

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 10587
October 26, 1992]

MODIFICATIONS TO THE PAYMENTS SYSTEM RISK REDUCTION PROGRAM

— Policy Statement on Daylight Overdraft Pricing

— Policy Statement on the Measurement of Daylight Overdrafts

— Amendments to Regulation J

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

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System concerning changes to its Payments System Risk Reduction Program:

The Federal Reserve Board has issued revisions to its payments system risk reduction program.

One key provision of the revised program is the adoption of a fee for daylight overdrafts that occur in the reserve and clearing accounts of depository institutions. Another key aspect revises the procedures used to measure the amount of overdrafts in reserve and clearing accounts during the day.

The Board made the changes after receiving comment on two separate occasions over the last three years.

Under an amendment to the Board's Regulation J, a paying bank will be required to settle for checks as early as one hour after presentment of those checks from a Federal Reserve Bank. This change is needed to implement procedures for posting check debits and credits to reserve and clearing accounts of depository institutions to measure daylight overdrafts more accurately. This provision as well as the modified measurement procedures go into effect on October 14, 1993.

A fee of 25 basis points at an annual rate will be assessed against the average daily total daylight overdraft of a depository. Fees of \$25 or less per two-week period will be waived to reduce the administrative burden on affected institutions.

The first phase of overdraft pricing — 10 basis points at an annual rate for the current 10-hour Fedwire operating day — will go into effect on April 14, 1994. The fee will rise to 20 basis points one year later and to 25 basis points a year after that.

The Board estimated that, when fully phased in, fewer than 300 institutions will be subject to actual payment of the fee under current conditions.

Enclosed is a copy of the text of the Board's two policy statements on daylight overdrafts, together with a copy of the amendments to its Regulation J, "Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfer Through Fedwire," effective October 14, 1993, all of which have been reprinted from the *Federal Register* of October 14. Additional single copies may be obtained at this Bank (33 Liberty Street) in the Issues Division on the first floor, or by contacting our Circulars Division (Tel. No. 212-720-5215 or 5216).

Questions regarding this matter may be directed to Richard J. Gelson, Daylight Overdraft Liaison Officer (Tel. No. 212-720-7766), or to Donald R. Anderson, Alternate Daylight Overdraft Liaison Officer (Tel. No. 212-720-5250).

E. GERALD CORRIGAN,
President.



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**DAYLIGHT OVERDRAFTS:
POLICY STATEMENTS
ON PAYMENTS SYSTEM RISK**

1. Modification of the Payments System Risk Reduction Program; Daylight Overdraft Pricing (*R-0668*)
Eff. April 14, 1994
2. Modification of the Payments System Risk Reduction Program; Measurement of Daylight Overdrafts (*R-0721*)
Eff. October 14, 1993

[Docket No. R-0668]

**Modification of the Payments System
Risk Reduction Program; Daylight
Overdraft Pricing**

AGENCY: Board of Governors of the
Federal Reserve System.

ACTION: Policy statement.

SUMMARY: As part of its payments system risk reduction program, the Board is adopting a policy under which Reserve Banks will charge a fee for average daily intraday overdrafts in reserve and clearing accounts. A fee of 60 basis points (annual rate) multiplied by the fraction of the day Fedwire is scheduled to operate will be phased in over three years (under current Fedwire operating hours the fee will equal 25 basis points (annual rate) when fully phased in). Reserve Banks will deduct from the gross fee an amount equal to 10 percent of qualifying capital valued at the fee for a 10-hour operating day. Fees of \$25 or less in any two-week period will be waived. The intent of the fee is to induce behavior that will reduce risk and increase efficiency in the payments system.

EFFECTIVE DATE: April 14, 1994.

FOR FURTHER INFORMATION CONTACT:

Edward C. Ettin, Deputy Director, Division of Research and Statistics (202/452-3388); Florence M. Young, Assistant Director (202/452-3955), Division of Reserve Bank Operations and Payment Systems; Oliver I. Ireland, Associate General Counsel (202/452-3625) or Stephanie Martin, Senior Attorney (202/452-3198), Legal Division; for the hearing impaired only: Telecommunications Device for the Deaf, Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

Background on Risk Reduction Program

The Board's payments system risk reduction program is designed to reduce both direct risk to the Federal Reserve and systemic risk. Direct risk to the Federal Reserve would result if a depository institution incurred an overdraft in its reserve or clearing account at a Reserve Bank and was unable to fund the overdraft by the close of the business day. Similarly, the failure of a participant on a private large-dollar transfer network to cover a net debit could prevent the creditors of that participant from settling their own commitments and could have further repercussions in the payments system and the economy in general. The Federal Reserve has taken a number of steps to induce risk-reducing behavior by payments system participants on both Fedwire and private large-dollar networks.

In 1985, the Board established a policy of capping net intraday debits of depository institutions (50 FR 21120, May 22, 1985). The Board adopted refinements to its policy in 1987 (52 FR 29255, August 8, 1987) and 1990 (55 FR 22087, May 31, 1990). Currently, depository institutions may incur

daylight overdrafts in their Federal Reserve accounts up to a maximum, or cap, that is a multiple of the institution's qualifying (risk-based) capital. The cap multiple is based on the institution's self-assessment of its own creditworthiness, credit policies, and operating controls. Since January 10, 1991, the cap has applied to total overdrafts of Federal Reserve accounts, with total overdrafts defined as combined funds overdrafts and uncollateralized overdrafts caused by book-entry securities transactions.

The Board requested comment on a proposal to price intraday Federal Reserve overdrafts in June 1989 (54 FR 26094, June 21, 1989) and has adopted the pricing proposal with minor changes, as discussed below. The pricing policy published today will be applied in conjunction with the cap policy.

Summary of Pricing Policy

The Board is adopting a new component to its payments system risk reduction program, under which Reserve Banks will charge a fee (adjusted for any future changes in scheduled Fedwire operating hours, as explained below) for average daily intraday ("daylight") overdrafts in reserve and clearing accounts. Reserve Banks will deduct from the gross fee an amount equal to 10 percent of qualifying capital valued at the fee for a 10-hour operating day. Fees of \$25 or less in any two-week interval will be waived.

The overdraft fee will be 60 basis points (annual rate), quoted on the basis of a 24-hour day. To obtain the daily overdraft fee (annual rate) for the standard Fedwire operating day, the quoted 60 basis point fee will be multiplied by the fraction of a 24-hour day during which Fedwire is scheduled to operate. Under the current 10-hour Fedwire operating day the overdraft fee will equal 25 basis points (60 basis points multiplied by 10/24), the same price as originally proposed by the Board. Daylight overdraft pricing is effective April 14, 1994, six months after the October 14, 1993, effective date of the Board's new overdraft measurement procedures, published elsewhere in today's Federal Register (Docket No. R-0721).

The Board plans to phase in the 60 basis point fee (times an operating hour fraction) over a three-year period. On April 14, 1994, the fee will be 24 basis points, rising to 48 basis points on April 13, 1995, and 60 basis points on April 11, 1996. Under current Fedwire operating hours, these phase-in fees are equal to the proposed phase-in fees of 10, 20, and 25 basis points. A change in the length of the scheduled Fedwire operating day

would not change the effective fee because the fee is applied to average overdrafts which, in turn, would be deflated by the change in the operating day. After evaluating the market's response to pricing, the Board may slow or accelerate the phase-in, cease the phase-in at a level below 60 basis points, or increase the fee above 60 basis points at the end of the phase-in or at a later date.

The fee will apply to combined funds and book-entry securities intraday overdrafts in accounts at the Federal Reserve. The average daily overdraft will be calculated by dividing the sum of the negative reserve or clearing account balances at the end of each minute of the scheduled Fedwire operating day (with credit balances set to zero) by the total number of minutes in the scheduled Fedwire operating day.

The Board has provided for a *de minimis* level of free overdrafts by incorporating a deductible into its pricing policy. The deductible is an amount equal to 10 percent of qualifying capital, i.e., that capital used by the institution in calculating its net debit cap (see the Board's comprehensive policy statement, 57 FR 40455, September 3, 1992). The gross fee for daylight overdrafts will be reduced by the amount of the deductible, valued at the daylight overdraft fee for a 10-hour operating day. The value of the deductible is kept constant at the 10-hour operating day rate and will not be affected by any changes to the scheduled Fedwire operating day.¹

Anticipated Market Responses to Pricing

A. Funds transfers

(1) Delayed Sends

The cheapest, and hence first, reaction to daylight overdraft pricing is likely to be the delay by depository institutions and their customers of less-time-sensitive payments. Not all payments are equally time-critical. However, in the current environment of free overdrafts and generally non-binding caps, there is, at best, little incentive to differentiate among

¹ The pricing deductible is independent of the exempt-from-filing test. Depository institutions are exempt from filing for a cap if their peak overdrafts do not exceed the lesser of 20 percent of their capital or \$10 million. The deductible (valued at the fee for a 10-hour operating day) is subtracted from the gross fee for average overdrafts. An institution could be exempt from filing for a cap but be subject to pricing because its average overdrafts were over 10 percent of its capital. It could also have to file for a cap because its peak overdrafts exceeded the lesser of 20 percent of its capital or \$10 million, but be exempt from pricing because its average overdrafts were less than 10 percent of its capital.

payments and, at worst, a competition among depository institutions to send all payments with great rapidity.

The largest participants in the New York Clearing House Interbank Payments System (CHIPS) have binding debit caps on that network, yet total net debits on CHIPS have increased by only 15 percent, while the value of CHIPS payment transfers nearly doubled, during the six years ending in mid-1991. Banks that approach their caps on CHIPS delay outgoing transfers until they have received incoming transfers that reduce their CHIPS net debit position. Fedwire participants have, by and large, not found their Fedwire caps to be as binding as their CHIPS caps and, as a result, have achieved less than half the payments efficiency (the ratio of payment values to reserve balances plus overdrafts) of CHIPS participants. If, by delaying less-time-critical payments, Fedwire participants achieved an improvement in payments efficiency equal to only one-half that achieved in the last six years on CHIPS, daylight overdrafts due to Fedwire funds transfers could fall by one-third.

Some commenters were concerned about the impacts of Fedwire payment delays. These commenters believed that gridlock could result if payment system participants, in order to avoid overdraft fees, awaited incoming funds before initiating payments. In addition, commenters were concerned that a delay of payments until late in the day could overburden the system if the volume was too high to be handled within a short processing time frame.

Commenters raised similar concerns when caps were introduced in 1986 and again were reduced in 1988. Although these concerns may have some validity, there has been no empirical support for any significant change in the intraday pattern of payments for all banks taken together. The Board anticipates that banks will delay sends in some cases, but does not believe that gridlock will become a serious problem. Some payments will not be time-critical and this will be delayed, but banks will have a business incentive to avoid delays for those transfers customers believe to be time-sensitive. Thus, there should be incentive to avoid delaying all transfers and assuring that time-critical payments are initiated promptly. Moreover, depository institution counterparties would be expected to refrain from dealing whenever possible with those institutions that delayed transfers excessively in order to shift credit exposures to others. For example, CHIPS participants have been successful admonished by the New York

Clearing House to distribute their transfers more evenly throughout the day in their common interest.

Some small banks, however, were concerned that they would have the economic power to resist delayed sends from larger banks and would, as a result, be relatively more disadvantaged by such practices. These concerns may be valid; however, test data from February 1988 and August 1989 indicate that the overdrafts of virtually all small banks would be modest under the proposed posting schemes and that most small banks would be exempt from both cap filing and pricing. Moreover, a large share of the transfers from larger to smaller banks involves the return of funds from federal funds and repurchase lending, the timing of which is likely to be negotiated and explicitly priced if daylight overdrafts are priced. Nonetheless, the larger banks' response to pricing could change the pattern of customer payments to smaller banks such that more small banks than anticipated incur overdrafts subject to fees.

Due to the concerns associated with shifts in the timing of payments, one trade association suggested that small banks should be exempt from pricing. Under the existing intraday pattern of payments, the deductible already exempts virtually all such institutions from pricing. Until there is evidence that delayed sends would disproportionately affect smaller banks so as to make them subject to more than *de minimis* charges, the Board does not believe such an exemption would be necessary. The Federal Reserve will monitor and evaluate the impact of pricing on small banks during the phase-in period.

(2) Shifts to CHIPS from Fedwire.

The second least costly way for larger banks to avoid Federal Reserve daylight overdraft fees would be to substitute unpriced net debits on CHIPS for priced overdrafts in reserve or clearing accounts. Such shifts substitute CHIPS payments, for which the participants absorb the direct and indirect risks of end-of-day net settlement, for Fedwire transfers, for which there is no private-sector settlement risk because the Federal Reserve guarantees final payment. CHIPS' settlement finality rules, adopted by CHIPS in 1990, provide for collateral liquidity and a loss-sharing formula that establishes claims against the collateral to assure same-day settlement. CHIPS settlement finality will minimize the increase in systemic risk that accompanies the reduction in direct Federal Reserve risk when, as expected, some Fedwire transfers shift to CHIPS.

The Board estimates that if all CHIPS participants shifted all payments to other CHIPS participants that now are sent over Fedwire, almost 10 percent of Fedwire transactions and approximately one-third of the value of Fedwire transfers could shift from Fedwire to CHIPS.² If the current average relationship between transfers and overdrafts continued, Federal Reserve daylight overdrafts could fall by one-third and CHIPS net debit could increase by 45 percent as a result of such shifts, assuming necessary adjustments in bilateral credit limits were acceptable to counterparties.

There are, however, three reasons to believe that the associated reduction in daylight overdrafts would be smaller than one-third. First, other market responses to pricing, such as netting, will siphon off some of the payments that might otherwise shift to CHIPS. Second, with settlement finality, CHIPS participants are unlikely to be willing to raise their bilateral credit limits for all other participants. Third, some users of payment services may insist that payments be made to them over Fedwire in order to assure immediate access to final funds.

(3) Netting

A significant proportion of daylight overdrafts do not result from third party transfers, but rather banks' funding of their own daily positions in the overnight funds and Eurodollar markets. Such loans are repaid relatively early each day and the proceeds of new loans, often from the same lender, are received later in the day, leading to intraday overdrafts in the accounts of the borrowing institution. A relatively cheap way, perhaps at a marginal cost of 10 to 15 basis points, to avoid such overdrafts is to use rollovers and continuing contracts. Instead of repayment and reborrowing each day, rollovers call for automatic renewal of the borrowed amount unless canceled at any time by either party, and continuing contracts permit the size of the loan to be changed each day, with net differences repaid or added to the loan. Only net principal amounts (if any) plus interest would be transferred daily over Fedwire or CHIPS. The Board estimates that shifts to such forms of netting could reduce daylight overdrafts by much as 85 percent.

In 1989, the Board published a policy statement on rollovers and continuing

² Such a shift may require increases in both bilateral credit limits and required collateral from CHIPS participants to establish a liquidity pool to support their additional settlement obligation.

contracts to reduce daylight overdrafts (54 FR 26107, June 21, 1989). This policy statement urges payment system participants to consider the uses of such techniques, after due regard to their benefits and risks. Pricing will greatly increase the incentive to rollovers and continuing contracts.

Banks that act as paying agents for commercial paper issuers typically pay investors for maturing paper before the issuing corporation has funded the bank, leading to large overdrafts. Daylight overdraft pricing should induce paying agent banks to require compensation for the overdrafts associated with commercial paper. The Depository Trust Company's book-entry commercial paper system, initiated in late 1990, contributes to reduction in some commercial paper-related overdrafts by synchronizing inflows and outflows associated with commercial paper transactions and should continue to contribute to further reductions as the system is expanded.

