non-wire net credits from opening-of-day to close-of-day posting for about 2,700 depository institutions that had such credits in the test period. It is this shift in posting that accounts for the large increase in the number of overdrafters. However, the inclusion of book-entry overdrafts accounts for two-thirds of the dollar increase in overdrafts.

If CHIPS net debits were removed from overdraft calculations and then smaller overdrafters were excused from filing for the Fedwire cap, the number of depository institutions that would have had to file for either a *de minimis* or other cap in the test period would fall to less than 450. However, the total Fedwire overdrafts at depository institutions subject to caps would have fallen only from $120.2 billion to $118.4 billion. Thus, with the small overdrafter exemption and the CHIPS exclusion, most depository institutions would not be directly affected by the change in the posting rules, and the amount of Fedwire overdrafts subject to the policy would be reduced by only a small amount.

One hundred forty-three depository institutions would have exceeded their cap during the test period under the proposed rules. Most of the overdrafts above cap are at a small number of depository institutions that exceed their caps because of book-entry overdrafts. In fact, the four major book-entry clearers accounted for virtually all of the overdrafts in excess of cap. As discussed in Docket No. R–0669, the Board is proposing that such depository institutions be permitted to exceed their cap, provided they post collateral. Thus, the cap per se is not a constraint for these depository institutions.

Most of the remaining overdrafts at depository institutions that would have exceeded their cap in the test period where at six large banks that would have exceeded their caps due to the proposed posting change. About one-half of the overdrafts at these six banks, and an even larger amount at other depository institutions (including some of the major book-entry clearers) was related to the settlement for maturing commercial paper.[15] The Depository Trust Company ("DTC") is expanding its existing same-day settlement system to include book-entry processing for commercial paper. Both the proposed posting procedures and pricing for overdrafts should accelerate this effort. The DTC book-entry system will virtually eliminate Fedwire overdrafts associated with commercial paper issuance, transfers, and redemption, removing a substantial part of the overdrafts above cap associated with the posting proposal.

During the test period, a significant part of the remaining overdrafts above cap, as well as those at a small number of other depository institutions with high cap utilization rates, were at correspondent banks that had only modest overdrafts under the current posting procedure. These depository institutions now benefit from opening-of-day posting of net credits for checks they collect on their own behalf and for respondents through the Federal Reserve and/or through local clearinghouses that settle on the books of the Reserve Banks. These credits would be recognized at the end of the day under the proposal.

Eighty-seven depository institutions incurred a modest level of overdrafts that exceeded their proposed 20-percent-of-capital *de minimis* caps because of the new posting rules. Some of these depository institutions could file for non-*de minimis* caps and operate with the new posting procedures.

Bankers' banks cannot avoid the impact of the posting proposal by filing for a cap. Bankers' banks are exempt from reserve requirements and, hence, do not have access to the discount window. Depository institutions without such access may not incur Fedwire overdrafts because they may, in some circumstances, have no other way to cover a daylight overdraft at the end of the day. Some bankers' banks may choose to become member banks in order to gain access to the discount window and thus avoid a restriction on the size of deposit a member bank may place with the bankers' bank.[16] However, Congress intended that discount window access be available only to a depository institution that is subject to reserves.[17] A bankers' bank eligible to become a member may have access to the discount window upon approval provided it agrees to maintain reserves. Nine bankers' banks have done so. Because the Board has ruled that credit unions may not become member banks, this access to the discounty window is not available to corporate credit unions.[18] Thus, bankers' banks organized as credit unions may not incur daylight overdrafts on Fedwire so long as they qualify as bankers' banks. They would have access, and would be subject to reserve requirements, if they fail to qualify as bankers' banks. For example, it may be possible for credit unions organized as bankers' banks to amend their charter so as to become depository institutions eligible for Federal Reseve credit. The Board requests comment on the effect of the risk proposals on bankers' banks and possible solutions to any problems.

