FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **10302**
June 28, 1989]

POLICY STATEMENTS REGARDING PAYMENTS SYSTEM RISK

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

The Board of Governors of the Federal Reserve System has issued three policy statements in connection with its program to reduce payments system risk. The statements deal with (1) private book-entry systems, (2) offshore netting and clearing arrangements, and (3) the prudent use of Fedwire rollovers and continuing contracts to reduce daylight overdraft exposure.

Following is the text of a statement issued by the Board of Governors announcing these actions:

The Federal Reserve Board has issued three policy statements as part of its overall Payments System Risk Reduction Program.

• A Policy Statement on Private Book-Entry Systems (Docket No. R-0665) establishes guiding principles for reducing risk on delivery-against-payment systems that settle on a net same-day basis over the Federal Reserve's wire transfer system.

• An Interim Policy Statement on Offshore Netting and Clearing Arrangements (Docket No. R-0666) establishes guiding principles for any offshore dollar clearing or settlement system settling directly or indirectly in the United States.

• A Policy Statement on Rollovers and Continuing Contracts to Reduce Daylight Overdraft Exposure (Docket No. R-0667) encourages the prudential use of rollovers and continuing contracts to reduce daylight overdrafts on Fedwire.

Printed on the following pages is the text of the statements, which have been reprinted from the *Federal Register* of June 21. Questions regarding these matters may be directed to George R. Juncker, Vice President, Payments System Studies Staff (Tel. No. 212-720-6491), or to our daylight overdraft liaison officer, Richard J. Gelson, Vice President (Tel. No. 212-720-7766).

E. Gerald Corrigan,
President.

[Docket No. R-0665]

RIN 7100-AA76

Policy Statement on Private Delivery-Against-Payment Systems

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy statement.

SUMMARY: The Board is issuing a policy statement establishing guiding principles for reducing risk on delivery-against-payment systems that settle on a net same-day basis over the Federal Reserve's wire transfer system. The Board believes that adherence to the policy statement will reduce systemic risk for both the Federal Reserve and system participants. This policy statement is issued in conjunction with the Board's requests for comments on proposals regarding its payments system risk reduction program and its policy statements regarding offshore clearing systems and rollovers and continuing contracts, published elsewhere in today's Federal Register.

EFFECTIVE DATE: June 15, 1989.

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director, Division of Research and Statistics (202-452-3368); 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: The Board is concerned about the systemic risk associated with private large-dollar payments and clearing systems. The potential systemic risk caused by the failure of a private system participant to settle its obligations can be far broader than the direct credit risk exposure to the Federal Reserve if a depository institution were unable to settle its net debit position on the Federal Reserve's wire transfer system ("Fedwire"). The receiver of a Fedwire payment is insulated from any losses associated with the failure of the sender because the receiver of the transfer receives good funds from the Federal Reserve upon receipt of advice of the credit; the Federal Reserve absorbs the direct credit risk that otherwise would be borne by counterparties to Fedwire payments.[1] Thus, the repercussions of the failure of an overdrafting sender on Fedwire to settle its obligations end with the loss to the Federal Reserve; no systemic losses are incurred by direct or indirect creditors of the Federal Reserve. In contrast, the creditor of participants on private networks are subject to systemic risk. This risk occurs because the direct counterparties of a failing participant may bear losses that in turn may affect their ability to meet their own settlement and other obligations. Additional indirect credit relationships may exist among participants in a network or in interbank credit relationships outside of payments networks. These indirect credit relationships and their attendant credit risks increase systemic risks associated with the failure of a participant to settle on a private network.

The Board is issuing a policy statement to address intraday credit risks arising out of the delivery of securities against payment through systems other than Fedwire. The Board believes that private book-entry systems have the potential to (1) Reduce operating risk by supplanting separate physical delivery and wire payment for definitive instruments; (2) lower operational costs by setting net positions rather than each underlying transaction, which also reduces the volume of funds necessary for settlement; and (3) reduce credit exposures by reducing the volume of intraday credit extensions. In addition, such systems lend themselves to techniques that permit participants to establish credit discipline amoung themselves. With the proper safeguards, such as collateral, debit caps, bilateral credit limits, pre-arranged loss-allocation formulas, and legally binding netting and close-out arrangements (e.g., novation), these systems can also be risk-reducing. In addition, such risk-reducing safeguards would serve to focus the attention of system participants on their own risk exposure.