(4) Intraday Funds Market

Daylight overdraft pricing could ultimately lead to an intraday funds market in which borrowers and lenders transfer funds for short intervals at a market rate less than the explicit fee charged by the Federal Reserve. However, it is unlikely that such a market will develop at the outset of pricing, especially given the modest charges that the Federal Reserve will impose for daylight overdrafts. Delaying sends, shifting payments to CHIPS, and netting are relatively easy and inexpensive ways to reduce daylight overdrafts by significant amounts. In addition, a true intraday market would require a new set of controls and systems and would be relatively expensive for banks to establish operationally.

Rather than developing an intraday funds market, it is more likely that market participants will structure transactions to provide for a time-specific delivery of funds in return for a premium below the Federal Reserve's daylight overdraft charge. For example, overnight borrowers of funds could pay a premium rate for the right to repay those funds in the late afternoon of the maturity day and/or the lender could receive a premium to deliver the proceeds of the borrowing early on the day of the loan. Such transactions are significantly less complex operationally than a fully-developed intraday funds market.

B. Book-entry Securities Transfers

(1) Return of Repurchase Agreement Collateral

With book-entry securities overdrafts subject to fees, the major clearing banks, which account for approximately 90 percent of all book-entry securities overdrafts, would have a considerable incentive to adjust their book-entry securities transfers and to induce their dealer customers to do so as well. In a priced environment, about one-half of aggregate fees, before any market response, would apply to these clearing banks, whose book-entry securities overdrafts account for 90 to 100 percent of their total overdrafts. The Board expects market responses to pricing of book-entry securities overdrafts, which account for approximately 60 percent of total daylight overdrafts, to be smaller than the response to pricing of funds overdrafts. However, there are operational limits to the amount of book-entry securities netting that can be achieved, as well as limits to the rapidity with a clearing bank or its dealer customers can fund a book-entry securities transfer after receipt of the security. This resulting temporal gap will continue to contribute to book-entry securities overdrafts.

It may be possible for depository institutions to reduce book-entry securities overdrafts by modifying their practices regarding the return of repurchase agreement (RP) collateral and the rapidity with which dealers choose to redeliver securities after receipt. Dealer customers of clearing banks finance their overnight securities positions using bank loans and RPs negotiated with both bank and non-bank lenders. Under an RP, the borrowing dealer transfers U.S. Treasury and agency book-entry securities to the lending bank (or the lender's bank) late in the day and receives the return of the securities by book-entry transfer early the next day. Because funds move in the direction from the securities, overdrafts decrease at the dealer's clearing banks late in the first day and increase early the next day.

This pattern of RP collateral transfers and the associated payment flows contribute significantly to the build-up in book-entry securities overdrafts from early in the day through mid-afternoon, when institutions negotiate their overnight position financing. These delays in sends of collateral for financing purposes until late in the day, as well as those associated with intraday receipt and origination of book-entry securities transfers for the dealer's own and customer accounts, reflect operational factors. Institutions must

determine the availability of securities for delivery, the amount that will be held overnight (and hence must be financed), and the methods and sources to be used in funding overnight positions. In addition, some specific issues of securities ("specials") are deliberately held until late in the day because of unusual demand and supply conditions that may cause their price to rise as the day progresses. Finally, dealers build positions during the day in order to deliver their biggest orders first; this practice reflects customers' unwillingness to accept partial deliveries and the costs to the selling dealer of failing to deliver the full order on the due date.³ Transfer limits, discussed in the next section, have already helped reduce position-building by requiring buyers to take partial deliveries of very large orders.

(2) Adjusting the Timing of Payment

Currently, clearing banks charge their dealer customers for overnight credit extensions, but their intraday fees are based not on intraday credit extension but rather on the number of transactions processed for the dealer. An important reason for such fee schedules is that the clearing banks' own book-entry securities overdrafts are both free and, given collateral pledged at Federal Reserve Banks, virtually unconstrained. Federal Reserve pricing for book-entry securities overdrafts will likely cause clearing banks to modify their own fee schedules, probably basing their fees at least in part on the amount of daylight credit extended to each dealer by the clearing bank.⁴ Such an approach could be expected to induce behavioral changes among dealers.

Dealers would be expected to try to send securities transfers earlier in the day and induce their counterparties to send them later in the day. Dealers have already shifted some originations of an earlier time as a result of both recommendations by the Federal Reserve Bank of New York and the Board's 1988 policy limiting book-entry securities transfers to \$50 million. The transfer limit, in effect, requires that large deliveries be accepted in segments, thus avoiding some dealer position-building to avoid "fails". Pricing

³ The cost of a "fail" is borne by the selling dealer and equals the day's accrued interest on the securities not delivered, plus the cost of overnight financing by the selling dealer of that part of the order remaining in the dealer's position because it was not delivered.

⁴ In contrast to a bank's determination of the cause of a customer's funds overdraft, measurement of a dealer's overdraft caused by security deliveries is more straightforward.

may lead to dealer requests for further Board-mandated reductions in transfer limits, and it will certainly bring economic pressure on dealers to manage their trade comparisons more closely and to improve their inventory control to limit their use of daylight credit.

Dealers could reduce their average overdrafts by arranging for the return of RP collateral for the previous night's financing later during the day of maturity, or at least spread out over the day. Intraday book-entry securities surpluses are concentrated (over 85 percent of the total) at five banks that act as custodians for customers who do a large amount of RP lending. Dealers could offer a fee to RP lenders (and/or their banks) to delay the return of RP collateral (and thus the repayment of the overnight loan) until later in the day; such fees could also be offered for RP lending earlier in the day for those dealers that can determine their overnight financing needs and arrange their collateral earlier in the day.

(3) Netting

Clearing banks already transfer a considerable amount of book-entry securities internally across their own books, and dealers net through the Government Securities Clearing Corporation (GSCC). As with funds, pricing of book-entry securities overdrafts would create even greater incentives to net, either by shifting more transactions into the overnight netting calculation at GSCC or by developing better ways to handle collateral supporting loans to reduce repetitive intraday transfers.

GSCC will add more transactions to its net as more dealers move to full-scale "next-day" netting in the system and as GSCC begins to offer "same-day" netting services. By early 1992, only three primary dealers were not yet participating in the GSCC net for "next-day" trades. Moreover, since 1990, GSCC has been netting post-auction "when-issued" trades in Treasury notes and bonds, thereby minimizing the number of redeliveries on issuance days. GSCC is adding non-primary dealers to the system over time and believes there is still the potential for significant additional netting over its network through this addition of more dealers and the future addition of "same-day" transfers.

There may also be further opportunities for eliminating repetitive movements of collateral in the course of the daily repayment of loans that will be rebooked at the end of the day. In particular, market participants are likely to use both term RPs and open RP contracts (the latter remain outstanding

until canceled by either party) more frequently when feasible. Also, institutions might net RPs with the bulk of the collateral held by the financing party on a continuing basis (i.e., only partially repay the RP each day while moving only part of the collateral). Daylight overdraft pricing would provide the incentive to expand or develop such arrangements if they entailed costs below the daylight overdraft charge.

(4) Shifts to Other Systems

In sharp contrast to a shift of funds transfers from Fedwire to CHIPS, options for shifting book-entry securities transfers from Fedwire to other systems do not currently exist. A book-entry system, by its very nature, concentrates the ownership records in one location. It is unlikely that the federal agencies would be willing to stop using the Federal Reserve as their fiscal agent for new issuance. Although GSCC can reduce overdrafts associated with next-day trades through netting, it will not be able to handle in the foreseeable future the same-day cash trades that make up the RP market that cause the bulk of the book-entry securities overdrafts.

Response to Public Comments

Application of Pricing to Total Overdrafts

Net debit caps apply to total (funds and book-entry securities) daylight overdrafts in reserve and clearing accounts because book-entry securities overdrafts present risks to Reserve Banks similar to those posed by funds overdrafts. Because of the high concentration of book-entry securities overdrafts at the major clearing banks and the disruption to the government securities market that could result if these banks had to keep their total overdrafts within their current net debit caps, depository institutions are permitted to exceed their caps because of book entry securities overdrafts, provided that all such overdrafts are collateralized.⁵

In June 1989, the Board proposed to apply pricing to total (funds and book-entry securities) overdrafts in Federal Reserve accounts. Some commenters, including the Board's Large-Dollar

⁵ Depository institutions that exceed their caps due to book-entry securities overdrafts by frequent (more than three times in any two consecutive two-week periods) and material (more than 10 percent) amounts must collateralize all of their book-entry securities overdrafts (net of any funds credits). Other institutions have the option of exempting their book-entry securities overdrafts in whole or in part from caps by pledging collateral. Depository institutions may not exceed their caps due to funds overdrafts by pledging collateral.

Payments System Advisory Group,⁶ supported this aspect of the proposal, but other commenters, including clearing banks and securities dealers, opposed the application of pricing to book-entry securities overdrafts and presented three major arguments in support of their position.

First, to the extent that book-entry securities overdrafts would already be collateralized, as they would be at virtually all institutions with large book-entry securities overdrafts, the commenters viewed a Federal Reserve charge as inequitable. The commenters argued that the collateral protected the Federal Reserve against losses. Further, because there are costs associated with pledging collateral, the commenters believed that charging for overdrafts as well as requiring collateral unduly penalized book-entry securities overdrafts. Some of the commenters suggested that depository institutions should be given the choice of pledging collateral or paying an overdraft fee.

The Board notes that collateral is required for large book-entry securities overdrafts as an exception that permits clearing banks and similarly-situated institutions to exceed their caps because of the difficulty of controlling book-entry securities overdrafts.⁷ Given the unusually large size of the Reserve Bank's credit exposure to clearing banks, the Board determined that collateral was prudent and necessary to secure potential discount window loans should operational or other problems make it necessary for daylight credit extensions to continue beyond the end of the day. For reasons of equity, all institutions were given the option of exempting their book-entry securities overdrafts from cap limits by posting collateral.

The collateral requirement is unlikely to be a constraint on the amount of book-entry securities overdrafts, particularly given the depository institution's option to pledge in-transit securities as collateral. With the ready availability of collateral, such a requirement provides no meaningful incentives for depository institutions or

⁶ This informal advisory group, made up of private-sector payments system specialists, was formed by the Board in 1985 to assist in the development of the Board's payments system risk reduction program.

⁷ The sender of book-entry securities receives payment from the Reserve Bank immediately, and the institution receiving the securities is charged even if it does not have sufficient funds in its reserve or clearing account at that time. The receiver has little control over the timing of the incoming transfer. In contrast, the originator of a funds transfer controls the timing, and the recipient's account is credited rather than debited.

their dealer customers to change procedures to reduce daylight overdrafts. Collateral and pricing serve two related but separate purposes. Although collateral limits Reserve Bank risk, its purpose is to make discount window loans to book-entry securities overdrafters feasible during periods of operational difficulty. Pricing is designed to create economic incentives to reduce and allocate more efficiently the use of daylight credit.

A second group of commenters argued that the institutions that would bear the cost of the fees for book-entry securities overdrafts would not be able to control the amount of the credit used and that there would be an irreducible minimum below which book-entry securities overdrafts could not decline. These commenters focused on the operational constraints that limit the ability of dealers and clearers to reduce the gap between the time securities are delivered and corresponding debits are made to the recipient's funds account and the time the recipient receives funds from its customer to pay for the securities. The commenters argued that, even with improvements in market mechanisms in response to pricing, overdraft levels would be high even at the most efficient dealers and clearers. The commenters stated that overdraft fees would be unfair given that daylight credit is necessary for the efficient operation of the government securities market.

A third group of commenters made a related argument, stating that pricing book-entry securities overdrafts would result in reduced depth in the government securities market and an associated increase in the Treasury's borrowing costs. Specifically, the commenters argued that, because dealers would bear the additional cost of book-entry securities transfers, they would be less willing to bid both for new issues and in the secondary market, and fewer dealers would be able to participate in auctions or secondary trades. For these reasons, the commenters believed that the Treasury's borrowing costs would rise.

The Board anticipates that dealers and clearers will take steps to avoid fees for book-entry securities overdrafts, as discussed previously. Nevertheless, the remaining daylight overdraft fees will fall initially on the clearing banks. The Board notes that there are significant differences in the transfer-to-overdraft ratio among the major clearing banks. The Board does not believe that these differences reflect differing operational efficiencies across the clearing banks, but rather reflect their

dealer customers' varying operational procedures, controls, and trading and management strategies. All of these factors are reflected in differing lags between incoming and outgoing transfers and the duration that potential collateral is held by dealers before they authorize its release for transfer by their clearing banks.

Board staff discussions with market participants suggest that overdraft pricing will induce clearing banks first to seek additional efficiencies to avoid charges and second to focus on efforts to pass the fee on to their dealer customers. (The extent to which dealers could, in turn, pass the overdraft fee on to their customers would be limited to those cost increases passed on by the lowest-cost dealers, as any price increase would, in a competitive market, result in shifts of business away from the higher-cost to the lower-cost dealers.) With comparable efficiency in their operations, the clearing banks should be successful in their price-shifting efforts. Clearing banks might eliminate the current charge per transfer and shift to a fee structure based mainly on the extension of credit by banks to the dealers.⁸ Charges to customers based on the value of the transfer would provide less incentive for dealers to reduce their overdrafts.⁹

The Board assumes that, in reducing the amounts subject to overdraft fees, dealers would incur costs up to the overdraft fee. There would be a tendency for dealers to limit certain kinds of trades on which there is virtually no profit margin, but overdraft fees would probably be too small to significantly affect the volume of dealer trading in anticipation of even modest price swings. Even if each additional transaction dollar resulted in an additional overdraft dollar, the overdraft fee would not exceed \$6.94 per million dollars in trades.¹⁰ This cost is modest

⁸ The banks' own overdrafts at Reserve Banks are not necessarily related to the position of individual bank customers.

⁹ Pricing based on the value of the transfer could induce a reduction in churning trades and a movement to term or open contract repurchase agreements, but would provide no incentive to reduce position building to avoid fails or increase the rapidity of securities turn-arounds. Pricing by clearing banks based on overdrafts, however, would create incentives to take all of the steps.

¹⁰ The fee of 60 basis points (annual rate) times the fraction of the day Fedwire is scheduled to operate (i.e., 25 basis points currently) is 0.0094 basis points per day (\$6.94 per million of overdrafts). On average, there are approximately \$3 of book-entry securities transfers for each \$1 of overdraft, reducing the daily overdraft charge to 0.0231 basis points per transfer or \$2.31 per million dollars of transfer.

relative to a small bid-ask spread of 1/64 of a percentage point, which is equal to \$156.25 per million in trades.

If all dealers were equally efficient, all of the additional costs of book-entry securities overdrafts would be shifted to investors. Such costs during the August 1989 test period would have been approximately \$20 to \$40 million per year. If these costs were allocated over all book-entry securities transfers (approximately \$100 trillion per year), investor yields would have declined by (or investors would have required a higher gross yield of) from 0.002 to 0.004 basis points. This estimate of yield decline is high, though, because there are differences in efficiencies across dealers and it is unlikely that a significant amount of the increased cost of book-entry securities transfers will be passed on to investors. Thus, the Board does not believe that pricing of book-entry securities overdrafts will significantly affect the cost of the public debt. Moreover, the Treasury will benefit (subject to adjustments in the tax liabilities of dealers and investors) in that overdraft fees will be returned to the Treasury with Federal Reserve profits.

On the other extreme, the dealers could entirely absorb the annual aggregate costs of \$20 to \$40 million. These costs represent approximately 2.25 to 4.5 percent of average 1990-mid-1992 estimated profits earned by primary dealers from their U.S. Treasury and agency securities activities. Although dealer profits rose sharply in 1990-mid-1992, margins earlier had been under intense pressure both from the increase in the number of dealers and the relative stability of interest rates. Even with the improvement in profits over the last two years, dealer absorption of overdraft charges would result in some profit reductions and could, at the margin, accelerate the exit of primary and other dealers. The number of primary dealers remaining, however, would remain high by historical standards. The Board would not expect more than a modest reduction in the number of primary dealers given the recent changes in primary dealer standards, and such a reduction would not be likely to have a measurable impact on the government securities market.