During the test period, 43 bankers' banks, virtually all of which were corporate credit unions, incurred overdrafts under the proposal, mainly as the result of the loss of opening-of-day net credits for non-wire transactions. While none incurred an overdraft as high as $50 million, the total overdrafts of such depository institutions were $200 million. Only three of the depository institutions could have met the exemption proposal if they were eligible for it. Relative to capital, their overdrafts under the proposed measuring procedure would in virtually all cases not permit them to operate within any cap constraint, if they were permitted to have a cap. Bankers' banks would thus, under the proposal, have to hold larger balances, reduce their federal funds sales, or take similar actions to reduce their wire payments relative to their wire inflows and balances.

In view of the proposal's impact on the overdraft level of various types of institutions, the Board requests comment

[14] During the test period, about 2,100 depository institutions incurred overdrafts under the posting proposal that would not have done so under the current policy, but over 400 would have ceased overdrafting under the proposal because their current opening-of-day ACH debits and/or late afternoon non-wire net debits would not be posted until after the close of Fedwire.

[15] Maturing commercial paper is presented to paying agent depository institutions by custodian or collecting depository institutions. New York Clearing House members settle such paper, net, as part of the New York Clearing House net settlement on the books of the Federal Reserve Bank of New York. Those depository institutions in a net credit position on the net settlement now receive that credit at the opening of the day. Under the proposal, this credit would be received after the close of business. In addition, issuing agent depository institutions often provide the issuers with proceeds of new issues before investors have transferred funds to the issuing agent depository institution.

[16] Section 19(e) of the Federal Reserve Act provides that nonmember bank shall keep on deposit with any depository institution without access to the discount window under section 10(b) of that Act a sum in excess of 10 percent of the member bank's capital and surplus.

[17] Colloguy of Congressmen St. Germain and Wirth, 126 Cong. Rec. H2291 (March 27, 1980).

[18] See letter from Secretary of the Board to Federal Reserve Bank of Minneapolis, S–540, August 6, 1942.

on alternative approaches to the treatment of Fedwire overdrafts over cap. For example, should some level of overdrafts in excess of cap continue to be permitted in extraoridinary cases at the discretion of the Federal Reserve Bank? Further, some overdrafts are readily secured and generally self-liquidating. For example, under the terms of Section 4–208 of the Uniform Commercial Code, depository institutions handling a check for collection may have a security interest in the check until payment is received. Overdrafts in excess of cap incurred in anticipation of check credits would be paid routinely when the credit is posted. Should such readily secured, self-liquidating overdrafts, or other secured overdrafts, in excess of cap be permitted? Who should bear the cost of maintaining collateral if collateralized overdrafts in excess of cap were permitted? Would permitting collateralized ovedrafts in excess of cap increase risks to other creditors of overdrafting depository institutions?

Federal Reserve Operational Modifications for Pricing

Federal Reserve operating outages could affect intraday liquidily in the banking system and thereby contribute to measured overdrafts at individual depository institutions. Therefore Fedwire's operating reliability is critical to the success of the payments system risk reduction program. To assure greater Fedwire reliability, the Federal Reserve Banks are improving overall Fedwire processing performance and developing and implementing disaster recovery capabilites for Fedwire operations.

Fedwire's reliability is high and has been improving steadily. The time Fedwire was unavailable during business hours, decreased sharply in 1988. Funds transfer downtime decreased by almost 50 percent and securities transfer downtime decreased by approximately 40 percent from the 1987 levels. In 1988, the funds transfer and securities transfer systems achieved 99.59 percent and 99.41 percent availability, respectively.

Hardware and software systems that will reduce the likelihood of Fedwire outages and facilitate more rapid recovery from operations problems are being implemented to improve reliability further. In addition, the Federal Reserve is strengthening its disaster recovery capabilities to minimize the likelihood of a prolonged service disruption. The New York Reserve Bank has demonstrated, in disaster recovery simulations at its dedicated contingency site, the ability to recover Fedwire operations, reconcile funds and securities transfers, and resume processing of new transfers within four hours of a disaster. The Chicago and San Francisco Reserve Banks also currently have, or are in the process of establishing, dedicated backup sites for Fedwire processing. The remaining Reserve Banks share a disaster recovery site located in Culpeper, Virginia.