The Board's policy statement establishes general guidelines to ensure that settlement occurs in a timely fashion and that participants do not face excessive intraday risk. Guidelines are established in four areas: (1) Liquidity safeguards for ensuring settlement, (2) provisions for reversals, (3) credit safeguards, such as collateral and netting features, and (4) open settlement accounting. The rules and procedures of those delivery-against-payment systems that use the Federal Reserve's net settlement services would be subject to prior and ongoing review on a case-by-case basis by the Federal Reserve in accordance with the Board's policy statement.

Policy Statement On Private Delivery-Against-Payment Systems

Private delivery-against-payment securities systems that settle on a net, same-day basis entail credit and liquidity risks for their participants and for the payments system in general. This policy statement provides guidance on payment risk management for those delivery-against-payment systems that settle their end-of-day obligations directly or indirectly over Fedwire.

The policy specifically addresses intraday credit risks arising out of the delivery of securities against payment through systems other than the Federal Reserve's wire transfer system ("Fedwire"). These systems meet the criteria listed in the Board's definition of a large-dollar payments system, but generally will not be subject to the specific measures adopted as part of the Board's risk reduction program, such as cross-system debit caps, provided that these systems conform to the requirements of this policy statement.

The Board believes that these systems should include risk-controlling features if they are to rely on Fedwire for ultimate settlement. The need for such risk controls is becoming increasingly important in view of these systems' potential for growth and high volume and the possible future course of the Federal Reserve's payments system risk reduction program, e.g., pricing intraday Fedwire funds and book-entry overdrafts. The Board is, therefore, establishing the following general policy framework for the treatment of the

[1] The private sector still faces credit losses outside of the payments system associated with a failing depository institution. Such indirect private-sector risks increase when the Reserve Banks reduce their direct credit risk by taking collateral to cover their daylight credit extensions. Failure of a sender would then cause no losses for Reserve Banks even though the receiver obtains full payment; other creditors of the failed depository institution, however, have fewer assets against which to make a claim.

payment risk in private-sector delivery-against-payment systems under its risk reduction program.

Delivery-against-payment securities systems, as described below, are expected to adopt appropriate liquidity and credit safeguards in order to ensure that settlement occurs in a timely fashion and that the participants do not face excessive intraday risks. In view of the continuing evolution of these systems, the Board has decided to establish general guidelines rather than to specify the exact form such safeguards should take. Reversals or "unwinds" of funds and securities transfers, however, are not considered appropriate liquidity control measures.

The policy addresses four issues: (1) Liquidity safeguards for ensuring settlement; (2) provisions for reversals; (3) credit safeguards, such as collateral and netting features; and (4) open settlement accounting. These components, and the scope and regulatory implications of this policy, are described below.

Scope of the Policy. This policy statement is specifically targeted at large-scale private delivery-against-payment securities systems that settle their obligations on a net, same-day basis over Fedwire, either directly or indirectly. These systems settle securities transactions for their participants by tranferring securities and the accompanying payments obligations on the books of a clearing corporation or a depository institution operating the system and arrange for final settlement of the funds positions on a net basis at the end of the processing day. Settlement on a "net basis" means that the funds obligations are netted among all participants, so that a participant can settle obligations to or from many counterparties by making a single transfer to or from the system. "Same day" settlement means that the appropriate funds and securities transfers are settled on the day that a delivery-against-payment request is entered into the system. "Large-scale" systems are those systems that routinely process a significant number of individual transfers larger than $50,000 or that would permit any one participant to be exposed to a net debit position at the time of settlement in excess of its capital.