Thus, the Board has determined to apply pricing to total overdrafts (book-entry securities and funds). Book-entry securities overdrafts would not decline as much as funds overdrafts under a pricing regime because the amount and timing of book-entry securities overdrafts are not fully under the

control of the institution incurring the overdraft. Nevertheless, both forms of overdraft create risks for Reserve Banks and are being used inefficiently while they are available without charge. The Board does not believe that pricing of book-entry securities overdrafts would raise the Treasury's borrowing cost in a measurable way, with increases of much less than one-tenth of a basis point. The effect of book-entry securities overdraft pricing would more likely be diffused mainly among dealers, reducing their profits somewhat, and possibly contributing to the exit of marginal dealers from an extremely competitive market.

Application of Pricing to Average Overdrafts

In its 1989 request for comment, the Board proposed to apply daylight overdraft pricing to the average level of total overdrafts. The Board proposed that overdrafts be measured at equally-spaced intervals throughout the day, with credit balances treated as zero, and that the average overdraft would be the sum of all the overdraft measurements divided by the number of intervals.

The Board's test data in its 1989 proposal used 15-minute intervals from 8:30 a.m. to 6:30 p.m. Eastern time, the current official Fedwire operating day. The 1989 proposal noted that the Federal Reserve would review the feasibility of measuring overdrafts in shorter time intervals (e.g., by second or minute) and whether the averaging period should be fixed (e.g. the hours over which Fedwire is scheduled to be open) or the actual period Fedwire is open at each Reserve Bank. In 1991, as part of its request for comment on revised overdraft measurement procedures (56 FR 3098, January 28, 1991), the Board proposed a one-minute overdraft measurement interval, measured over the official Fedwire operating day.

Under current Fedwire operating hours, the average overdraft of large institutions is approximately one-third of the peak overdraft. The Board proposed to price average, rather than peak, overdrafts to focus depository institutions' attention on the continuous management of their positions and to provide flexibility for institutions to adjust to book-entry securities overdrafts that are not under their direct control.

The commenters generally supported the use of daily averages, but some argued that intraday credit balances should be included in the average overdraft calculation to offset intraday debit balances. Some commenters stated that explicit returns should be paid on credit balances if fees were to be levied

on overdrafts. However, Congress has not authorized the Board to pay interest on reserve balances. To offset debits with credit balances in calculating the average overdraft subject to pricing would provide an implicit return on positive reserve balances, which would be inconsistent with the congressional view.¹¹

One commenter suggested that, to make reserve management easier in a pricing regime, the Board should liberalize its carry forward rule on excess or deficient reserve balances. Prior to September 1992, the rule restricted such carryovers into the next maintenance period to the larger of 2 percent of required operating balances or \$25,000. The commenter suggested that this quantitative restriction be removed, allowing depository institutions to vary their average reserve balance in a maintenance period over an extremely wide range and to make up for the implied surpluses or deficiencies in the subsequent maintenance period.

Although the Board has not eliminated quantitative restrictions altogether, it has increased the carryover allowance to the larger of 4 percent of required operating balances or \$50,000 (57 FR 38415, August 25, 1992). Eliminating quantitative restrictions would reduce considerably the predictability of overall reserve demand in any given maintenance period, thereby making it difficult for the Federal Reserve to judge the appropriate system-wide reserve supply and significantly impairing the effectiveness of monetary policy implementation. In addition, the commenter's suggestion would make it easier for depository institutions to manage their end-of-day positions (particularly on the last day of a maintenance period), but would not ease the task of managing intraday overdrafts, which would be subject to pricing.

Generally, the commenters supported the Board's proposal to measure daylight overdrafts on a minute-by-minute basis, but expressed concern regarding the costs of implementing systems to capture positions minute-by-minute. The Board believes that the number of banks that will change their internal tracking and posting systems in order to charge customers for their use of daylight credit will be relatively

¹¹ Banks with net credit balances during the day would be able to sell those balances to others in net debit positions if the time of day the credits occurred had positive value in an informal intraday market. Although the Federal Reserve attaches no value to these net intraday credits, others may choose to use such net credits to rearrange, for a fee, a bank's federal funds position to the advantage of those with net debit positions.

small. Over 90 percent of the institutions covered by the risk reduction policy will not incur daylight overdraft charges, and thus would not be likely to undertake costly system changes. A few banks may incur overdraft charges in amounts high enough to justify system changes. Although these banks would face increased operational costs, most of their system changes would be necessary regardless of the measurement interval. A shorter measurement interval improves the accuracy of daylight overdraft calculations.

The Board has adopted its 1989 proposal, as amended by its 1991 proposal, to apply pricing to average daily daylight overdrafts. The average will be calculated by dividing the sum of the negative reserve or clearing account balances at the end of each minute of the scheduled Fedwire operating day (with credit balances set to zero) by the total number of minutes in the scheduled Fedwire operating day.

Size of Overdraft Fee

The Board requested comment on a fee of 25 basis points, annual rate, to be levied on the average amount of total daylight overdrafts in excess of the deductible, phased in over three years—10, 20, and 25 basis points, respectively, in each year. The proposed fee would be charged only on business days. The Board stated that it planned to reserve the right to (1) terminate the phase-in before application of the full 25 basis points, or (2) continue the phase-in to a level in excess of 25 basis points, depending on its assessment of the impact of pricing.

Most commenters did not oppose the size of the fee, and a small number believed the fee was too low to have a significant impact or to eliminate the subsidy inherent in daylight overdrafts. The Board believes that even a low daylight overdraft price can have a significant impact because depository institutions' costs of avoiding the fee appear to be modest. Thus, the Board believes the proposed fee is consistent with the objective of inducing risk-reducing changes without slowing down payment flows or drastically increasing the public's cost of making payments. The Board recognizes that the fee is probably not sufficient to eliminate all of the subsidy resulting from the provision of daylight credit at below-market rates, although the appropriate market rate is unclear at the present time. The Board has chosen a relatively low fee so as not to risk disruption to the payments system.

Some commenters suggested that higher prices be applied to later-in-the-day overdrafts, to avoid possible disruptions caused by delayed sends. Some of these commenters suggested a higher deductible and a lower price in the morning coupled with a lower deductible and higher price in the afternoon. Time-of-day pricing would create an inducement to send payments earlier, provided that others, or at least those acting as counterparties to the earlier-sending institutions, do so as well. If only one institution sends earlier, that institution's costs may actually rise (it would pay the morning overdraft fee plus the higher afternoon overdraft fee if its overdrafts were not extinguished by then), unless the morning deductible were large enough to eliminate the morning fee. For time-of-day pricing to reduce overdrafts, a group of banks would have to agree to send to each other earlier in the day to benefit from the lower overdraft fee, and the cost of doing so would have to be less than the price differential between morning and afternoon overdrafts. This approach might require disciplining of uncooperative counterparties by the coalition of banks. Discipline could take the form of delayed sends that keep the disciplined party in overdraft until the afternoon, when higher fees are charged.

The Board believes that any inducement to accelerate payments under a time-of-day pricing plan would be offset by (1) the administrative complexity and the associated uncertainty about the impact on non-coalition payment participants, and (2) the incentive to accelerate all payments, regardless of their time sensitivity, resulting in less efficient resource allocation and little risk reduction.

The Board has adopted the overdraft fee at the proposed level; however, the fee will be quoted at a rate of 60 basis points (annual rate) for a 24-hour day. To obtain the daily overdraft fee (annual rate) for the standard Fedwire operating day, the quoted 60 basis point fee is multiplied by the percentage of the 24-hour day during which Fedwire is scheduled to operate. Further, the Board has adopted a standard 360-day bank year as the basis for quoting the annual daylight overdraft fee.

Thus, under the current 10-hour Fedwire operating day, the fully-phased-in overdraft fee will come to 25 basis points (60 basis points time 10/24), the same price as originally proposed by the Board. Quoting the overdraft fee independently of the Fedwire operating day is intended to reduce market confusion about rates as scheduled Fedwire hours are changed, to permit

the overdraft charge per minute to remain constant in the event of changes in scheduled Fedwire operating hours, and to prevent price biases from influencing a depository institution's choice of whether or not to use a longer operating day.

The Board plans to phase in the 60 basis point fee (times an operating hour fraction) over a three-year period. On April 14, 1994, the fee will be 24 basis points, rising to 48 basis points one year later, and 60 basis points the following year. These phase-in fees are equal to the proposed 10, 20, and 25 basis point fees under current Fedwire operating hours. After evaluating the market's response to pricing, the Board may slow or accelerate the phase-in, cease the phase-in at a level below 60 basis points, or increase the fee above 60 basis points at the end of the phase-in or at a later date.

Deductible

The Board proposed to allow a *de minimis* level of free overdrafts by authorizing a deduction from the amount subject to pricing equal to 10 percent of qualifying capital. The deductible would (1) provide liquidity to the payments system, recognizing the lack of payments synchronization, especially for book-entry securities overdrafts; (2) compensate depository institutions, on average across all depository institutions over time, for Reserve Bank periodic computer down-time; and (3) contribute to operational simplicity by exempting from pricing a very large number of depository institutions that account for a very small amount of total overdrafts.

Commenters strongly supported the concept of the deductible, but some believed it should be higher than 10 percent to address all of the objectives of the deductible and to offset the treatment of intraday credit balances. However, a higher deductible would not only increase the amount of overdrafts exempt from pricing, but would also increase both the incentive and the capacity of institutions that do not themselves need or incur overdrafts at the Federal Reserve to sell their overdraft capacity to institutions that have exhausted their deductible and would otherwise have to pay a Federal Reserve fee. A deductible of 10 percent of capital exempts virtually all small overdrafters.

Some commenters suggested that the pricing program begin with a higher deductible and phase down to the proposed 10 percent level over time in order to provide depository institutions time to adjust to pricing and the new measurement procedures. The Board

believes that by implementing the new measurement procedures one year in advance of pricing, and by phasing in the full price over three years, depository institutions will have sufficient time to adjust to pricing.

The Board has made a revision in the deductible calculation to take into account the possibility of longer Fedwire operating days. A change in the length of the operating day could alter the value of the deductible, and, as with the fee, an adjustment is necessary in the algorithm for the deductible to account for the effect of such change. If the fraction of the 24-hour day accounted for by the official Fedwire operating day is applied to both the nominal 24-hour rate and the net average overdrafts subject to pricing (i.e., average overdrafts less the deductible), those institutions that incur no additional overdrafts during an extended Fedwire operating day could benefit from an effective increase in their deductible.¹² The percentage increase in the deductible would be equal to the percentage increase in the operating day.

Thus, it is necessary to multiply the deductible by a factor to ensure that the value of the deductible does not vary with the length of the scheduled Fedwire operating day. Therefore, the Reserve Banks will calculate the gross daily fee on average daily overdrafts (based on the fraction of the 24-hour day that Fedwire is scheduled to operate, which could increase in the future) and reduce that amount by the fee that would apply to the deductible, based on a 10-hour Fedwire operating day. This calculation will provide the same result as that originally proposed for public comment (25 basis point annual rate on a 10-hour operating day) and will produce that same result for any other length of the

¹² Assume a bank with \$10 billion in capital and \$8 billion in daily average overdrafts over the current 10-hour operating day. Its daily fee under the pricing procedure proposed for comment would be the daily 25 basis point (annual rate) fee times the average daily overdrafts less the deductible (10 percent of capital), or $(0.0025/360) (8-1)$ billion dollars = \$34,722. The daily price would be the same using the pricing algorithm adopted by the Board, which incorporates the fraction of the day Fedwire is scheduled to operate: $(.0060/360) (10/24) (8-1)$ billion dollars = \$34,722. However, if the Fedwire operating day is increased to 12 hours, the bank's fee would fall to $(.0060/360) (12/24) (5-1)$ billion dollars = \$33,333. Daily average overdrafts fall from 6 to 5 because the operating day used to calculate the average has been increased by 20 percent. However, while the effect of the reduction in average overdrafts from 6 to 5 is offset by the increased fraction from 10/24 to 12/24, the increased fraction is applied to the same deductible, which has the effect of increasing the value of the deductible and thus reducing the overdraft charge, provided that overdrafts do not rise proportionally to the extended operating hours.

operating day. Maintaining a constant deductible is consistent with the goals of providing payments system liquidity, compensating for Reserve Bank downtime, and operational simplicity, but avoids building into the pricing algorithm a mechanism for automatically increasing the value of free credit permitted to depository institutions if operating hours are extended.

Incidence of Pricing and Economic Burden

Although daylight overdraft pricing will increase costs for those institutions subject to pricing, the Board believes that overall impact on the economy will be modest. Most depository institutions will be exempt from pricing, given the 10 percent deductible. During a 20-day test period ending August 23, 1989, and without any market responses to pricing, 285 banks (representing 220 bank holding companies) would have been subject to pricing, and over 8,000 banks would have been exempt from pricing. Over 80 percent of all fees would have been collected from the ten institutions paying the largest fees in the test period. The Board expects that depository institutions will take actions to avoid Federal Reserve overdraft fees, resulting in a lower incidence of pricing than was projected in the test period.

In light of the 10 percent deductible, it is unlikely that delayed sends and other responses to pricing by large banks will shift payment patterns so as to cause many more small banks to become subject to pricing. During the test period, over 42 percent of those banks that would have been subject to pricing would have paid annual fees of less than \$1,000, and many would have paid annual fees of less than \$500. Because the Board anticipates that a large number of banks will incur small fees, the Board has determined to waive any fee of \$25 or less per two-week period to reduce the administrative burden on Reserve Banks and affected depository institutions.

Competitive Impact Analysis

The Board assesses the competitive impact of changes that have a substantial effect on payment system participants.¹⁹ Under this analysis, the Board determines whether the change would have a direct and material adverse effect on the ability of other service providers to compete effectively

¹⁹ These assessment procedures are described in the Board's policy statement entitled "The Federal Reserve in the Payments System" (55 FR 11648, March 28, 1990).

with the Federal Reserve in providing similar services.

The Board does not believe that daylight overdraft pricing will adversely affect the ability of private-sector payments system participants to compete with the Reserve Banks in providing payments services. Private-sector correspondent banks have the ability to charge for intraday credit extended to their customers, either explicitly (as will the Reserve Banks under the pricing policy), or implicitly as part of overall service fees. In fact, Federal Reserve daylight overdraft pricing may benefit private-sector payments systems, such as CHIPS, if institutions shift payments from the Federal Reserve to private systems to avoid overdraft fees. Although there are aspects of the Board's risk reduction program that could adversely affect the ability of others to compete with the Federal Reserve (see the Competitive Impact Analysis regarding the Board's overdraft measurement procedures, Docket R-0721, elsewhere in today's Federal Register), the Board does not believe that pricing in itself has an adverse effect on competition.

Policy Statement

The Board has adopted the following, to be inserted as part (I)(B) in its "Federal Reserve System Policy Statement on Payments System Risk" under the headings "I. Federal Reserve Policy" and "B. Pricing.":

Each Reserve Bank will charge a fee for average daily daylight overdrafts in Federal Reserve accounts. Reserve Banks will deduct from the gross fee an amount equal to 10 percent of qualifying capital valued at the fee for a 10-hour operating day. Fees of \$25 or less in any two-week interval will be waived.

The overdraft fee is 60 basis points (annual rate), quoted on the basis of a 24-hour day. To obtain the daily overdraft fee (annual rate) for the standard Fedwire operating day, the quoted 60 basis point fee is multiplied by the fraction of a 24-hour day during which Fedwire is scheduled to operate. For example, under a 10-hour scheduled Fedwire operating day, the overdraft fee equals 25 basis points (60 basis points multiplied by 10/24). Daylight overdraft pricing is effective April 14, 1994.