Federal Reserve pricing for daylight overdrafts will require that reliable information be made available to depository institutions by their Reserve Banks regarding the depository institutions' payment activity affecting their reserve or clearing accounts during the day. The Reserve Banks have developed an Account Balance Monitoring System ("ABMS"), which will enable depository institutions to obtain their current account balance during the day. The ABMS will reflect the depository institution's opening balance, funds and securities transfers as they occur, and selected non-wire transactions that would be posted to the monitor periodically during the day consistent with this proposal. While some institutions may rely on ABMS exclusively, other institutions may use it in conjunction with their own internal monitoring systems. ABMS will be available to depository institutions before any pricing scheme in implemented.

Proposed Implementation Schedule

The Board proposes that the new payments system risk reduction policy be implemented in a series of staggered effective dates. As indicated on Docket No. R–0669, Fedwire debit caps would be applied to total Fedwire overdrafts (funds and book-entry), with collateral required for total Fedwire overdrafts exceeding the Fedwire cap because of book-entry securities transfers, in the second quarter of 1990. As indicated in Docket No. R–0679, the effective date for requiring collateral of all Fedwire overdrafts of foreign banks with Fedwire overdrafts exceeding their cap based on U.S. capital equivalency would also be in the second quarter of 1990.

The Board proposes that the use of risk-based capital to compute debit caps as well as the other cap and daylight overdraft measurement proposals become effective in late 1990 or early 1991. CHIPS settlement finality is also expected to occur within this time frame, and thus CHIPS net debits would be excluded from the cross-system net debit cap in late 1990 or early 1991.

Approximately three months after adoption of the overdraft measurement changes, Reserve Banks would begin sending mock bills to depository institutions as if pricing were being applied. The Board proposes that, by mid-1991, Reserve Banks would begin assessing the first 10 basis points of the 25 basis point charge. The second 10 basis points would be applied in mid-1992 and the final 5 basis points in mid-1993. The Board reserves the right to accelerate or extend the phase-in period, depending on market responses. The Board also reserves the right to terminate the phase-in at a lower price than 25 basis points or to continue the phase-in to a higher price, depending on market responses.

By order of the Board of Governors of the Federal Reserve System, June 15, 1989.

William W. Wiles,

Secretary of the Board.

[FR Doc. 89–14636 Filed 6–20–89; 8:45 am]

BILLING CODE 6210–01–M

FEDERAL RESERVE SYSTEM

[Docket No. R–0669]

RIN 7100–AA76

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

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board is requesting comment on a proposed policy to reduce the risks to the Federal Reserve arising from daylight overdrafts associated with transfers or book-entry securities on Fedwire. This policy is proposed in conjunction with the other requests for comments and policy statements regarding the Board's payments system risk reduction program, published elsewhere in today's **Federal Register.** The proposed policy would require depository institutions that frequently exceed their Fedwire caps by material amounts solely because of book-entry transfers to collateralize their total Fedwire overdrafts. The proposal sets guidelines regarding preferred types of collateral and identification of collateral and also establishes guidelines for the Reserve Banks to implement the policy.

DATES: Comments must be submitted on or before November 17, 1989.

ADDRESSES: Comments, which should refer to Docket No. R–0669, 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 5:00 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); Florence Young, Assistant Director, Division of Federal Reserve Bank Operations (202/452–3926); 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: This is one of three proposals regarding payments system risk that the Board is issuing for public comment today. The others concern pricing of overdrafts on the Federal Reserve's wire transfer system ("Fedwire") and related overdraft measurement and cap proposals (Docket No. R–0668) as well as the daylight overdraft policy for U.S. branches and agencies of foreign banks (Docket No. R–0670). The Board encourages all interested parties to comment on each of these proposals. The Board urges that in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each. This procedure will facilitate the Board's processing and analysis of the comments on these proposals by ensuring that each comment is quickly brought to the attention of those responsible for analyzing each specific proposal. In addition, the Board encourages entities that plan to submit identical comments, such as affiliated institutions within a holding company, to consolidate their efforts; the Board will give equal consideration to one letter signed by a number of commenters as it would to numerous identical letters submitted by those commenters. Comments are due November 17, 1989, and the Board does not intend to extend the comment period beyond that date.