This policy applies to systems that function primarily as a means of transferring securities and funds between participants. If a firm or bank is providing clearing services to a customer, and these services focus primarily on the bilateral relation between the clearer and the customer, the firm or bank would not be viewed as a system under this policy. Moreover, at least initially, a system that is an integral component of a full service ban, such that obligations that settle on an item-by-item basis are the direct obligations of the bank, will not be subject to this policy because of the existing supervisory oversight of a bank's liquidity and credit resources.

This policy applies to systems in the United States that transfer debt and equity securities, including those not eligible for Fedwire. The policy does not apply to systems dealing with other financial instruments, such as futures and options.

This policy is directed at limiting the risks arising out of the intraday credit generated in private delivery-against-payment systems. The policy does not address other potential sources of risk in these systems, such as inadequate management or facilities. The Board expects that these systems will be subject to regulatory oversight because they are typically clearing agencies subject to supervision by the Securities and Exchange Commission, or because they are limited purpose trust companies subject to state or federal banking supervision, or both. These supervisors have broad responsibility for ensuring the safety and integrity of these systems.

Liquidity Safeguards. Because they give rise to intraday credit, private delivery-against-payment systems rely on payments by participants with net obligations to the system ("net debtor" participants) in order to make settlement payments to participants with net obligations due from the system ("net creditor" participants). In the absence of appropriate safeguards, failure by a single participant with a net debit position may delay all settlement transfers by the system. The result of a system's failure to settle in a timely manner will be that participants do not receive the transfers of funds and securities that they expected and that they may need to conclude transactions outside the system. Because settlement typically occurs at the end of the day, the system and net creditor participants will have relatively little time to react to any failure that may occur.

This policy seeks to ensure that these private systems settle in a timely manner, so that participants can rely on the funds or securities obtained as a result of transfers through the system. The importance of ensuring reliable transfers is due in part to the fact that these systems generally allow participants to re-transfer funds credits or securities acquired during the day. If, for example, a participant sold securities early in the day and later used his funds credits to purchase other securities, then a failure in the settlement of the earlier transaction could result in a failure of the settlement of the later transaction.

The Board believes that private systems should protect timely settlement by adopting safeguards that are commensurate with the risk of settlement failure. The Board recognizes that a private system relying on intraday credit will not be able to guarantee timely settlement of funds and securities transfers under all conceivable circumstances and, therefore, that such a system cannot make an absolute guarantee of settlement finality. At a minimum, however, a system must have sufficient safeguards so that it will be able to settle on time if any one of its major participants defaults. In addition, the Board strongly encourages systems to adopt settlement safeguards beyond this required minimum.

Liquidity arrangements that will enable a system to make end-of-day settlement payments are crucial settlement safeguards. Liquidity safeguards adopted by private delivery-against-payment systems should include provisions that give the system access to sources of readily available funding that will support timely settlement in case a participant is unable to settle its obligation. Funding sources could, for example, include prearranged lines of credit or a pool of funds contributed by the participants. The system should limit, on an intraday basis, the size of potential net debit positions to ensure that these liquidity sources will be adequate.

Because settlement risks and structure may vary in different systems, the Board does not consider it appropriate to specify the exact structure of acceptable safeguards. One example of an appropriate liquidity safeguard may be a cap on the net debit funds position that may be incurred by an individual participant, which is tied to the liquidity resources available to the system and/or to the participant. If such a cap is used, it may be appropriate for it to be administered in a flexible manner, with due regard for liquidity and credit risks and for the efficient operation of the system.

Generally, net debits incurred by a depository institution within the system will not be applied to cross-system net debit caps established under the risk reduction program, which are applicable to Fedwire or CHIPS, nor will net credits on these systems be available as offsets.

Reversals. Currently, certain systems permit reversals of transfers of funds and securities to facilitate settlement if a participant defaults. By reversing transactions, the systems try to reduce the obligations of the defaulting participant. However, settlement with reversals will not ease the liquidity problems caused by a default; reversals will simply transfer a liquidity shortfall from the defaulter to another participant and will do so at the end of the day, when it may be difficult to arrange for alternate sources of liquidity. The return of securities, with the resulting reversal of a funds credit, may cause the participant receiving the returned securities to default on its obligations. Thus, settlement using reversals will not achieve this policy's objective, because participants will not be able to rely on transfers of funds and securities if transfers may be reversed.