The 60 basis point fee (times an operating hour fraction) will be phased in over a three-year period. On April 14, 1994, the fee will be 24 basis points, rising to 48 basis points on April 13, 1995, and 60 basis points on April 11, 1996. Under a 10-hour scheduled Fedwire operating day, these phase-in fees are equal to 10, 20, and 25 basis points, respectively. A change in the

length of the scheduled Fedwire operating day would not change the effective fee because the fee is applied to average overdrafts which, in turn, would be deflated by the change in the operating day. After evaluating the market's response to pricing, the Board may slow or accelerate the phase-in, cease the phase-in at a level below 60 basis points, or increase the fee above 60 basis points at the end of the phase-in or at a later date.

The fee applies to combined funds and book-entry securities daylight overdrafts in accounts at the Federal Reserve. The average daily overdraft is calculated by dividing the sum of the negative Federal Reserve account balances at the end of each minute of the scheduled Fedwire operating day (with credit balances set to zero) by the total number of minutes in the scheduled Fedwire operating day.

The gross fee for daylight overdrafts will be reduced will be reduced by the amount of a deductible, valued at the daylight overdraft fee for a 10-hour operating day. The deductible is an amount equal to 10 percent of qualifying capital, i.e., that capital used by the institution in calculating its new debit cap. (See section (I)(C), "Capital.") Because the fee applicable to the deductible is kept constant at the 10-hour operating day rate, any changes to the scheduled Fedwire operating day will not affect the value of the deductible.

The pricing deductible is independent of the exempt-from-filing test under the net debit cap policy. (See section (I)(D)(3), "Exemption From Filing.") Depository institutions are exempt from filing for a cap if their peak overdrafts do not exceed the lesser of 20 percent of their capital and \$10 million. The deductible (valued at the fee for a 10-hour operating day) is subtracted from the gross fee for average overdrafts. An institution could be exempt from filing for a cap but be subject to pricing because its average overdrafts were over 10 percent of its capital. It could also have to file for a cap because its peak overdrafts exceeded the lesser of 20 percent of its capital and \$10 million, but be exempt from pricing because its average overdrafts were less than 10 percent of its capital.

By order of the Board of Governors of the Federal Reserve System, October 6, 1992
William W. Wiles,

Secretary of the Board.

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[Docket No. R-0721]

Modification of the Payments System Risk Reduction Program; Measurement of Daylight Overdrafts**AGENCY:** Board of Governors of the Federal Reserve System.**ACTION:** Policy statement.

SUMMARY: As part of its payments system risk reduction program, the Board is adopting new procedures for posting debits and credits to depository institutions' accounts at Federal Reserve Banks in order to measure daylight overdrafts accurately. Accurate measurement of daylight overdrafts is necessary in order to assess fees for the use of Federal Reserve intraday credit. (See Docket No. R-0668 elsewhere in today's *Federal Register*.) Appendix 2 summarizes the final version of the Board's modifications to the procedures for measuring daylight overdrafts and includes the major types of transactions affecting depository institutions' Federal Reserve accounts. The intent of overdraft measurement and pricing is to induce behavioral changes that will reduce risk and increase efficiency in the payments system.

EFFECTIVE DATE: October 14, 1993.

FOR FURTHER INFORMATION CONTACT: Florence M. Young, Assistant Director (202/452-3955), or Myriam Y. Payne, Senior Financial Services Analyst (202/452-3219), Division of Reserve Bank Operations and Payment Systems; Oliver I. Ireland, Associate General Counsel (202/452-3625) or Stephanie Martin, Senior Attorney (202/452-3198), Legal Division; for the hearing impaired only: Telecommunications Device for the Deaf, Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: One of the purposes of the Board's payments system risk reduction program is to reduce the Federal Reserve's direct credit risk. This risk is created when Reserve Banks extend intraday credit to depository institutions as payments are processed. If an institution is unable to settle its intraday overdraft at a Reserve Bank before the end of the day, the Reserve Bank could incur a loss. Furthermore, depository institutions create risk by permitting their customers, including other depository institutions, to transfer uncollected balances over wire systems in anticipation of their coverage by the end of the day.

Current Risk Reduction Program

Under the Board's current program, depository institutions establish a maximum amount of intraday overdrafts

that they may incur in their accounts at the Reserve Banks. This maximum, or net debit cap, is a multiple of a depository institution's risk-based capital and is based on the institution's assessment of its own credit-worthiness, credit policies, and operational controls. The guidelines for the self-assessment were established by the Board, and the documentation supporting each depository institution's rating is reviewed by the institution's primary supervisory agency examiners. (See 52 FR 29255, August 6, 1987.)

Currently, daylight overdrafts are measured on an *ex post* basis. Fedwire funds and book-entry securities transfers are posted as they are processed during the business day. The net of all automated clearing house (ACH) transactions is posted as if the transactions occurred at the opening of business. All non-wire transactions are netted at the end of the business day; if the net is a credit, that credit is added to the opening-of-day balance, and if the net is a debit, the debit is deducted from the end-of-day position. Debits for original issues of U.S. Treasury securities as well as credits for redemptions and interest payments on Treasury and government agency securities are posted at 9:15 a.m., Eastern Time (ET). This *ex post* measure allows a depository institution to use its non-wire, net credit to offset Fedwire debits during the day, but postpones the need to cover a non-wire, non-ACH net debits until after the close of business.

1989 Pricing and Measurement Proposals

In 1989, the Board issued for public comment a comprehensive package of proposals to reduce payments system risk (54 FR 26090, June 21, 1989). The centerpiece of this package was a proposal to assess fees for depository institutions' use of Federal Reserve intraday credit. Before fees can be assessed for the use of intraday credit, it is necessary to have in place a rational and reasonable methodology for determining the amount of intraday credit used by depository institutions. The current *ex post* measurement procedures were designed to provide depository institutions some intraday credit, as a means of easing their adjustment to the payments system risk reduction program when it was implemented in 1986. While the current measurement procedures have eased the transition, they do not provide a satisfactory basis for determining a depository institution's use of intraday Federal Reserve credit.

The Board's proposal to modify the procedures used to measure daylight overdrafts was based on the following

principles: (1) To the extent possible, the measurement procedures should not provide intraday credit to payments system participants; (2) the procedures should recognize the legal rights and responsibilities of both parties to a transaction and, in particular, should reflect the time at which payor institutions are obligated to pay for a transaction; (3) users of payments services should be able to control their use of intraday credit; and (4) to the extent possible, the Reserve Banks should not obtain any competitive advantage from the measurement procedures.

To accomplish these objectives, the Board proposed to continue to post Fedwire funds and book-entry securities transfers as they are processed during the business day and to post all commercial ACH and non-wire transactions after the close of business. Commenters raised serious concerns about the effect of this proposal on current cash management practices and questioned the equity of charging for the intraday use of funds collected through the check and ACH mechanisms.

1991 Measurement Proposal

In light of the serious concerns raised by commenters, in 1991 the Board requested public comment on a revised approach to modifying the measurement procedures (56 FR 3098, January 28, 1991). The Board proposed to account for non-wire transactions on a quasi-real-time basis. (Appendix 1 outlines the details of this proposal.) Under this approach, Fedwire funds and book-entry securities transfers would have continued to be posted as they were processed. Credit for non-wire transactions, such as checks, would have been posted, on average, when debits would have been posted to the accounts of paying institutions.

The 1991 proposal was straightforward for the majority of payment transactions, such as ACH transactions, because debits to payor institutions and credits to collecting institutions can be posted at the same time easily. The proposal for posting credits for checks collected through the Reserve Banks, however, was fairly complex because checks are paper instruments that must be presented physically to payor institutions. Presentment times, which are typically dependent on courier delivery schedules, range from early in the day until 2 p.m. Pacific Time (PT) or 5 p.m. ET. To provide credit as early as possible during the business day, the Board proposed to post credits based on the Reserve Banks' ability to present

checks to and obtain settlement from payor institutions. This conceptual approach resulted in the development of a unique set of crediting fractions for each of the Federal Reserve's 141 availability zones. The sets of fractions would have been used as the basis for posting check credits hourly during the business day, beginning at 11 a.m. ET and concluding at 6 p.m. ET.

A total of 209 commenters responded to the Board's 1991 measurement proposal. Comparing the 1991 proposal with the 1989 proposal, many commenters commended the Board for addressing their concerns about early intraday funds availability and current cash management practices.

While commenters expressed concerns about the proposed times for posting many types of payment transactions, their most significant concerns centered on the proposal to credit the accounts of institutions collecting checks through the Reserve Banks using the fractional availability methodology. Over 35 percent of the commenters specifically supported the concept of posting check transactions during the business day. Most commenters, however, viewed the proposal as exceedingly complex. These commenters indicated that its adoption would cause depository institutions to incur implementation and ongoing operating costs that would exceed any benefits directly related to the reduction of payments system risk.

The industry's concerns about the complexity and the cost of implementing the proposed methodology for posting check transactions were reinforced in an August 1, 1991, meeting between Board and Reserve Bank staff and industry representatives at which alternative check posting methodologies were discussed.

A. Commercial Check Transactions

Approximately 130 commenters specifically addressed the treatment of check transactions. As noted, the most significant concern raised by these respondents dealt with the complexity of the fractional availability methodology proposed for posting check credits intraday.

Commenters indicated that they would incur substantial costs to modify their systems for monitoring customers' intraday account balances, if they were to make funds available to their customers in the same way that they received credit from the Reserve Banks. Further, the commenters stated that attempting to emulate the proposed approach to granting intraday credit for checks would require very complex systems to calculate customers' daylight

overdrafts in order to charge them for their use of intraday credit. Commenters estimated that one-time implementation costs would range from \$200,000 to \$3 million and that ongoing operating and maintenance costs would range from \$100,000 to \$3.0 million annually, per institution.

Several commenters were also concerned about the costs they would incur to determine the value of their customers' check presentments, in order to obtain payment from their customers by the time the institution would be charged by the Federal Reserve.¹ These commenters indicated that they would either need to (1) purchase payor bank services from the Federal Reserve Banks or (2) expand their operating capacity for processing customer checks to determine customer presentment totals in order to obtain payment by the proposed posting times. One respondent indicated that the cost of obtaining additional payor bank services would amount to \$180,000 per year and another respondent indicated that its ongoing operating expenses would increase by 30 to 40 percent.

To address their concerns, commenters suggested that: (1) The number of intraday posting times be reduced, (2) check credits, or check credits and debits, be posted at one time per day, or (3) the current measurement scheme be retained. Some of the respondents who urged the Board to retain the current measurement scheme recommended that the value of the intraday float created by the current posting methodology be recovered through Federal Reserve service fees.

The Board believes that the responses received on the 1991 measurement proposal reflect depository institutions' concerns about the combined effects of the proposals to modify the measurement procedures and to charge for daylight overdrafts. In assessing commenters' concerns, the Board believes that depository institutions can be expected to make rational business decisions before changing the systems currently used to monitor their customers' intraday account balances or developing systems to charge their customers for intraday credit extensions. Thus, institutions whose daylight overdrafts would not exceed their net debit caps as a result of changes to the measurement procedures (over 93 percent of institutions covered

¹ In most cases, customers using controlled disbursement services and payable-through banks maintain zero or very low overnight balances and fund daily check presentments late in the day after they have been advised of the value of the day's presentments.

by the policy) and institutions that would not be subject to Federal Reserve daylight overdraft charges (about 96 percent of institutions covered by the policy) would not be expected to undertake costly system changes.² Further, depository institutions would not incur costs to recover daylight overdraft charges from their customers, if those costs exceed either the charges imposed by the Federal Reserve or the income they expect to derive through charging customers over some reasonable time frame.

The types of changes that depository institutions would need to make to check processing and customer monitoring systems if they choose to emulate the Federal Reserve's 1991 proposal for posting check transactions indicates that the costs of such system changes could vary considerably, depending upon the sophistication of an institution's existing system. Institutions with very sophisticated systems might be able to accomplish the task at a fairly low cost. Institutions with less sophisticated systems, however, could find the undertaking extremely costly and could incur expenditures in the ranges estimated by commenters. For the few institutions that the Board expects might undertake such changes,³ developing systems to charge customers for their use of daylight credit would be very expensive, requiring fundamental changes in depository institutions' demand deposit accounting and customer monitoring systems. Discussions with representatives of depository institutions have indicated that, even if the current *ex post* measurement scheme were retained, the daylight overdraft pricing may necessitate significant changes in the systems that are used to monitor their customers' intraday positions in order to charge them for the use of daylight credit.

It is not possible to estimate with any degree of accuracy the costs that the industry might bear under the Board's 1991 proposal for posting check credits intraday. It is reasonable to assume, however, that the majority of the costs would be borne by the few large institutions subject to substantial

² This analysis is based on survey data for a four-week period ending August 23, 1989. Because this analysis could not assess the results of potential behavioral changes, the potential number of institutions affected by the proposal could be somewhat overstated or understated.

³ The Board estimates that only 30 institutions would be charged fees amounting to more than \$120,000 per year, if a fee equal to an annual rate of 25 basis points were assessed for daily average daylight overdrafts.

daylight overdraft charges. Nevertheless, the Board has modified the 1991 proposal, as explained below, to reduce the relative complexity of the check posting process and to facilitate the industry's adjustment to the new measurement procedures.

Check Debiting—As noted above, several commenters indicated that debiting payor institutions approximately an hour after presentment takes place would increase operating expenses. The Board believes that the majority of payor institutions could adjust to intraday debiting for check presentments fairly easily. For example, depository institutions could require their controlled disbursement and payable-through-draft customers to fund their accounts based on estimated presentments rather than expending real resources to determine the value of checks to be paid by each customer before the time the institution would be debited by the Federal Reserve.

Several industry representatives have also indicated that beginning to post debits for check presentments at 11 a.m. ET would place east coast institutions at a competitive disadvantage compared with institutions located on the west coast. These individuals argue that the majority of east coast institutions would be charged for check presentments by 12 noon ET, which would cause the institutions to incur daylight overdrafts starting at that time. Conversely, they argue, institutions located on the west coast would not be debited until late in the day. As a result, the duration of their intraday overdrafts would be shorter than the duration for east coast institutions.

While it is true that over 70 percent of the value of checks drawn on institutions located in the Eastern Time zone would be charged to payor institutions by 12 noon ET, the majority of checks collected by these institutions is drawn on eastern institutions. Thus, these institutions would likely receive credit for a substantial percentage of the checks they collect through the Reserve Banks by 12 noon ET. Moreover, the staff believes that providing early-in-the-day credits to institutions using Federal Reserve check collection services provides benefits that more than offset the early-in-the-day debits to payor institutions.

Furthermore, depository institutions located in the Eastern Time zone currently have a competitive advantage in offering controlled disbursement services to corporate customers, compared with institutions located in the Pacific Time zone. Charging for check presentments during the business

day may reduce some of the current competitive differences.

Several commenters suggested posting check credits and debits simultaneously so that depository institutions could continue to benefit from the netting of check transactions. Conceptually, such an approach would be simple for both depository institutions and the Reserve Banks to implement. Its adoption, however, would result in either (1) payor institutions being debited before presentment or (2) collecting institutions being credited very late in the day. The Board believes that, absent voluntary participation in other arrangements, such as electronic presentment arrangements, checks should be presented physically to payor institutions before their Federal Reserve accounts are charged to provide an opportunity for the payor institution to verify receipt of checks. In addition, late-in-the-day crediting is inconsistent with the public's desire to use the proceeds of check deposits to fund investments and other payments.

Finally, several commenters requested that the current measurement procedures be retained and suggested that the value of intraday float be recovered through the Reserve Bank's check collection fees. The Board believes that retaining the current procedures for posting checks and including the value of intraday float in the Reserve Banks' check collection fees could promote inefficiencies in the payments system. Such an approach would contribute to cross-subsidies among users of the Federal Reserve's check collection services and, thus, would not ensure that the parties benefiting from intraday float bore its costs.