In addition to its requests for comment, the Board is also issuing today three risk-related policy statements regarding private delivery-against-payment systems (Docket No. R–0665), offshore clearing and netting systems (Docket No. R–0666), and rollovers and continuing contracts (Docket No. R–0667).

Background

The Board's current payments system risk reduction program establishes a maximum amount of intraday funds overdrafts 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 a self-evaluation 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 transfers have been exempt from the cap limits, pending development of procedures to bring these extensions of credit by Reserve Banks within the ambit of the policy. (For additional background on the Board's payments system risk reduction program, see Docket No. R–0668, elsewhere in today's **Federal Register.**) For depository institutions that are major clearers of government securities, however, such caps would have to be sizeable to cover the overdrafts associated with the operations of an efficient market for U.S. government securities.[1] As described more fully below, the Board proposes changes to its payments system risk reduction program that will more fully secure the Reserve Banks, while continuing to provide flexibility to depository institutions engaged in clearing U.S. government securities.

Proposed policy regarding book-entry securities transfers. The Board is requesting comment on the following multi-faceted proposal to deal with book-entry overdrafts:

• 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 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 assets 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.

As previously noted, the Board's current payments system risk reduction program exempts book-entry related daylight overdrafts from cross-system net debit caps. In making this decision, the Board realized that, for the vast majority of depository institutions, book-entry overdrafts are small in size and present limited risk to the Federal Reserve System. By far, the majority of book-entry overdrafts are concentrated in a few clearing banks which serve the major dealers and brokers in government securities. Restricting the overdrafts of these banks could impede the smooth functioning of the government securities market.

On two previous occasions the Board has issued for public comment proposals that would deal with the risks arising from book-entry overdrafts by requiring that such overdrafts be collateralized (50 FR 21132, May 22, 1985, and 51 FR 45046, December 16, 1986). On both occasions, commenters have agreed that the Federal Reserve should be protected by collateral but have argued that the means proposed to do so were too restrictive and rigid in nature. The previous proposals focused on the use of those book-entry securities in transit that give rise to the overdraft as collateral rather than on other possible types of collateral. Commenters argued that reliance on this collateral would burden book-entry processing with complex and costly control processes. As a result, a collateralization policy has not been adopted, though the underlying causes of book-entry overdrafts have been at least partially addressed by a limit on transaction size, increased secrutiny of dealer clearing practices, and issuance of guidelines for dealer clearance behavior.

These measures to control book-entry overdrafts have had some success, particularly as they relate to the value of overdrafts per dollar of securities transferred and to the size and timing of peak overdrafts at large clearing banks. Book-entry related overdrafts, however, still account for 60 percent of all Fedwire peak intraday overdrafts and have an average peak value of approximately $60 billion per day. Further, these overdrafts continue to be highly concentrated at a small number of depository institutions, primarily clearing banks located in New York

[1] For foreign banks, caps that reflect their world-wide capital would allow overdrafts of a size that would be inappropriate given their U.S. assets subject to U.S. supervision and their U.S. funding capacity. (For the Board's proposals regarding foreign banks see Docket No. R–0670, elsewhere in today's Federal Register.) In the case of foreign banks, collateral has been looked to as the means to secure overdrafts above the cap level and has been considered in the past as a means of securing book-entry related overdrafts. In reviewing this policy, the Board has concluded that partial collateralization of Fedwire overdrafts is not desirable.