Because the Board does not view reversals as a satisfactory liquidity safeguard, the systems covered by this policy should not use reversals as a substitute for liquidity arrangements, such as those discussed above, in order to ensure timely settlement.

Credit Safeguards. As stated above, these systems effectively allow participants to use intraday credit when receiving securities. All participants may be affected by one participant's failure to repay this credit if the system's liquidity arrangements permit settlement. The Board, therefore, believes that these systems should adopt clear loss-allocation rules and should minimize credit risks incurred through the system. Methods of reducing credit risk may vary in different systems. Appropriate methods include requiring contributions by all participants to a fund that may be used in the event of a default or requiring the pledging of a sufficient volume of market-to-market collateral. The loss allocation schedule should not increase risks to the system. In particular, the system should calculate the loss resulting from a default on the basis of the net obligations of the defaulter rather than on the basis of the underlying gross obligations between the defaulter and its counterparties. Thus, the Board would find a loss allocation scheme to be unacceptable if it reversed all transactions between the defaulter and other participants.

It is worth noting that this policy statement, including the restriction on reversals, is not intended to prevent a system from allocating credit losses to the counterparty of a defaulter based on the business dealings between the counterparty and the defaulter. It may be appropriate and prudent for a system to have rules which would require participants who have dealt with the defaulter to be responsible, after settlement, for the related loss. These arrangements could well include returning securities to the counterparty to help absorb the loss.

Open Settlement Accounting. As the systems described in this policy grow in size and volume, the timely and orderly completion of end-of-day settlements take on an increased importance for the settlement of other large-dollar payments systems. As a general matter, the Board believes that it will be easier for market participants and supervisors to monitor and protect against settlement risks if current information is readily available. Participants in a delivery-against-payment system should therefore have up-to-date information on their net position and on the settlement progress of the system, and appropriate market supervisors should have ready access to current intraday information on both the system's settlement and participants' positions. For those systems wishing to use Fedwire payments as a means of settlement, the Board encourages the use of Federal Reserve Bank net settlement services rather than individual wire payments that cannot be distinguished from all other Fedwire payments. This policy is in no way intended to broaden access to Federal Reserve services; neither Fedwire nor net settlement services will be available, as a general matter, to non-member nondepository institutions.

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

William W. Wiles,

Secretary of the Board.

[FR Doc. 89-14638 Filed 6-20-89; 8:45 am]

BILLING CODE 6210-01-M

[Docket No. R-0666]

RIN 7100-AA76

Interim Policy Statement on Offshore Netting and Clearing Arrangements

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Interim Policy Statement.

SUMMARY: The Board is issuing an interim policy statement to establish guiding principles for any offshore dollar clearing or settlement system settling directly or indirectly on Fedwire or CHIPS. The Board believes that adherence to the policy statement will result in a reduction in risk on large-dollar payments systems in the United States. This interim policy statement is issued in conjunction with the Board's requests for comments on proposals regarding its payments system risk reduction program and its policy statements regarding private delivery-against-payment systems and rollovers and continuing contracts, published elsewhere in today's **Federal Register**.

EFFECTIVE DATE: June 15, 1989.

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director, Division of Research and Statistics (202/452-3368) or 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: The Board of Governors of the Federal Reserve System has issued the following policy statement concerning offshore netting and clearing arrangements. This policy statement is being issued in conjunction with the Board's requests for comments on proposals regarding its payments system risk reduction program and its policy statements regarding private delivery-against-payment systems and rollovers and continuing contracts, published elsewhere in today's **Federal Register**.