The Board, therefore, has determined that debits for check presentments should be posted on the next clock hour that is at least one hour after presentment takes place, beginning at 11 a.m. ET.⁴⁵ Debits for check

⁴ Currently, subpart A of Regulation J requires a paying bank to settle for checks presented by a Reserve Bank by the close of its banking day or the close of the Reserve Bank's banking day whichever is earlier. The Board has adopted amendments to Regulation J to allow Reserve Banks to debit for check presentments on the next clock hour that is at least one hour after presentment takes place. (See Docket No. R-0722, elsewhere in today's Federal Register.)

⁵ It should be noted that, if there were a significant demand for early-in-the-day funds availability, the Board might consider allowing the Reserve Banks to debit payor institutions before 11 a.m. ET, so long as the earlier debiting time were consistent with Regulation J (12 CFR part 210).

presentments will be posted hourly thereafter until all debits are posted at 6 p.m. ET. Table 1 illustrates the relationship between the time of presentment and the posting time of debits for check presentments.

TABLE 1.—CHECK DEBITING TIMES

[All times are Eastern Time]

Presentment time	Posting Time
Through 10:00 a.m.	11:00 a.m.
10:01 a.m. to 11:00 a.m.	12:00 noon.
11:01 a.m. to 12:00 noon	1:00 p.m.
12:01 p.m. to 1:00 p.m.	2:00 p.m.
1:01 p.m. to 2:00 p.m.	3:00 p.m.
2:01 p.m. to 3:00 p.m.	4:00 p.m.
3:01 p.m. to 4:00 p.m.	5:00 p.m.
4:01 p.m. to 5:00 p.m.	6:00 p.m.

Depository institutions may receive multiple check presentments from the Federal Reserve each day. For example, Federal Reserve Banks make two daily presentments to depository institutions in the High Dollar Group Sort (HDGS) program. HDGS institutions typically receive a regional check processing center (RCPC) presentment and an HDGS presentment. The Federal Reserve will debit these institutions no earlier than one hour after each presentment. In the case of city institutions, the Federal Reserve may present some checks at the established clearing house exchange to those city banks that participate in the exchange, and present the remainder of the checks at approximately noon. For city banks, debits will be posted at two times: (1) Checks presented by 10 a.m. ET will be posted at 11 a.m. ET, and (2) checks presented after 10 a.m. ET will be posted on the next clock hour that is at least one hour after the last physical presentment.

The Federal Reserve presents checks to some depository institutions electronically. Debits for electronic presentments will also be posted on the next clock hour that is at least one hour after the time of presentment⁶—but not earlier than 11 a.m. ET and no later than 3 p.m. local time. Depository institutions that receive presentments of checks in both electronic and paper form will be charged separately for their electronic and paper presentments.

The Reserve Banks will determine the actual time(s) that checks are presented to each paying institution to establish the initial debit-posting time(s).

⁶ The presentment of electronic items is defined in the agreement between the paying bank and the Federal Reserve. As in the case of paper checks, all electronic presentments will be made by 2 p.m. local time.

Depository institutions will receive notification of their debiting time(s) during 1993.

The debit for returned checks presented to a depository bank will be posted at the same time as the debit for forward collection checks presented to that bank as paying bank. The posting time will be the same even if the returned checks are presented at a location and at a time different from the presentment of the forward collection checks.⁷

The Federal Reserve will adjust the debit posting time for checks if all of the following conditions exist: (1) Check presentments are made after the scheduled delivery time; (2) a depository institution reports that checks were presented either less than one hour before the scheduled posting time or after the scheduled posting time; and (3) the institution would have either incurred a daylight overdraft charge or exceeded its net debit cap if the debit were posted according to the regular schedule. In addition, the Federal Reserve will post debits for checks that were presented after the close of the paying bank's banking day at the institution's scheduled debiting time on the following business day.

Check Crediting Alternatives—The Board evaluated numerous check crediting alternatives after the 1991 proposal was issued for public comment. Each crediting alternative evaluated below is based on the Board's determination that debits for check presentments should be posted on the next clock hour that is at least one hour after presentment takes place, beginning at 11 a.m. ET.

The following three alternatives were the least complex options considered: (1) Post check credits at one national float-weighted time; (2) post check credits at one float-weighted time for each of the four U.S. time zones; and (3) post check credits based on a unique set of fractions per time zone.

The concept underlying alternative 1 (one national posting time) and alternative 2 (one posting time per time zone) differs from the 1991 proposal in that it involves the creation of intraday float. Aggregate net intraday float, however, would be close to zero because the amounts of intraday credit

and debit float created for brief periods would offset one another. For example, if half of the dollar value of all checks were charged to payor institutions at 12 noon ET and the other half were charged at 1 p.m. ET, a float neutral crediting time of 12:30 p.m. ET could be established. Because payor institutions would be charged at noon for half of the dollar value of checks, but credit would not be granted until 12:30 p.m., credit float would exist for 30 minutes. Likewise, debit float would exist for 30 minutes after the 12:30 p.m. crediting time because the remaining payor institutions would not be charged until 1 p.m. Thus, some intraday credit and debit float would be created, but net intraday float would be zero.

Alternative 1—Under one nationwide crediting time, survey data collected by the Reserve Banks in April 1992 indicate that all check credits could be posted at 12:15 p.m. ET. Adoption of a single crediting time would significantly simplify the intraday posting of check credits. Although it would result in later availability than the original proposal, several industry representatives who attended a meeting on August 1, 1991, at which check posting issues were discussed expressed a preference for this approach. Twenty-five percent of the commenters on the Board's January 1991 proposal also expressed a similar preference.

A single float-weighted posting time also has several disadvantages. First, a single crediting time might increase daylight overdrafts at institutions where debits for check presentments would be posted at 11 a.m. ET, but credits for check deposits would not be posted until 12:15 p.m. ET. Second, some deposits in the Central, Mountain, and Pacific time zones are very close to or after 12:15 p.m. ET. As a result, the Reserve Banks' Account Balance Monitoring System (ABMS), which many institutions use to manage their intraday Federal Reserve account positions, could not reflect the institutions' balances based on the posting rules.⁸ This disadvantage is largely offset by the fact that check depositors are aware of the value of their deposits, that is, their credits. Third, because credits for checks drawn on payor institutions located in the Pacific Time zone would be made available to collecting institutions before the majority of the checks can be presented to payor institutions, it could be difficult for correspondent banks to

compete with the Federal Reserve in providing intraday availability in this region. Conversely, the majority of east coast presentments is made to payor institutions before 11:00 a.m. ET, making a 12:15 p.m. ET crediting time unattractive for checks drawn on east coast institutions. Finally, west coast institutions might be able to inflate their intraday Federal Reserve account balances artificially by exchanging large-dollar checks. Institutions depositing such checks with the Federal Reserve would receive credit at 12:15 p.m. ET, but the payors would not be charged until later in the day. The Board believes that the disadvantages of this alternative outweigh its simplicity.

Alternative 2—If check credits were posted based on one float-weighted time per time zone, depository institutions would face no more than six crediting times.⁹ Compared with the 143 sets of fractions,¹⁰ which some depository institutions would have faced under the 1991 proposal, this alternative should be considerably easier for depository institutions to implement. Further, many smaller institutions deposit only mixed cash letters and would face only one crediting time.

This alternative would result in somewhat later posting times than the Board's 1991 proposal. Credit for checks drawn on payor institutions located in the Eastern Time zone (about 60 percent of all checks collected through the Reserve Banks), however, could be posted at about 11:45 a.m. ET, based on April 1991 survey data.

As with the one float-weighted posting time, no credit would be

⁹ Institutions depositing separately sorted deposits drawn on payor institutions located in all four time zones would receive credits at four times during the day. Institutions depositing mixed cash letters would receive credit at one time during the day, based on the mix of checks deposited at Federal Reserve offices in each time zone. Similarly, institutions depositing other Fed cash letters would receive credit at one time during the day. If an institution deposited checks in all four time zones and deposited a mixed and an other Fed cash letter with its Local Reserve office, it would receive credit at six different times.

Separately sorted cash letters consist only of checks drawn on payor institutions located in a specific availability zone. Mixed cash letters consist of checks drawn on any institution, other than the depositing institution. Other Fed cash letters consist of checks drawn on institutions located outside of the availability of the depositing institution's local Federal Reserve office.

¹⁰ Sophisticated collecting institutions frequently deposit separately sorted checks in each of the Federal Reserve's 141 availability zones and also deposit mixed and other Fed cash letters with their local Reserve offices. Under the 1991 proposal, a separate set of crediting fractions would have been developed for each of the 141 availability zones and for each Reserve office's mixed and other Fed products.

⁷ A Reserve Bank has the right to deliver returned checks to a depository bank at the same location as it presents forward collection checks to that bank (12 CFR 229.32(a)(1)). If a bank requests that the Reserve Bank deliver returned checks to a different location than its presentment location for forward collection checks, the Reserve Bank will generally do so if the bank agrees to accept the debit for the returned checks at the same time as its debit for forward collection checks.

⁸ The Daylight Overdraft and Pricing System (DORPS) would calculate daylight overdrafts for purposes of assessing charges after the fact and would post check credits at the designated times.

available to collecting institutions at 11 a.m. ET. Thus daylight overdrafts at institutions debited for check presentments at 11 a.m. ET might increase somewhat. The timing difference between the first debiting time and the first crediting time, however, is 45 minutes, rather than the one hour and 15 minutes difference under the one-posting-time alternative.

Additionally, granting credit based on float-weighted posting times for each time zone would result in credit for some check deposits not being reflected in the ABMS by the posting times because some deposit deadlines are very close to or later than the float-weighted posting times. As noted earlier, this situation should not cause significant problems for collecting institutions because they know the value of their check deposits.

The Board believes that this alternative addresses commenters' concerns about the complexity of the January 1991 proposal. At the same time, this alternative might tend to increase daylight overdrafts somewhat more than the increase estimated under the original proposal.

Alternative 3—The alternative under which check credits would be posted based on a unique set of fractions per time zone would permit collecting institutions to receive some credit for check deposits beginning at 11 a.m. ET. This option would appeal to those institutions that are more concerned about intraday availability than complexity. Under this alternative, based on April 1991 survey data, collecting institutions could receive credit for about 50 percent of the checks collected through the Federal Reserve at 11 a.m. ET, assuming the composition of their check deposits reflects the national averages.

As with the other two alternatives, all credits could not be reflected in the ABMS by the first posting time. The Reserve Banks estimate that from 5 to 19 percent of the dollar value of check deposits would not be reflected in the ABMS at 11 a.m. ET. As indicated previously, delays in ABMS posting should not cause significant problems for collecting institutions.

Posting check credits based on a unique set of fractions per time zone offers availability that is comparable to the fractional availability approach originally proposed, but collecting institutions would face no more than six sets of fractions, rather than the 143 sets of fractions that they would have faced under the 1991 proposal. If depository institutions chose to emulate this crediting alternative in their customer monitoring systems, their implementation costs should be lower than if they attempted to emulate the 1991 proposal.

Crediting Alternatives Adopted by the Board—Both the float-weighted posting time per time zone and the unique set of crediting fractions per time zone are basically consistent with the Board's guiding principles. Because some depository institutions might be negatively affected if no credit for check transactions were provided by 11 a.m. ET, the Board has determined to permit depository institutions to choose to receive credits for checks collected through the Reserve Banks based on (1) one float-weighted posting time per time zone, or (2) a unique set of fractions for each of the four U.S. time zones. Further, the Board indicated that a depositing institution may select only one crediting option for all of its check deposits. Finally, the crediting option selected by a correspondent bank will apply to check credits posted by the Reserve

Banks for all of its respondent institutions.

Under the *float-weighted posting time per time zone* option, a depository institution would receive credit at one time for all separately sorted, group sorted, and fine sorted deposits made to any Federal Reserve office located in the respective time zone. The credit posting time for checks that are transported (either by transportation arranged by the Federal Reserve, that is, consolidated shipment, or by transportation arranged by the depositor, that is, direct send) from one Federal Reserve office territory to another Federal Reserve office, will depend on the time zone of the destination Federal Reserve office, not the location of the paying bank. Table 2 illustrates the posting times that might apply to deposits at Federal Reserve offices in each time zone.

TABLE 2.—SEPARATELY SORTED FLOAT-WEIGHTED POSTING TIMES¹

[All times are Eastern Time]

Time zone	Posting time
Eastern.....	11:45 a.m.
Central.....	12:15 p.m.
Mountain.....	1:00 p.m.
Pacific.....	2:00 p.m.

¹ These data are preliminary and are based on an April 1991 survey. The actual posting times will be calculated using updated survey data on the actual debiting times for paying banks. Banks will be notified of the final posting times by July 1993.

Under the *fractional posting option*, a depository institution would receive credit for check deposits according to an intraday availability schedule with credits posted beginning at 11 a.m. ET and hourly thereafter. Table 3 estimates the credit percentages that would apply to each clock hour in each time zone.

TABLE 3.—SEPARATELY SORTED DEPOSIT FRACTIONAL POSTING TIMES¹

Time zone	Percentage of total dollars credited (ET)					
	11:00	12:00	1:00	2:00	3:00	4:00
Eastern.....	59	13	22	6		
Central.....	48	10	16	22	4	
Mountain.....	34	18	7	12	29	
Pacific.....	13	10	6	29	10	32
Percent of total dollars.....	50	12	18	13	3	4

¹ Preliminary data, see footnote 1 to Table 2.

Mixed and Other Fed Check Deposits—The Federal Reserve Banks will post credits for deposits of mixed and/or other Fed cash letters in accordance with the crediting option selected by the depositing bank, or its correspondent institution. The

procedures and the available options parallel the crediting procedure for deposits of separately sorted checks. The Federal Reserve Banks will calculate credit posting times that are float-neutral, based on the mix of checks generally contained in mixed and other

Fed deposits at all Federal Reserve offices in each of the four U.S. time zones. Table 4 provides estimated credit posting times that would apply under the one posting time per time zone option for deposits of mixed and other

Fed cash letters at Federal Reserve offices in each time zone.

TABLE 4.—MIXED AND OTHER FED FLOAT-WEIGHTED POSTING TIMES ¹

[All times are Eastern Time]

Time zone	Posting time	
	Mixed	Other Fed
Eastern.....	12:00 noon	12:00 noon
Central.....	12:15 p.m.	12:00 noon
Mountain.....	12:45 p.m.	12:45 p.m.
Pacific.....	2:00 p.m.	12:30 p.m.

¹ Preliminary data, see footnote 1 to Table 2.

For example, the credit posting time for mixed cash letters deposited at the Los Angeles Branch (Pacific Time) would be 2 p.m. ET, and the credit posting time for other Fed cash letters deposited at this office would be 12:30 p.m. ET. These float-weighted times reflect the location of the payor banks on which the checks that are deposited at Federal Reserve offices in the Pacific Time zone are drawn.

Under the fractional posting option, a collecting institution will receive credit

for mixed and other Fed deposits according to an intraday availability schedule with credits posted beginning at 11 a.m. ET and hourly thereafter. Tables 5 and 6 estimate the credit percentages that would apply to each clock hour in each time zone for mixed and other Fed deposits.

TABLE 5.—FRACTIONAL POSTING TIMES FOR MIXED DEPOSITS ¹

Time zone	Percentage of total dollars credited (ET)					
	11:00	12:00	1:00	2:00	3:00	4:00
Eastern.....	56	13	20	8	3	
Central.....	48	11	16	19	4	2
Mountain.....	37	15	10	15	18	5
Pacific.....	16	10	7	28	10	29

¹ Preliminary data, see footnote 1 to Table 2.

TABLE 6.—FRACTIONAL POSTING TIMES FOR OTHER FED DEPOSITS ¹

Time zone	Percentage of total dollars credited (ET)					
	11:00	12:00	1:00	2:00	3:00	4:00
Eastern.....	53	13	18	11	5	
Central.....	51	12	18	13	6	
Mountain.....	39	12	14	18	6	11
Pacific.....	42	13	14	14	9	8

¹ Preliminary data, see footnote 1 to Table 2.