City. The four largest clearing banks, while reducing their overdrafts for the reasons noted above, still account for about two-thirds of all book-entry related daylight overdrafts. The ten largest clearing banks account for approximately 80 percent of all such overdrafts. The government securities markets could be seriously disrupted if these institutions were significantly restricted in their ability to provide intraday credit to their customers. On the other hand, if one of these institutions were to experience a problem requiring overnight funding, the overdrafts involved could present considerable risk to its Reserve Bank. Thus, there continues to be a need to develop a program that will protect the Federal Reserve by collateralizing large book-entry overdrafts while at the same time recognizing the wide disparity among depository institutions incurring overdrafts and the types of business such overdrafts reflect.

In response to this need, the Board has developed a proposal that integrates book-entry overdrafts with funds overdrafts for measurement purposes and provides for flexible treatment of the relatively few institutions that incur very large overdrafts. This proposal has several aspects. First, it recognizes that book-entry overdrafts are similar to those created by funds transfers in that both expose the Federal Reserve to the risk of loss. Thus, there seems to be little reason to continue the policy of separating the two types of overdrafts and creating, at times, misleading the two types of overdrafts and creating, at times, misleading overdraft data for individual depository institutions. For the vast majority of depository institutions, combining book-entry and funds overdrafts under the current cap structure would have little effect. In the last quarter of 1988, only six depository institutions with assets over $1 billion and 41 with assets under $1 billion would have experienced increases in their cap utilization rates of more than 25 percent under such a program. Of those 47 depository institutions, only 15 would have exceeded their caps as a result of the inclusion of book-entry overdrafts. Five large depository institutions whose total overdrafts exceeded their caps because of their book-entry overdrafts are major clearing banks. The total Fedwire overdrafts of these depository institutions (all of which would be collateralized under the proposal, as discussed below) account for almost 40 percent of the aggregate Federal Reserve direct credit risks resulting from daylight overdrafts. The ten remaining banks that would exceed their cap due to book-entry overdrafts account for only 0.2 percent of total Fedwire overdrafts.

The Board believes that book-entry and funds overdrafts should be combined under the current cap program. The Board does not believe, however, that the few depository institutions severely affected should be required to reduce overdraft levels, as they would be if caps had been exceeded as a result of funds transfers. Rather, the Board proposes that these depository institutions be asked to collateralize the total exposure they create for Reserve Banks from funds and book-entry overdrafts. This collateralization policy will apply only to these depository institutions that frequently incur total Fedwire daylight overdrafts that, solely because of book-entry related overdrafts, are materially in excess of their Fedwire caps. All other depository institutions will be expected to manage their total overdrafts (funds and book-entry) within the existing cap system, with the exception of occasional, modest daylight overdrafts that are due solely to book-entry transfers.

A second aspect of the Board's proposal would provide that collateral cover the entire daylight overdraft of an affected depository institution, not just that created by book-entry overdrafts. This reflects the reality that, if Federal Reserve lending at the discount window is needed, the entire credit must be collateralized, not just that portion created by book-entry transfers or that amount in excess of the depository institution's cap.

The third aspect of the Board's proposal involves the type of collateral to be used to secure the overdraft. The Board believes that discount window and other pools of acceptable collateral, held either by the Reserve Bank or by the depository institution, should be relied upon, to the extent possible, to cover daylight overdrafts. Discount window collateral and portfolio pools of assets are more easily identified than the book-entry securities being transferred that are eligible for pledge to secure overdrafts. Such collateral would cover a large portion of many large depository institutions' overdrafts. Moreover, using existing discount window collateral and asset pools as a primary source of collateral for overdrafts minimizes the need to rely on book-entry securities being transferred as collateral and would help to avoid potential conflicting claims on these securities. Some depository institutions may be able to pledge the securities being transferred by some customers, primarily brokers and dealers, to cover the depository institution's book-entry overdrafts, but depending on the availability of discount window collateral and asset pools this may not be necessary in all cases. Any security agreement between a Reserve Bank and a depository institution will exclude collateral that the institution is not authorized to pledge. Each depository institution subject to this collateralization requirement will be expected to work with its Reserve Bank to develop the mix of discount window collateral, other asset pools, and incoming book-entry securities to be used as collateral. The resulting program of collateralization will thus be customized to the depository institution so as to accommodate its business needs as well as to provide adequate protection to the Reserve Bank.