Interim Policy Statement on Offshore Dollar Clearing and Netting Systems

For some time, the Board has been sensitive to the risks associated with the actual and potential development of netting and clearing arrangements for U.S. dollar payments located outside of the United States. In particular, the Board has been concerned that the steps being taken to reduce systemic risk in U.S. large-dollar payments systems may themselves induce the further development of "offshore" dollar payments systems. These offshore systems can settle through payments on the Federal Reserve's wire transfer system ("Fedwire") or the New York Clearing House's Clearing House Interbank Payments System ("CHIPS"), but may operate without adequate procedures for the management of risks and without any form of official oversight. However, the Board recognizes that the development of offshore clearing and netting arrangements raises issues of concern which go beyond the immediate question of payment risks in the U.S. banking system.

Banks in all countries have been experiencing strong incentives to reduce payment flows and credit exposures. As an apparent consequence, there are an increasing number of proposed or actual interbank netting arrangements which affect an offset or netting of amounts due between banks, arising not only from payment instructions but also from the settlement of foreign exchange and other financial contracts, on either a bilateral or multilateral basis. When located outside of the country of issue of the currency subject to the netting, these arrangements have the potential to alter significantly the structure of the international interbank clearing and settlement process.

In response to these developments, the Group of Experts on Payments Systems from the G–10 central banks, meeting at the Bank for International Settlements ("BIS") in Basle, Switzerland, studied a variety of payment and currency netting arrangements. The BIS Payments Experts' "Report on Netting Schemes" primarily addresses the allocation of credit and liquidity risk in various netting structures and draws general conclusions as to whether these risks are increased or decreased by the different "institutional forms" of netting. The Board believes that, in so doing, the Report of the Payments Experts provides a valuable starting point for the consideration of risk in the international payment process.

In addition, the Report notes that a number of broader monetary, financial, and supervisory policy implications are associated with the further development of netting arrangements for interbank markets. Netting systems for foreign currency payments and contracts have the potential to create changes in the financial character of affected interbank markets, as well as in the cross-border relationships between national banking systems. These changes, in turn, raise questions about the extent and quality of central banks' oversight and supervision of settlements in their respective currencies, including the allocation of supervisory responsibility among various central banks and national supervisory authorities.

On the basis of this preliminary work, the Governors of the G–10 central banks have determined that a further study of these broader issues be undertaken with a view toward establishing an international understanding of the monetary, financial, and supervisory issues raised by the development of offshore or cross-border netting arrangements. The Board welcomes the development of a cooperative study of netting and offshore payments issues by the G–10 central banks. The Board hopes that this work can provide the foundation for a consensus, among central banks and national supervisory authorities, on the nature and extent of supervision appropriate for netting arrangements as well as on the monetary and financial policy issues associated with netting.

At the same time, however, the Board recognizes that the technological, market, and regulatory incentives that are giving rise to the growth of these arrangements will continue to operate. The Board believes that it is important, therefore, to begin to address the potential policy concerns raised by the further development of offshore netting and clearing systems for U.S. dollar payments and the risks that these systems may create. This is particularly the case in light of the significant steps that have been and are being taken by the Federal Reserve and the U.S. banking industry to address payment risk issues. These include both the Board's ongoing payments system risk reduction program and the efforts of the New York Clearing House Association to improve CHIPS participants' awareness of payment risks, to control the level of daylight exposures within CHIPS, and now to adopt settlement finality procedures.

Offshore clearing of U.S. dollar payments, for subsequent net settlement in the United States, may create transaction and other efficiencies for participants in such offshore systems. If, however, the allocation of credit and liquidity risks associated with the netting and settlement is not clearly understood or defined, offshore dollar clearing arrangements may well obscure, or even increase, the level of systemic risk in U.S. large dollar payments systems as well as in the international dollar settlement process generally. The BIS Report notes that this shifting of risk "can be particularly troubling where the transaction cost efficiencies are enjoyed by banks located in one country, but the credit and liquidity risks associated with the settlement of payments resulting from that netting system may be experienced in the banking system of another country." This is precisely what can happen when U.S. dollar payments are netted in systems outside of the United States and subsequently settled through CHIPS or Fedwire.