The Reserve Banks will provide the check crediting times that will be effective October 14, 1993, to depository institutions during July 1993. Depository institutions will receive credit for check deposits at the single posting time per time zone unless an institution notifies its local Federal Reserve office no later than September 14, 1993, that it wishes to use the fractional crediting option. An institution may change its crediting option with 30-days advance notice to the Federal Reserve. The Federal Reserve will update the credit schedule semiannually based on changes to the times that debits are posted and the mix of checks received for collection.

Other Check Transactions—The Federal Reserve's implementation of a quasi, real-time approach to posting non-wire transactions will change the way a number of other check transactions are posted.

a. U.S. Treasury Checks, Postal Money Order, U.S. Savings Bonds Deposited Under the EZ-Clear Program, and Checks Drawn on Local Federal Reserve Banks.—Deposits of these items currently receive same-day credit when

deposited in separately sorted cash letters by deadlines that typically range from 3 p.m. to 4 p.m. local time.¹¹ In order to provide credit for these checks early in the day, the Board's 1991 proposal indicated that the Federal Reserve Banks would establish new deposit deadlines at 12:01 a.m. or later (local time) for separately sorted deposits of these items. Credit for separately sorted deposits received by the new deadline would have been posted at the opening of Fedwire, currently 8:30 a.m. ET.

Several commenters requested that the Federal Reserve post credits for such deposits one hour after they are delivered to the Federal Reserve or one hour after the opening of Fedwire, whichever is later. Based on the experience of Reserve Bank personnel, these types of deposits are typically received with other check deposits on regularly scheduled check courier deliveries. As a result, it is unlikely that significant dollar volumes of these items

¹¹ Refer to the Reserve Banks' operating circular for details on current deposit rules and deadlines.

would be deposited throughout the business day. Nevertheless, the Board determined that, to provide somewhat earlier intraday credit and to standardize the time at which credit is granted across Reserve offices, new deposit deadlines for separately sorted items will be established at 12:01 a.m. or later (local time) and at 4 p.m. ET, effective July 1, 1993. When the new measurement procedures are implemented on October 14, 1993, credit for items deposited by the new "12:01 a.m." deadline will be posted at the opening of Fedwire and credit for items deposited by 4 p.m. ET will be posted at 5 p.m. ET. In addition, the Board determined that Reserve Bank offices may continue their current late afternoon deadlines for separately sorted deposits—with credit posted after the close of Fedwire. If the Reserve Banks begin to receive large-dollar volumes of these items at other times during the day, consideration will be given to adding deposit deadlines.

Depository institutions may also deposit these items in mixed and city

cash letters. When they are contained in such deposits, they will be posted at the float-weighted posting time or included in the 11 a.m. ET fraction, for the time zone of the Federal Reserve office at which they are deposited.

b. *Foreign check deposits.*—Credit for deposits of foreign checks will be posted after the close of Fedwire. Debits to the accounts of collecting institutions through which the Federal Reserve collects foreign checks will also be posted after the close of Fedwire.

c. *Nonmachinable check deposits.*—Credit for deposits of nonmachinable checks will be posted after the close of Fedwire.

d. *Corrections.*—Data entry errors discovered by the Federal Reserve or by depository institutions amounting to \$1 million or more affecting the amount of credit or debit for cash letters will be corrected as soon as discovered and posted beginning at 11 a.m. ET and hourly thereafter. Smaller errors will be posted to Federal Reserve accounts after the close of Fedwire.

B. ACH Transactions

The Board's proposals concerning ACH transactions were discussed by 131 commenters. Nearly 90 percent of these commenters supported the proposal to post debits to the accounts of institutions originating *ACH credit transactions* and credits to the accounts of institutions receiving such transactions at the opening of Fedwire on the settlement day. These commenters indicated that the proposal was consistent with current industry practices, which allow customers to use the proceeds of ACH credit transactions early in the morning on the settlement day. Only two respondents opposed the proposal. These commenters were concerned that posting debits to originating institutions' accounts at the opening of Fedwire would have a detrimental effect on the ACH mechanism because institutions would be required to fund their accounts the day before the settlement day.

Numerous discussions with users of the ACH mechanism have indicated that the benefits of early-in-the-day funds availability for receivers of ACH credit transactions are important to the future viability of the mechanism. Further, originating institutions are aware of the value of payments settling each day and can plan to cover those payments. Survey data for the four-week period ending August 23, 1989, also indicated that the proposal would not disadvantage the majority of originating institutions. The Board, therefore, has determined that debits to the accounts of originators and credits to the

accounts of receivers of ACH credit transactions should be posted at the opening of Fedwire as proposed in 1991.

In the case of *ACH debit transactions*, nearly 80 percent of the commenters opposed the proposal to post credits to the accounts of institutions originating ACH debit transactions and debits to the accounts of institutions receiving such transactions at 11 a.m. ET. Because of the desire to receive credit early in the day, the majority of these respondents requested the Federal Reserve to post ACH debit transactions at the opening of business. Commenters noted that ACH debit transactions were used for a variety of purposes in addition to cash concentration transactions and that the transactions were funded not only by checks becoming available on the settlement date, but also in a variety of other ways. As a result, these commenters indicated that associating the posting time for ACH debit transactions with the first posting time for commercial check transactions did not reflect depository institutions' funding practices.

Several respondents acknowledged that posting ACH debit transactions at the opening of Fedwire causes daylight overdrafts in many receiving institutions' Federal Reserve accounts. The majority of these commenters suggested that overdrafts caused by ACH debit transactions be exempt from overdraft charges. A number of commenters located on the west coast indicated that the posting time for ACH debit transactions should be based on local time to permit west coast institutions to obtain funding before the debit is posted.

Posting ACH debit transactions at 11 a.m. ET would delay funds availability to originators of these transactions compared with the current measurement procedures. At the same time, posting ACH debit transactions at the opening of business would cause about 200 to 300 institutions to start the day in an overdrawn position. As commenters indicated, the Reserve Banks do not presently counsel institutions that incur daylight overdrafts due solely to ACH transactions, largely because these institutions do not currently have the opportunity to obtain funding for ACH debit transactions before their accounts are charged. The Board believes, however, that when fees are assessed for daylight overdrafts, no overdrafts should be exempt from charges beyond the deductible determined by the Board. Finally, if the accounts of receivers of ACH debit transactions were debited based on local time, as suggested by some commenters, it would be necessary to grant credit to the accounts

of originators based on the location of the receiving institution to avoid creating intraday float. Such a step would significantly complicate operating procedures and would certainly reduce the attractiveness of this electronic mechanism.

Receivers of ACH debit transactions cannot predict with certainty the value of transactions that they will receive on a certain day. In order to avoid incurring overdrafts, receiving institutions need some time after the opening of Fedwire to obtain funding for payments before their accounts are debited. The Board, therefore, has adopted the 1991 proposal to credit the accounts of originators and debit the accounts of receivers of ACH debit transactions at 11 a.m. ET.

The Board has also determined that ACH return items and check truncation items, which are processed during the day for same-day availability and are normally delivered to receiving institutions around 4 p.m. ET, should be posted at 5 p.m. ET, as proposed in 1991.

C. Net Settlement Transactions

Under the 1991 proposal, members of private-sector clearing arrangements would be permitted to determine the time at which the net settlement entries for their clearing arrangements would be posted.¹² The Reserve Banks would accept multiple settlement statements and would post settlement entries one hour after the data were received from the agent for the clearing arrangement. Thirteen of the 20 commenters that discussed this proposal supported it. Four of these respondents suggested that entries be posted 30 minutes after receipt by the Federal Reserve.

Respondents opposing the proposal were concerned that members of clearing arrangements would select late posting times, thus delaying availability. Other commenters indicated that Reserve Bank participation in clearing arrangements that selected late posting times would create competitive inequities by creating incentives for corporate customers to maintain accounts with institutions receiving late afternoon charges. Several commenters suggested that posting times for net settlement entries should be no later than 12 noon or 1 p.m. ET. One commenter suggested that the current procedures should be retained; that is, post net credits as though they occurred at the opening of Fedwire and net debits

¹² The Reserve Banks provide net settlement services to about 250 private clearing arrangements, including local check clearing arrangements, privately operated ACH networks, automated teller machine (ATM) networks, point-of-sale (POS) networks, and credit card processing arrangements.

as though they occurred after the close of Fedwire. Five commenters indicated that the current procedures should be retained for exchanges of short-term instruments, such as commercial paper.

The Board believes that permitting members of clearing arrangements to agree on the time at which settlement entries would be posted provides clearing arrangements the means to provide effective and competitive services. To the extent that the posting times selected by clearing groups are late in the day, the Reserve Banks would exercise their option of not participating in such arrangements. The Board also recognizes that the value of short-term instruments exchanged among members of the New York Clearing House is large. It would be inconsistent with the Board's objective of eliminating intraday float, however, to retain the current procedures for posting these entries. Further, the Depository Trust Company's book-entry commercial paper clearing and settlement system continues to expand and should contribute to a reduction in daylight overdrafts caused by commercial paper activity. Finally, the Board believes that providing the Reserve Banks an hour to post net settlement entries is not unreasonable because processing is often performed manually. In addition, the Reserve Banks' staffs must ensure the accuracy of the data submitted and determine that the entries are in balance before they are posted.

The Board, therefore, has determined that members of private-sector clearing arrangements should be permitted to determine the time at which the net settlement entries for their clearing arrangement will be posted, as proposed in 1991. The Reserve Banks will accept multiple settlement statements and will post net settlement entries on the next clock hour approximately one hour after the data are received from the agent for the clearing arrangement.¹³

D. Book-Entry Securities Activity

Thirty-eight commenters discussed the posting of book-entry securities activity. These respondents indicated that, because the book-entry transfer system is sender-driven, it is difficult for receivers of incoming securities to control overdrafts caused by such transfers. The majority of these commenters requested that the book-

entry transfer system be opened later than the funds transfer system to provide receiving institutions time to obtain funding before securities transfers are delivered. Suggested opening times ranged from 9:15 a.m. to 11:30 a.m. ET. Commenters also suggested that the system be modified to provide receivers time to obtain funding during the day before the securities are delivered and debits are posted to their accounts. Finally, two commenters expressed concern about overdrafts caused by deliveries of original issues of U.S. Treasury securities. One commenter proposed that new issues be deposited in a separate account, which would not be subject to daylight overdraft charges. The other commenter suggested that deliveries be delayed until 11 a.m.

In April 1990, the Board adopted uniform opening hours for the Fedwire funds and securities transfer systems. Concerns raised by some commenters on the uniform opening time proposal regarding funding incoming securities transfers were addressed at that time, although it is not clear that commenters had considered the full implications of the Board's 1989 proposal to charge for daylight overdrafts. Consideration is now being given to expanding Fedwire operating hours, and a request for comment on this issue appears elsewhere in today's *Federal Register*. (See Docket No. R-0778.) In the context of that proposal, the public will have an opportunity to discuss the benefits and costs of opening the book-entry securities system at the same time as the funds transfer system.

The Board understands the concerns of commenters about their inability to control daylight overdrafts caused by incoming book-entry securities transfers. The commenters' suggestion that receivers be provided time to obtain funding before securities are delivered would require a fundamental change in the design of the current book-entry securities system. The Federal Reserve is designing a new book-entry securities transfer system, however, and that design could include features that would provide receivers of incoming securities greater control over the receipt of such transfers.

With respect to overdrafts caused by the delivery of original issues of book-entry securities, the Board believes that these overdrafts, like overdrafts caused by other securities transfers, should be included in the calculation of a depository institution's daily average daylight overdraft. Currently, original issues of Treasury securities are delivered to purchasing institutions

beginning at 9:15 a.m. ET. Thus, depository institutions are given some time to obtain funding before they are charged for the securities. Moreover, institutions purchasing new issues of Treasury securities are aware of the payments associated with their purchases in advance of the settlement date and should be able to arrange funding.

E. Other Transactions

Commenters on the 1991 proposal discussed a number of other transactions processed by the Reserve Banks, such as adjustments, currency and coin transactions, discount window loans, and Treasury investments.

1. *Adjustments*—Several commenters requested that adjustments for check transactions be posted before the close of Fedwire, rather than after the close of Fedwire as proposed by the Board. Other commenters indicated that adjustments should include compensation for the cost of funds as well as adjustments to daylight overdraft charges.

Although respondents to the Board's proposal focused on the treatment of adjustments for check transactions, the Board believes that similar concerns about the treatment of adjustments apply to all types of transactions processed by the Reserve Banks. Large-dollar adjustments may have a significant effect on depository institutions' intraday Federal Reserve account positions and, as pointed out by commenters, could affect daylight overdraft charges.

To address the concerns raised by commenters, the Board believes that large-dollar credit adjustments, that is, those amounting to \$1 million or more, should be posted during the business day. On the other hand, depository institutions should have an opportunity to arrange funding for debit adjustments.

The Board, therefore, believes that debit adjustments should be posted after the close of Fedwire.

Because adjustments are typically processed as of the date of the original transactions, the interday value of funds is currently taken into consideration. With respect to the intraday value of funds, depository institutions are expected to manage their Federal Reserve accounts each day in a way to ensure that their use of Federal Reserve credit does not exceed their net debit caps and that their closing balance is positive. Thus, the Board believes that adjustments should only be considered in the calculation of daily average overdrafts on the day that the adjustment is found and posted to an

¹³ The Board's determination does not affect clearing arrangements that use Fedwires to complete settlement, such as the Clearing House Interbank Payment System, the Depository Trust Company, the Participants Trust Company, and participants using VISA's national ACH services. The Fedwires sent and received to complete settlement would be posted as they are processed.

institution's account. At the same time, posting large-dollar credit adjustments during the business day as they are discovered and posting debit adjustments after the close of business on the day they are discovered gives depository institutions the benefit of the doubt with respect to the intraday effect of adjustments.

The Board, therefore, has determined that (1) credit adjustments amounting to \$1 million or more should be posted hourly beginning at 11 a.m. ET as they are discovered during the business day and (2) small-dollar credit and all debit adjustments should be posted after the close of Fedwire.

2. Currency and Coin Transactions—Thirteen commenters discussed the Board's proposal to post (1) credits for currency and coin deposits on a flow basis, beginning at 11 a.m. ET and hourly thereafter until all credits have been posted on the day of deposit, and (2) debits for shipments of currency and coin after the close of Fedwire on the day the shipment is dispatched. Two commenters opposed the proposal. Some commenters indicated that there should be fewer posting times during the day. One commenter suggested that the value of currency and coin deposits did not warrant intraday posting. On the other hand, one commenter stated that credits for currency and coin deposits should be posted at time of shipment to the Federal Reserve, and another commenter requested that charges for currency shipments be delayed until the date of actual delivery.

While the value of currency and coin transactions is not significant in absolute terms for many depository institutions, survey data gathered during the four-week period ending August 23, 1989, indicated that several hundred depository institutions' overdrafts could be measurably reduced if currency and coin deposits were posted during the business day. Further, granting credit for currency and coin deposits during the business day should address some concerns raised by smaller depository institutions about the equity of Federal Reserve policies.

With respect to the manner in which credits would be posted during the business day, the Reserve Banks plan to verify currency and coin deposits as they are received. Following verification, accounting entries would be generated and sent to the Reserve Banks' Integrated Accounting System (IAS). These accounting entries would be accumulated and posted on each clock hour, beginning at 11 a.m. ET until all entries had been posted. Although posting would continue throughout the business day, many depository

institutions make only one currency or coin deposit a day. As a result, they would normally receive only one credit each business day and would not be exposed to multiple posting times. For those institutions that make more than one deposit a day, the only way to reduce the number of posting times would be to delay crediting for all deposits until the last deposit was verified. The Board believes that providing credit for deposits as they are verified would benefit more institutions than it would disadvantage.