The final aspect of the Board's collateralization proposal concerns the manner in which rights to collateral in the form of book-entry securities being transferred will be conveyed to Reserve Banks. Ideally, such securities would be segregated in real-time on Reserve Banks' books, valued at market price less appropriate haircuts, and released from pledge to the Reserve Banks only as daylight overdrafts are extinguished. Such a process would involve extensive operational changes at both depository institutions and Reserve Banks, requiring a long lead time for development and implementation. Thus, the Board believes that using incoming book-entry securities as collateral should be accomplished in two phases, interim and long run. In the interim, those depository institutions that would find it necessary to repledge customer securities to Reserve Banks would mark the repledged collateral on their own books and not segregate the collateral at the Reserve Bank. Unfortunately, under this arrangement, a Reserve Bank could not assure on a real-time basis that the total collateral actually pledged, i.e., discount window collateral, other asset pools, and securities being transferred and marked on the depository institution's books, would be sufficient to cover the depository institution's overdraft. However, as an interim measure, the intraday pledge of book-entry securities, recorded on the books of the overdrafting depository institution, would reduce the unsecured credit risk now incurred by the Reserve Banks.

In the long run, intraday on-line valuation and segregation capabilities, similar to the services clearing banks now provide their customers, will be available as a result of the Reserve Banks' decision to design and develop a new book-entry operating system. This effort is expected to take threee to five years to implement and will require extensive changes by Reserve Banks, depository institutions, and the major government securities dealers. Concurrently, the Department of the Treasury is in the process of revising its regulations that govern the legal transfer of interests in U.S. government securities. The Reserve Banks will be working with all interested parties to assure that the future book-entry securities system not only provides the means of efficiently and prudently securing Fedwire book-entry daylight overdrafts, but also includes the capabilities, procedures, and protections that will serve the future needs of the clearing banks, the dealer community, and their customers.

The Board expects the Reserve Banks to implement the new book-entry securities program with considerable flexibility. Reserve Banks are to require any depository institution that frequently exceeds its Fedwire cap because of book-entry overdrafts to collateralize its entire overdraft. However, the specific application of the collateral requirement is to be worked out by the Reserve Bank and the depository institution on a case-by-case basis. Reserve Banks will determine the definition of "frequently and materially" on a flexible basis, and will work to perfect an interest in the types of collateral the depository institution can most easily provide. It would be expected that both the type and loan value of the collateral would be consistent with each Reserve Bank's discount window policies, even if the collateral used is not routinely taken for discount window purposes. Finally, if book-entry securites being transferred are needed as collateral, Reserve Banks will work with each depository institution to determine what internal processes are needed to ensure the best repledge of securities that can be effected.

To implement this proposal, Reserve Banks will:

• Work flexibly with each depository institution affected by the proposal;

• Accept only the type and loan value of collateral that would be broadly consistent with the Bank's discount window policies;

• Develop model agreements for pledging collateral held in the possession of Reserve Banks, held for discount window purposes by the depository institution, or repledged by the institution as a result of customer book-entry transfer business; and

• Develop a new book-entry system that will provide the means for segregation and valuation of book-entry securities being transferred on Reserve Bank books.

By order of the Board of Governors of the Federal Reserve System, June 15, 1989.

William W. Wiles,

Secretary of the Board.

[FR Doc. 89-14640 Filed 6-20-89; 8:45 am]

BILLING CODE 6210-01-M

[Docket No. R-0670]

RIN 7100-AA76

Proposals To Modify the Payments System Risk Reduction Program; U.S. Agencies and Branches of Foreign Banks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board is requesting comment on a proposed risk reduction policy that would require collateralization of all Fedwire overdrafts (funds and book-entry) of foreign banks operating through U.S. agencies and branches if such overdrafts exceed the banks' Fedwire cap. This policy is proposed in conjunction with the other requests for comment and policy statements regarding the Board's payments system risk reduction program, published elsewhere in today's **Federal Register**.