Because of the potential for offshore dollar clearing systems both to shift risk to U.S. large-dollar payments systems and to be used to avoid the Board's domestic risk reduction policies, the Board believes that it is appropriate for it to provide preliminary guidance on the framework within which offshore dollar systems should operate. The Board recognizes that the question of the degree of oversight and supervision of offshore clearing and netting systems can only be fully addressed on a cooperative basis among central banks and national bank supervisory authorities. However, pending the conclusion of the study of netting by the G–10 central banks and the outcome of any further international consultations, the Board's approach to offshore dollar clearing and netting systems will be guided by the following general principles:

1. An offshore dollar clearing or netting system, which settles directly or indirectly through CHIPS or Fedwire, should at a minimum be subject to oversight or supervision, as a system, by a relevant central bank or supervisory authority.

2. The participants should be responsible for clearly identifying the operational, liquidity, and credit risks created within the system and for assuring the prudent management of these risks.

3. The system should have arrangements in place which provide for the finality of settlement obligations and the practical means to assure the timely satisfaction of these obligations.

4. The direct or indirect settlement of the system's obligations through CHIPS or Fedwire should be conducted by an identified settlement agent, in the United States, so that satisfaction of the settlement obligations can be readily ascertained by the participants, the Federal Reserve, and other relevant central banks and supervisory authorities.

Consistent with the foregoing interim principles, the Federal Reserve is prepared to work with the central bank and/or supervisory authorities of the country in which an offshore dollar clearing or netting system is located, on a cooperative basis, to assure the continuing adequacy of the system's procedures for controlling risk.

The Board believes that these interim principles are consistent with the concerns identified by the BIS Payments Experts Group. The minimal conditions that they would impose on offshore clearing and netting systems are similar to the risk-reduction procedures that have been established for CHIPS. These principles should not be regarded as establishing a policy of either encouraging or discouraging the operation of offshore dollar payments systems. Rather, they represent an initial attempt by the Board to indicate the minimum structural features that the

Board believes are appropriate for offshore dollar clearing arrangements. These principles also presume a cooperative international approach to the supervision of offshore clearing and netting arrangements.

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

William W. Wiles,

Secretary of the Board.

[FR Doc. 14637 Filed 6-20-89; 8:45 am]

BILLING CODE 6210-01-M

[Docket No. R-0667]

RIN 7100-AA75

Policy Statement on Rollovers and Continuing Contracts To Reduce Daylight Overdrafts

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy statement.

SUMMARY: The Board is issuing a policy statement encouraging the prudential use of rollovers and continuing contracts to reduce daylight overdrafts on Fedwire. The Board believes that the use of such arrangements is consistent with its overall payments system risk reduction program. This policy statement is being issued in conjunction with the Board's requests for comments on proposals regarding its payments system risk reduction program and its policy statements regarding private delivery-against-payment systems and offshore clearing systems, published elsewhere in today's **Federal Register**.

EFFECTIVE DATE: June 15, 1989.

FOR FURTHER INFORMATION CONTACT: Edward C. Ettin, Deputy Director, Division of Research and Statistics (202/452-3368) or Oliver I. Ireland, Associate General Counsel, Legal Division (202/452-3625); for the hearing impaired *only*: Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: The Board of Governors of the Federal Reserve System has issued the following policy statement concerning rollovers and continuing contracts to reduce daylight overdrafts. This policy statement is being issued in conjunction with the Board's requests for comments on proposals regarding its payments system risk reduction program and its policy statements regarding private delivery-against-payment systems and offshore clearing systems, published elsewhere in today's **Federal Register.**

Policy Statement on Rollovers and Continuing Contracts To Reduce Daylight Overdrafts

The Board of Governors of the Federal Reserve System believes that the use of market innovations, such as federal funds or Eurodollar rollovers or continuing contracts, to reduce daylight overdrafts on the Federal Reserve's wire transfer system ("Fedwire") and the New York Clearing House's Clearing House Interbank Payments System ("CHIPS") is consistent with the Board's policy concerning daylight overdrafts. The Board urges market participants to consider using such innovations for these and other financial instruments where feasible. In doing so, participants should be mindful that implementing changes of this type may involve incremental costs, at least transitionally, and modified risk positions. Accordingly, participants should evaluate these factors and take them into account when selecting and negotiating with counterparties.