The times at which credits and debits would be posted to the accounts of depository institutions participating in the Reserve Banks' early credit/delayed debit program was not addressed in the Board's January 1991 proposal. The Board agrees with commenters that credits should be posted to the accounts of depository institutions participating in the early credit program on the day that the institution ships currency or coin to the Federal Reserve. Similarly, debits for shipments of currency and coin to the accounts of institutions participating in the delayed debit program should be posted after the close of Fedwire on the day that the institution is scheduled to receive the shipment.

The Board, therefore, has determined that credits for currency and coin deposits should be posted on the clock hour, beginning at 11 a.m. ET until all credit have been posted. Accounting entries will be posted hourly as the Reserve Banks receive and verify currency and coin deposits or receive notifications of shipments from institutions participating in the early credit program. The Board has also determined that debits for shipments of currency and coin should be posted after the close of Fedwire on the day the shipment is dispatched or, for institutions participating in the delayed debit program, on the day the shipment is scheduled to be received.

3. Discount Window Loans—In 1991, the Board proposed to post both credits for extensions of discount window loans and debits for their repayment after the close of Fedwire. On an exception basis, the Reserve Banks' staff would have had the option to post the credit for a loan before the close of business and to post the repayment 24 hours later.

Twelve commenters discussed the treatment of discount window loans and seven commenters supported the Board's proposal. Commenters opposing the proposal indicated that discount window loans represent large credits for small institutions and that posting such transactions after the close of Fedwire would disadvantage them. These

commenters requested that posting of discount window loans be permitted at any time during the business day.

Staff also has been advised that there may be some circumstances in which depository institutions would prefer to repay discount window loans before the time at which the loan is due. In most cases, the desire to repay early is related to a borrower's need to obtain the release of securities pledged as collateral to secure its discount window loan in time to permit transfer of the securities over the book-entry system the same day. To accommodate this need, it was suggested that, on an exception basis and where valid reasons are given, depository institutions be permitted to repay discount window loans before the time of day that the loan becomes due.

The Board continues to believe that, in an active intraday pricing environment, discount rates should represent the cost of 24-hour extensions of Federal Reserve credit, which would be comparable in term to 24-hour extensions of credit in the federal funds market. In response to the introduction of charges for intraday credit by the Federal Reserve, participants in the federal funds market presumably will begin to price 24-hour credit extensions differently from overnight extensions. In this event, the Board believes that the 24-hour federal funds rate would be most relevant to the determination of term funds rates and other money market rates and, hence, of most interest in the implementation of monetary policy. The anchor to the federal funds rate stems in part from the interaction of the System's intended level of adjustment plus seasonal borrowing with the willingness of institutions to tap the window at the prevailing discount rate. Hence, it would seem most appropriate to link the level of borrowing to a 24-hour federal funds rate by having the maturities of discount window loans be 24 hours or multiples thereof.

At the same time, the Board agrees with commenters that there may be occasions, consistent with the basic policies governing all use of Federal Reserve credit, when a depository institution should be permitted to use funds advanced through the discount window during a portion of the day on which the loan is granted. The Board also agrees that there may be some circumstances that would justify allowing repayment of a discount window loan before its scheduled maturity of 24 hours or a multiple thereof.

The Board, therefore, has determined that credits for discount window loans and debits for repayments normally should be posted after the close of Fedwire. In the occasional circumstances where a depository institution does not have ready access to money markets and must make unanticipated payments during the business day, however, the Reserve Bank may post the loan during the business day and post the repayment 24 hours later. Further, on an exception basis and where a valid reason is given, an institution may be permitted to repay a loan before it otherwise would be due. The associated-debit would be posted at the same time.

4. Treasury Investments—All eight commenters that discussed the proposal to post advance notice Treasury investments (that is, Treasury direct and special direct investments) at the opening of Fedwire and to post same-day investments at 2 p.m. local time supported the Board's proposal. The Treasury Department, however, expressed concern that posting same-day investments at 2 p.m. local time might discourage participation in the program.

The Board acknowledges that some Treasury Tax and Loan (TT&L) depositories may wish to invest funds in Treasury securities. Because the Fedwire securities transfer system officially closes at 2:30 p.m. ET, the Board agrees that some depositories might be unable to invest funds based on their preferences if the Board's proposal for same-day investments were adopted. The Reserve Banks typically receive information from the Treasury Department about same-day investments between 11:30 a.m. and 12:30 p.m. ET. Because a small number of institutions participate in the program, the Reserve Banks have indicated that they would be able to post same-day Treasury investments by 1 p.m. ET. The Board, therefore, has determined that advance notice Treasury investments should be posted at the opening of Fedwire and that same-day investments should be posted by 1 p.m. ET. For practical purposes, this determination would mean that same-day investments will be posted, on a flow basis, from 12 noon through 1 p.m. ET, as Reserve Banks receive and process information from the Treasury Department.

5. Letters of Credit—The Board proposed to post all manual letters of credit that had been processed by 2 p.m. ET at that time and to post all remaining transactions at 5 p.m. ET. (The majority of letter-of-credit activity is processed

over Fedwire and, as a result, credits are posted to recipients' accounts when the funds transfers are processed.)

All eight commenters that discussed this proposal supported it. Because the payments associated with these transactions involve very large amounts and would typically be invested on the day of receipt, the Board has determined that all manual letters of credit should be posted as proposed in January 1991.

6. State and Local Government Series—Treasury Securities (SLGs)—SLGs are nonmarketable securities issued by the Treasury Department to state and local governments. All records of ownership are maintained on the books of the Treasury Department. SLGs may not be transferred as a result of sale or exchange nor may they be assigned or pledged.

The Board proposed to post (1) debits to the accounts of depository institutions for new issues of SLGs after the close of Fedwire on the issue date and (2) credits to the accounts of depository institutions for interest and principal payments for SLGs made via reserve account entries at the opening of business on the interest payment and redemption dates. Interest and principal payments that are made via the ACH or by means of Treasury checks would be treated like other ACH credit and Treasury check transactions.

All eight commenters that discussed the treatment of SLGs supported the Board's proposal. Because the risk faced by the Reserve Banks in handling these transactions is limited, the Board has determined to adopt its 1991 proposal for posting debits for original issues and credits for interest and redemption payments for SLGs.

F. Effect of Modifications on Depository Institutions

Because the changes to the Board's 1991 proposal for measuring daylight overdrafts do not result in significant changes in the times that payment transactions would be posted, the effect of this set of modifications would be similar to the effect of the 1991 proposal.¹⁴

It is clear that implementation of the modifications to the measurement proposal would require some adjustment by all institutions using Federal Reserve payment services. Survey data for the four-week period ending August 23, 1989, indicate that the elimination of intraday float would increase the level of daylight overdrafts by about \$30 billion per day. The number of institutions incurring daylight overdrafts

would increase by about 50 percent, and more than 400 institutions would exceed their net debit caps. Approximately 240 of the institutions with excess overdrafts, however, would be eligible for either higher caps or the exempt-from-filing status, which was implemented in January 1991. In addition, the majority of excess overdrafts are due to book-entry securities activity and are concentrated at the three New York clearing banks. Depository institutions are permitted to exceed their caps due solely to book-entry activity, provided they fully collateralize those overdrafts. As a result, these excess overdrafts would not need to be reduced due to the implementation of the modified measurement scheme.

While the number of institutions affected in a material way would not be extremely large, the majority of institutions would need to make some adjustment to the procedures they use to manage their intraday Federal Reserve account positions. In this regard, several commenters expressed concern about the Reserve Bank's ability to provide the information needed by depository institutions to make cash management decisions, monitor their intraday positions, and reconcile daylight overdraft charges.

Because a large number of institutions rely upon the Reserve Banks' ABMS to manage their intraday use of Federal Reserve credit, the ABMS is being modified to provide depository institutions account balance information reflecting (1) all transactions that have been posted to the Reserve Banks' Integrated Accounting System throughout the day and (2) balances available for transfer under the measurement scheme adopted by the Board. The first balance can be used for cash management purposes and the second balance can be used to manage the amount of intraday credit an institution uses. In addition, the Reserve Banks will provide information concerning the value of specific types of transactions processed and the time during the day that funds will be debited or credited to an institution's account. To ensure that the information services provided by the Reserve Banks satisfy the needs of the majority of depository institutions, Federal Reserve staff will survey representatives of depository institutions to determine their specific requirements and will consider those requirements in the final design of Reserve Bank information services.

Although a fairly large number of depository institutions would need to make some adjustments to manage their

¹⁴ See 56 FR 3107, January 28, 1991.

use of Federal Reserve intraday credit under the proposal, the Board believes that the costs of these changes should be relatively low. In order to manage their intraday Federal Reserve account positions, some depository institutions may need to modify the procedures that they use to monitor their customers' intraday account balances. In particular, the determination that debits for check presentments be posted during the business day is likely to necessitate depository institutions' requiring some customers to fund check presentments earlier in the day than they do now. Further, a relatively small number of institutions may choose to modify their customer monitoring systems and develop systems to charge customers for daylight overdrafts. These institutions could incur material costs. Although implementing the modified measurement scheme would contribute to some cost increases for depository institutions, it would also place the burden associated with intraday float reduction on the parties responsible for making payments—both senders of electronic payments and issuers of checks.

Competitive Impact Analysis

Under its competitive equity policy, the Board assesses the competitive impact of changes that have a substantial effect on payments system participants.¹⁵ Under this analysis, the Board determines whether the change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services.

The Board believes that the modified measurement scheme would permit depository institutions and private clearing groups to offer safe and effective payment services that would compare favorably with those offered by the Reserve Banks. In the case of the check collection service, depository institutions participating in private clearing houses would be able to establish the time at which net settlement entries for checks exchanged among participants would be posted to Federal Reserve accounts. Thus, the participants would be able to control the time at which credits and debits would be posted to their accounts. Correspondent banks that clear checks on behalf of respondents would be able to make payments to their respondents for any checks collected through the Federal Reserve on the availability date

without incurring daylight overdrafts, provided that the timing of the payments to respondents followed the receipt of credit from the Federal Reserve. Private collecting institutions that enter into bilateral agreements with payor institutions currently are able to obtain payment for check presentments on the day of presentment and, in some cases, do not pay presentment fees to the payor institutions. At the same time, the modification to subpart A of Regulation J and the measurement procedures improve further the Reserve Bank's ability to obtain settlement for check presentments vis-a-vis some private-sector collecting institutions.

The Board's proposal to amend Regulation CC to provide same-day settlement for private-sector presentments requested comment on whether payor institutions should be obligated to settle for private-sector presentments on as timely a basis as required in the 1991 proposed modification to subpart A of Regulation J (56 FR 4743, February 6, 1991). The Board recently adopted a same-day settlement rule, and a discussion of the timing of private-sector presentments is included in Docket R-0723, elsewhere in today's Federal Register.

In the case of the ACH service, the availability of funds to receivers of ACH credit transactions would be slightly more favorable than the terms of the national ACH net settlement service. On the other hand, institutions originating ACH credit transactions would be charged earlier than they would be under the terms of the national ACH net settlement service. In the case of ACH debit transactions, funds availability under the proposal would be comparable to the terms of the national ACH net settlement service. Because there are a variety of reasons that depository institutions choose to use private-sector processors, including pricing and deposit deadlines, slight differences in the timing of credits and debits for transactions are unlikely to cause institutions to shift their transactions to the Federal Reserve's ACH.

Summary

The Board believes that the method adopted for posting check transactions during the business day addresses many of the concerns that were raised by commenters on the 1989 and 1991 proposals. At the same time, the Board acknowledges that the banking industry will incur some incremental costs in implementing the measurement scheme. The Board does not believe that the implementation and ongoing costs that

will be borne by the industry will be substantial, unless a large number of institutions choose to emulate the Federal Reserve's procedures for monitoring their customers' intraday account positions. Because it is likely that depository institutions will make rational business decisions, the Board expects depository institutions to implement any changes that will be required in the most cost effective way possible and, thus, keep to a minimum potential expenditures.

The Board has determined to adopt modifications to the procedures used to measure daylight overdrafts that result in intraday accounting for non-wire transactions based on a quasi-real-time approach. In particular, depository institutions collecting checks through the Federal Reserve would have the option to receive check credits (1) at one float-weighted posting time for each of the four U.S. Time zones; or (2) based on a unique set of fractions for each time zone. The Board has also determined that debits for check presentments should be posted on the next clock hour that is at least one hour after presentment takes place, beginning at 11 a.m. ET.

Fedwire funds and book-entry securities transfers would continue to be posted as they are processed. The details of the Board's determination are outlined in Appendix 2.

Policy Statement

The Board has adopted the following to replace part (I) (A) in its "Federal Reserve System Policy Statement on Payments System Risk" under the headings "I. Federal Reserve Policy" and "A. Daylight Overdraft Definition," effective October 14, 1993:

A daylight overdraft occurs when a depository institution's Federal Reserve account is in a negative position during the business day. The Reserve Banks use an *ex post* system to measure daylight overdrafts in depository institution's Federal Reserve accounts. The procedures used result in Fedwire funds and book-entry securities transfers being posted as they are processed during the business day. Intraday accounting for automated clearing house (ACH) and non-wire transactions is based on a quasi-real-time accounting approach. The following table (the table presented in appendix 2 will be included in the policy statement) presents the detail of the procedures used by the Federal Reserve for measuring daylight overdrafts.

¹⁵ These assessment procedures are described in the Board's policy statement entitled "The Federal Reserve in the Payments System" (55 FR 11048, March 29, 1990).

By order to the Board of Governors of the Federal Reserve System, October 6, 1992.

William W. Wiles,
Secretary of the Board.

Appendix 1—1991 Proposal for Measuring Daylight Overdrafts

Opening Balance (Previous Day's Closing Balance)

Post at the Opening of Fedwire Funds Transfer System

- +/- Government and Commercial ACH Credit Transactions
- + Advance Notice Treasury Investments
- + Treasury State and Local Government Series (SLGs) Interest and Redemption Payments
- + Treasury Checks, Postal Money Orders, Federal Reserve Bank Checks, and EZ-Clear Savings Bond Redemptions Deposited the Previous Night

Post Throughout Business Day

- +/- Fedwire Funds Transfers
- +/- Fedwire Book-Entry Securities Transfers
- +/- Net Settlement Entries ¹

Post at 9:15 a.m. Eastern Time

- Original Issues of Treasury Securities ²
- + U.S. Treasury and Government Agency Interest and Redemption Payments

Post at 11 a.m. Eastern Time

- +/- ACH Debit Transactions

Post at 11 a.m. Eastern Time and Hourly Thereafter

- +/- Commercial Check Transactions, Including Return Items
- + Currency and Coin Deposits

Post at 2 p.m. Eastern Time

- + Processed Manual Letters of Credit ³

Post at 2 p.m. Local Time

- + Same-Day Treasury Investments

Post One Hour After Deposits Deadline (4-5 p.m. Local Time)

- + Same-Day Treasury Checks, Postal Money Orders, Federal Reserve Bank Checks, and EZ-Clear Savings Bond Redemptions

Post at 5 p.m. Eastern Time

- + Processed Manual Letters of Credit
- +/- Same-Day ACH Transactions ⁴

¹ Net settlement entries would be posted one hour after settlement data are received by the Reserve Banks.

² Original issues of Government agency securities are delivered as book-entry securities transfers and would be posted when the securities are delivered to the purchasing institutions.

³ Letters of credit transactions are drawdowns of government grants.

⁴ Same-day ACH transactions include ACH return items and check truncation items.

⁵ In unusual circumstances if a depository institution does not have ready access to money markets and has demonstrated a need to make

Post After the Close of Fedwire Funds Transfer System

- +/- All Other Non-Wire Transactions (such as, Noncash, Government Coupons, TT&L Calls, Subscription for SLGs, Discount Window Loans and Repayments,⁵ and Currency and Coin Shipments.)