DATES: Comments must be submitted on or before November 17, 1989.

ADDRESSES: Comments, which should refer to Docket No. R-0670, 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 5:00 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), Jeffrey C. Marquardt, Senior Economist, Division of International Finance (202/452-3697); for the hearing impaired *only*: Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: This is one of three proposals regarding payments system risk reduction that the Board is issuing for public comment today. The others concern pricing of overdrafts on the Federal Reserve's wire transfer system ("Fedwire") and related overdraft measurement and caps proposals (Docket No. R-0668), as well as the inclusion of book-entry securities transfers in the measurement of Fedwire overdrafts (Docket No. R-0669). The Board encourages all interested parties to comment on each of these proposals. The Board urges that in filing comments on these proposals, commenters prepare separate letters for each proposal, identifying the appropriate docket number on each. This procedure will facilitate the Board's processing and analysis of the comments on these proposals by ensuring that each comment is quickly brought to the attention of those responsible for analyzing each specific proposal. In addition, the Board encourages entities that plan to submit identical comments, such as affiliated institutions within a holding company, to consolidate their efforts; the Board will give equal consideration to one letter signed by a number of commenters as it would to numerous identical letters submitted by those commenters. Comments are due November 17, 1989; and the Board does not intend to extend the comment period beyond that date.

In addition to its requests for comment, the Board is also issuing today three risk-related policy statements regarding private delivery-against-payment systems (Docket No. R-0665), offshore clearing and netting systems (Docket No. R-0666), and rollovers and continuing contracts (Docket No. R-0667).

In April 1985, the Board of Governors adopted a policy to reduce risk on large-dollar payments systems. This policy, which was 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. The maximum, or cap, is a multiple of a depository institution's adjusted primary capital and is based on a self-evaluation 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 cross-system net debit caps, thus reducing the maximum daylight overdrafts permitted to individual depository institutions.[1]

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

The Board has applied its daylight overdraft policy to foreign banks as well as domestic institutions in a manner consistent with the policy of "national treatment," i.e., applying similar rules to foreign entities operating within the United States as are applied to domestic institutions. In this regard, U.S. subsidiary banks owned by foreign banks are treated identically to all other U.S. banks under the program. The policy for branches and agencies of foreign banks, however, of necessity, takes into account certain differences between these entities and domestically-chartered institutions, including the following: (1) Most of a foreign bank's assets and liabilities are located and controlled outside of the United States and only the operations of the U.S. branches and agencies are subject to supervisory review by U.S. authorities, and (2) for many foreign banks, the volume of dollar payments that would flow through their U.S. branch network is substantial relative to the level of their assets in the United States and their local dollar funding capacity. As such, there may be practical limits on the ability of branches and agencies of foreign banks to raise funds in the market, either through unsecured borrowings or by providing collateral in an acceptable form, to meet liquidity needs in the event of credit or operational problems.

In this initial policy, the Board based the cross-system cap (for Fedwire and CHIPS [2] combined) for branches of foreign banks on their world-wide capital, but based the Fedwire cap (for Fedwire funds overdrafts) on a surrogate for capital in the U.S. ("U.S. capital equivalency" [3]), which is significantly smaller than world-wide capital. Foreign banks with U.S. branches and agencies are permitted to incur Fedwire overdrafts above their Fedwire caps (up to the cross-system cap) by posting collateral for the amount of such overdrafts in excess of their Fedwire caps.

A few foreign banks operating through U.S. branches and agencies have indicated that Fedwire caps are too binding for their dollar payments business, that their Fedwire caps do not recognize their world-wide strength, and that their U.S. operations do not involve the kind of assets to permit the posting of collateral for larger Fedwire overdrafts. In the summer of 1987, the Board reconsidered its policy in light of these concerns and determined that the policy should not be changed. This decision was based in part on the fact that U.S. branches and agencies of foreign banks were generally operating well within their Fedwire caps and seemed to be able to obtain large volumes of private intraday credit on CHIPS.