Many overnight interbank federal funds and other similar purchases and sales are negotiated in the morning with the funds being sent over Fedwire in the afternoon. Typically the previous day's overnight borrowings are returned to the seller in the early morning, thus leaving a midday time gap of three or more hours between the morning repayment and the receipt of that same day's new borrowing. Often these transactions are between the same two banks for the same amount. This funding time gap can contribute to daylight overdrafts of the borrowing institution and create risk to Reserve Banks.

Rollovers are interbank overnight transactions where the principal does not change and is not returned the next day to the seller but, instead, is rolled over for the next overnight period. The overnight interest rate is negotiated daily between buyer and seller. The maturity is one business day, or no maturity is specified, and the arangement may be cancelled at any time by either party. The Board understands that national bank lending limits would not apply to federal funds transactions that have a maturity of one business day or no stated maturity and require no advance notice for termination. Because the rollover procedure eliminates the daily movement of principal on Fedwire and the corresponding time gap that could otherwise exist between repayment of the previous day's borrowings and receipt of new reborrowing, daylight overdrafts are reduced.

Continuing contracts are similar to rollovers. With a rollover, the size of each day's sale is the same. With a continuing contract, the size of each day's sale can vary, and only the difference in principal from the previous day's borrowing is moved over Fedwire or CHIPS. Such arrangements reduce the size of the daily movement of principal on Fedwire and CHIPS and also eliminate the time gap that could otherwise exist between repayment of the previous day's borrowings and receipt of new reborrowing, thereby reducing Fedwire daylight overdrafts or net debits on CHIPS. When the same maturity conditions apply to a continuing contract as apply to a rollover (one business day or unspecified maturity and cancellation at any time by either party) national bank lending limits do not apply.

An industry task force that evaluated alternatives for reducing the level of daylight overdrafts absorbed by the federal funds and Eurodollar markets sought to devise improved settlement practices, e.g., rollovers and continuing contracts, that sustain the present rate negotiation mechanism. Each participant should satisfy itself that it has the flexibility to negotiate amounts, rates, and maturity options before using these practices for federal funds, Eurodollars, or other financial instruments. Either of these practices, rollovers or continuing contracts, can reduce daylight overdrafts or intraday net debits, and their prudential use by the banking industry is consistent with the Federal Reserve's policy of reducing intraday exposures on Fedwire and CHIPS. When borrowing banks reduce their daylight overdrafts by use of these practices, some extra operational costs and risks may be incurred by either party compared to current arrangements in the overnight market. For example, sellers of federal funds and other instruments may have to develop alternative audit trail procedures and may accept some addition risk of repayment since funds would not be returned each day before they would be relent. In addition, buyers of federal funds and other instruments may experience some extra initial operating costs to set up rollover arrangements between themselves and lending banks and may have to pay a higher rate to induce lenders to commit their funds for a longer time. However, these costs and risks, if any, should be reflected in the rate or rate spread received and paid. On balance, however, it is unclear whether rates on interbank funds transferred daily over Fedwire and CHIPS will fall relative to rates paid for rollovers, continuing contracts, or term funds, or whether the reverse will occur. The Board believes that it is important that the negotiation of terms relative to the use of these arrangements be left to the free operation of the private market.

The Board also supports efforts to encourage timely return of overnight federal funds and other borrowings and encourages operational improvements that would consistently allow timely receipt of funds purchased soon after a seller negotiates a sale. Similar arrangements and industry standards were suggested for federal funds by the American Bankers Association in July 1986.

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

William W. Wiles,

Secretary of the Board.

[FR Doc. 89-14639 Filed 6-20-89; 8:45 am]

BILLING CODE 6210-01-M