Foreign bank representatives have noted that the Basle Accord capital standards should meet or alleviate the Board's concerns about the capital positions and supervision of foreign banks with U.S. branches and agencies. In early 1989, the Institute of International Bankers renewed its request that the Board permit world-wide capital to be used as the base for determining Fedwire caps for foreign banks operating in the U.S. through branches and agencies.

There continues to be little evidence, however, that foreign banks are seriously constrained in their access to U.S. payments systems, despite rapid growth in their overdrafts. Since the Board's policy was initiated, both Fedwire funds and CHIPS daily average peak overdrafts of U.S. branches and agencies of foreign banks have risen more rapidly than have those of U.S.-chartered entities. In the fourth quarter of 1988, 64 branches or agencies of foreign banks incurred $6.4 billion of Fedwire funds overdrafts, and 96 incurred $31.0 billion of CHIPS net debits. Very few of these entities use their Fedwire cap intensively, however the few who do exceed their Fedwire cap under the proposed policy would have to collateralize the total amount of their Fedwire overdraft.

The Board does not believe that the current daylight overdraft policy is causing a hardship for foreign banks. Moreover, given the lack of U.S. asset base and potential limits on dollar funding capacity that would apply to some foreign banks, the current policy appears to be sound. Including book-entry overdrafts under the cap policy (see Docket No. R–0669) would have virtually no impact on the Fedwire cap utilization of foreign banks operating through U.S. branches and agencies. However, the proposed collateral policy for book-entry overdrafters requires that collateral be posted by U.S.-chartered depository institutions for all Fedwire overdrafts if the Fedwire cap is exceeded because of book-entry overdrafts. A parallel policy for those U.S. branches and agencies of foreign banks that exceed their Fedwire cap based on U.S. capital equivalency would provide that collateral be posted equal to the total Fedwire overdrafts, not just the amount in excess of the cap. The current policy that permits U.S. branches and agencies of foreign banks to incur uncollateralized Fedwire overdrafts up to their Fedwire cap based on U.S. capital equivalency would not be changed. Under the proposal, foreign banks could have Fedwire overdrafts up to the amount of their cap multiplied by their world-wide capital if all of those overdrafts were collateralized.

At the current time, such a policy change would have virtually no impact on foreign banks, which use CHIPS much more than Fedwire and have relatively low Fedwire cap utilization rates. Such a change would also serve as better protection for Reserve Banks if large exposures do occur.

Accordingly, the Board is soliciting public comment on a proposal that would extend the collateral requirements to all Fedwire overdrafts (funds and book-entry) of foreign banks operating through U.S. branches and agencies if such overdrafts exceed their Fedwire cap. The Board also requests comment on the proposed general overdraft policy (see Docket No. R–0668) as it applies to these entities.[4] Specifically, the Board is requesting comment on the relative burdens and benefits of the proposed collateral policy versus maintaining the current policy (but including book-entry overdrafts in the total Fedwire overdrafts subject to cap).

The Board is also requesting comment on alternative definitions of U.S. capital equivalency, particularly in light of the recent international accord on the definition of bank capital. Commenters are asked to suggest alternative definitions that would provide a reasonable balance between the practical U.S. asset and dollar liquidity limits of foriegn banks and the interests of foreign banks in more flexible access to Fedwire.

By order of the Board of Governors of the Federal Reserve System, June 15, 1989.

William W. Wiles,

Secretary of the Board.

[FR Doc. 89–14641 Filed 6–20–89; 8:45 am]

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[2] "CHIPS" is the Clearing House Interbank Payments System, operated by the New York Clearing House.

[3] U.S. capital equivalency is 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.

[4] Edge corporations would continue, as now, to be required to post collateral for all their Fedwire overdrafts. No change in policy is being proposed for these entities.