EQUALS

Closing Balance

Appendix 2—Modified Procedures for Measuring Daylight Overdrafts ⁶

Opening Balance (Previous Day's Closing Balance)

Post at the Opening of Fedwire Funds Transfer System

- +/- Government and Commercial ACH Credit Transactions
- + Advance Notice Treasury Investments
- + Treasury State and Local Government Series (SLGs) Interest and Redemption Payments
- + Treasury Checks, Postal Money Orders, local Federal Reserve Bank Checks, and EZ-Clerk Savings Bond Redemptions in Separately Sorted Deposits

Post Throughout Business Day

- +/- Fedwire Funds Transfers
- +/- Fedwire Book-Entry Securities Transfers
- +/- Net Settlement Entries ⁷

Post by 9:15 a.m. Eastern Time

- + U.S. Treasury and Government Agency Book-Entry Interest and Redemption Payments
- + U.S. Treasury and Government Agency Matured Coupon and Definitive Securities Received before the Maturity Date

Post Beginning at 9:15 a.m. Eastern Time

- Original Issues of Treasury Securities ⁸

Post at 11 a.m. Eastern Time

- +/- ACH Debit Transactions

Post at 11 a.m. Eastern Time and Hourly Thereafter

- +/- Commercial Check Transactions, Including Return Items
- +/- Check Correction Amounting to \$1 million or more
- + Currency and Coin Deposits
- + Credit Adjustments Amounting to \$1 million or more

Post by 1 p.m. Eastern Time

- + Same-Day Treasury Investments

unanticipated payments. Reserve Banks may post the credit for a discount window loan when it is granted, provided it is repaid 24 hours later.

⁶ The posting changes do not affect the overdraft restrictions and overdraft measurement provisions for nonbank banks established by the Competitive Equality Banking Act of 1987 and the Board's Regulation Y (12 CFR 225.52).

⁷ Net settlement entries will be posted on the next clock hour approximately one hour after settlement data are received by the Reserve Banks.

⁸ Original issues of Government agency securities are delivered as book-entry securities transfers and

Post at 2 p.m. Eastern Time

- + Processed Manual Letters of Credit ⁹

Post at 5 p.m. Eastern Time

- + Treasury Checks, Postal Money Orders, local Federal Reserve Bank Checks, and EZ-Clear Savings Bond Redemptions in Separately Sorted Deposits
- + Processed Manual Letters of Credit
- +/- Same-Day ACH Transactions ¹⁰

Post After the Close of Fedwire Funds Transfer System

- +/- All Other Non-Wire Transactions such as, Noncash, Government Coupons ¹¹ TT&L Calls, Subscription for SLGs, Discount Window Loans and Repayments,¹² and Currency and Coin Shipments.)

EQUALS

Closing Balance

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will be posted when the securities are delivered to the purchasing institutions.

⁹ Letters of credit transactions are drawdowns of government grants.

¹⁰ Same-day ACH transactions include ACH return items and check truncation items.

¹¹ U.S. Treasury and government agency matured coupons and definitive securities received on or after the maturity date.

¹² In occasional circumstances where a depository institution does not have ready access to money markets and must make unanticipated payments, Reserve Banks may post the credit for a discount window loan when it is granted, and post the repayments 24 hours later. In addition, on an exception basis and where a valid reason is given, an institution may be permitted to repay a loan before it would otherwise be due.

Board of Governors of the Federal Reserve System

AMENDMENTS TO REGULATION J

Measurement of Daylight Overdrafts Under the Payments System Risk Reduction Program

(Effective October 14, 1993)

FEDERAL RESERVE SYSTEM

12 CFR Part 210

[Regulation J; Docket No. R-0722]

Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board is adopting an amendment to its Regulation J to require paying banks that receive presentment of checks from a Federal Reserve Bank to settle for those checks as soon as one hour after receipt of the checks. This amendment is necessary to implement the procedures for posting debits and credits to depository institutions' reserve and clearing accounts in order to measure daylight overdrafts accurately under the Board's payments system risk reduction program. The intent of the program is to reduce both Federal Reserve and overall payments system risk. The Board is also making other technical and clarifying amendments to Regulation J.

EFFECTIVE DATE: October 14, 1993.

FOR FURTHER INFORMATION CONTACT:

Oliver I. Ireland, Associate General Counsel (202/452-3625), Stephanie Martin, Senior Attorney (202/452-3198), Legal Division; or Florence M. Young, Assistant Director, Division of Reserve Bank Operations and Payment Systems (202/452-3955); for the hearing impaired only: Telecommunications Device for the Deaf, Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: As part of its payments system risk reduction program, the Board has determined to charge a fee for daylight overdrafts in reserve and clearing accounts at Federal Reserve Banks. To measure daylight overdrafts accurately, the Board has adopted procedures under which debits

and credits will be posted to reserve and clearing accounts for various transactions. (See Docket Nos. R-0668 and R-0721, elsewhere in today's *Federal Register*.) Under the measurement procedures adopted by the Board, debits and credits for check transactions will be posted throughout the business day, based on when checks are presented by Reserve Banks. When the intraday check posting procedure was published for comment in January 1991, the Board also requested comment on an amendment to Regulation J (12 CFR part 210) to allow Reserve Banks to debit the reserve and clearing accounts of banks¹ as early as one hour after presentment of checks (56 FR 3047, January 28, 1991). The Board has adopted the proposed amendments to Regulation J, modified as explained below.

Regulation J Before Amendment

Subpart A of Regulation J governs the collection of checks by Reserve Banks and applies to "all parties interested in an item handled by any Reserve bank."² Regulation J provides for deferred posting of checks, i.e., a paying bank can wait until the day after presentment to decide whether to pay or return a check if it settles for the check on the day of presentment. Deferred posting allows banks more time to process checks internally than they would have if the checks were presented over the counter for immediate payment in cash and is essential to the methods currently used by paying banks in determining whether to pay checks.

¹ Under Regulation J, bank includes all depository institutions, such as commercial banks, savings and loan associations, and credit unions. Regulation J defines paying bank as the bank by, at, or through which an item is payable or collectible and to which it is sent for payment or collection, or the bank whose routing number appears on the item and to which it is sent for payment or collection. (12 CFR 210.2(b) and (j)).

² 12 CFR 210.3(b).

Before adoption of the amendments published today (which are effective October 14, 1993), § 210.9(a)(1) of Regulation J had provided that a paying bank would become accountable for a check presented by a Reserve Bank unless it settled for or returned the check by the close of its banking day on which it received the check.³ Section 210.9(a)(2) of Regulation J specified that settlement proceeds must be available to the Reserve Bank by the close of the Reserve Bank's banking day on the day the paying bank received the checks. Under these two provisions, it appeared that a paying bank had to settle for a check presented to it by a Reserve Bank by the close of its banking day or the close of the Reserve Bank's banking day, whichever was earlier. As a practical matter, in many cases this time was likely to be mid-afternoon, when the paying bank closed its lobby. Generally, if settlement was made under Regulation J, the paying bank could exercise deferred posting and return the check before midnight of its next banking day in accordance with § 4-301 of the Uniform Commercial Code (UCC).⁴

Although the UCC allows deferred posting of checks, the time for settlement by paying banks under the UCC differs from the time for settlement by paying banks for checks presented under Regulation J. Section 4-302 of the UCC provides that a paying bank becomes accountable for a check unless it settles for or returns the check before midnight on the banking day it receives the check. If the UCC settlement obligation is met the paying bank may

³ Settlement under regulation J (both before and after amendment) must be by a debit to an account on the books of the Reserve Bank, cash, or other form of payment agreed to by the Reserve Bank.

⁴ UCC § 4-301 provides that if a paying bank settles for a check by midnight on the banking day of receipt, it may return the check or send notice of nonpayment by midnight of the banking day following the banking day of receipt.

exercise deferred posting under UCC § 4-301. Thus, Regulation J requires the paying bank to settle for a check presented by a Reserve Bank at an earlier time than does the UCC if it wishes to retain the right to return the check on the next banking day.⁵

Reserve Banks may enter into agreements with paying banks to alter the settlement time for checks presented by Reserve Banks, and the Board has the ability to make further changes regarding the collection of checks under the authority of the Federal Reserve Act. Section 16(14) of the Act authorizes the Board to make regulations concerning the transfer of funds among Reserve Banks and to require Reserve Banks to act as clearing houses for other Reserve Banks and for depository institutions. Section 13 of the Act authorizes Reserve Banks to engage in check collection on behalf of members and non-members, and section 11 grants the Board general supervisory and rulemaking authority over Reserve Bank activities.⁶

Amended Regulation J

The primary purpose of the Board's 1991 Regulation J proposal was to allow Reserve Banks to debit paying banks' accounts for presented checks during the day for purposes of measuring daylight overdrafts under the risk reduction program. The proposal also included amendments intended to clarify the accountability provisions of the regulation and to explain the rules that would apply on days when either the Reserve Bank or the paying bank was closed. The Board received 65 comments that specifically addressed the proposed amendments to Regulation J. Many other commenters suggested that the proposed check posting procedures in Docket R-0721 be modified and also suggested that Regulation J be amended to reflect those revisions or delayed until new posting procedures were developed. Three commenters supported the Regulation J changes overall. One commenter conditioned support on the adoption of pricing and another on the ability of depository institutions to monitor their accounts on a real-time basis.

⁵ In addition, the means of settlement that a paying bank may use to meet this obligation are more limited under Regulation J than under the UCC.

⁶ The Board's authority to set the time and form of settlement for checks presented by Reserve Banks has been upheld by the courts on two occasions. See *Community Bank v. Federal Reserve Bank of San Francisco*, 500 F.2d 292 (9th Cir. 1974), and *Independent Bankers Association of America v. Board of Governors of the Federal Reserve System*, 500 F.2d 812 (D.C. Cir. 1974).

Timing of Settlement to Avoid Overdraft Charges

The proposed amendments to § 210.9(a)(2) of Regulation J required a paying bank to settle with a Reserve Bank for checks, or return the checks, by the end of the clock hour after the hour during which presentment had taken place,⁷ or by one hour after the scheduled opening of Fedwire, whichever was later (or by such later time as provided in the Reserve Bank's operating circular).

The proposed amendments provided that if the proceeds of the settlement were not available within the designated time frame and the check was not returned, the paying bank would be subject to any applicable overdraft charges. The Board has adopted the proposed amendments with minor revisions and clarifying changes in the regulatory format.

The Board received 34 comments on the proposed amendments to § 210.9(a)(2) regarding the timing of settlement to avoid overdraft charges. Twenty-four commenters stated that a time frame of one or two hours between presentment and settlement is too short, nine commenters supported the proposed time frame, and one commenter suggested that check transactions be posted on the hour after presentment regardless of how much time has passed.

Generally, the commenters who opposed the settlement timing proposal stated that one hour does not allow sufficient time for a paying bank to verify receipt, examine cash letters, and settle for or return checks. Five commenters suggested lengthening the time between presentment and settlement to two or three hours, and one commenter suggested settlement be delayed until just before the close of Fedwire.

The Board believes that the cash letter verification practices of most paying banks would be unaffected by a settlement deadline of at least one hour after presentment. Generally, all checks now presented by the Federal Reserve for same-day settlement are received by the paying bank by 2 p.m., local time. Although Regulation J generally has

provided an opportunity for the paying bank to examine the checks to decide whether to settle for or return them by the close of business, this time period permitted only limited verification of cash letters. For example, a paying bank could verify that a cash letter had been received, but usually could not examine individual checks prior to settling for the cash letter at the close of business. This limited verification, however, is consistent with the theory and practice of deferred posting of checks under the UCC. Paying banks generally do not examine checks individually until after the close of business on the day of presentment or during the following day. Under the Regulation J amendment, paying banks would continue to have at least one hour to verify the receipt of a cash letter before settling for it or to return the cash letter and avoid having to settle for it.

Four commenters noted that the earlier settlement time would have a negative impact on controlled disbursement and cash management practices because customer accounts would have to be funded earlier in the day. Seven commenters expressed concern that banks would be unable to allocate check debits to their customers or respondents within one hour to determine overdraft positions and thus would be unable to motivate behavioral changes through direct pricing.

Although it is true that paying banks wishing to prevent daylight overdrafts caused by check debits might have to require earlier funding of their customers' accounts, collecting banks and their customers will benefit from earlier crediting of checks to reserve and clearing accounts. The Board believes that most paying banks could require controlled disbursement customers to fund their accounts based on estimated presentments rather than expending resources to determine the exact amount of checks to be presented by the Federal Reserve each day. Further, the Board believes that only a relatively small number of banks will change their internal tracking and posting systems in order to charge customers for their use of daylight credit. Over 90 percent of the institutions covered by the risk reduction policy will not exceed their net debit caps or incur daylight overdraft charges, and thus would not be likely to undertake costly system changes. A few banks may incur overdraft charges in amounts high enough to justify system changes. These banks would likely make such system changes even if settlement for checks presented by Reserve Banks were not required until the close of business, due

⁷ For example, a paying bank would have to settle for checks presented at 12:30 p.m. ET by 2:00 p.m. ET. Generally, paying banks authorize Reserve Banks, through an autocharge agreement, to debit their reserve or clearing accounts for the amount of checks presented. This authorization would constitute settlement for the checks even if the Reserve Bank did not post the charge to the paying bank's account until after the time at which the settlement obligation arose.

to their need to track other types of payment transactions.

Three of the commenters in support of the proposal conditioned their support on the establishment of an adjustment process as part of the posting procedures to correct for early or erroneous debits that may have caused daylight overdrafts. Another commenter suggested that explicit adjustment procedures be included in Regulation J. Five commenters objected to basing the timing of check debits on expected presentment times, stating that Reserve Bank courier schedules are often unpredictable and can vary by as much as an hour.

When the Reserve Bank presents checks via courier, the checks will generally arrive at the paying bank at the same time each day, but could arrive any time before 2 p.m. The Reserve Banks will make adjustments in overdraft charges if a presentment is reported to have been made late (and a reserve or clearing account is debited too early) or if the amount of a debit is incorrect.

Four commenters stated that the proposal did not allow enough time for the paying banks to transport checks from their presentment point to their correspondent or processing center, and thus they would be unable to verify receipt or cash letter totals. The Board recognizes that there may be a limited number of cases when paying banks that have established presentment points at locations distant from their processing centers will be unable to transport and verify cash letters within an hour after presentment. These paying banks may wish to select new presentment locations. The Board believes that, in most cases, one hour is sufficient time for paying banks to verify that presentment was made and transport cash letters to their processing center. Reserve Banks often deliver directly to paying banks' processing centers.

One commenter suggested that the settlement time should be triggered by the receipt of the final check bundle for those institutions that receive multiple presentments from the Reserve Bank. Another commenter suggested that the Board clarify that presentment occurs when the paying bank has picked up the checks at the Reserve Bank or when the Reserve Bank courier has delivered the checks to the paying bank. Generally, presentment by a Reserve Bank occurs when a check is delivered to the paying bank or made available for pick-up at a presentment point designated by the paying bank. The Reserve Bank may present more than one cash letter each

day, and the time for settlement for each cash letter is triggered by the presentment of that cash letter.

One commenter suggested that the Board clarify whether a paying bank may return an entire cash letter before the end of its banking day and how much a return would affect settlement. Under amended Regulation J, a paying bank can avoid incurring any overdraft charges that would have resulted from settlement by sending a cash letter for return by the next clock hour that is at least one hour after presentment or by one hour after the scheduled opening of Fedwire, whichever is later (or by a later time as provided in the Reserve Bank's operating circular). As discussed below, the paying bank may avoid accountability for that cash letter by sending it for return before the close of Fedwire or the close of its banking day, whichever is later. Both of these return deadlines (the deadline for avoiding overdraft charges and the deadline for avoiding accountability) may be extended under certain conditions, in accordance with § 229.30(c) of Regulation CC (12 CFR 229.30(c)).

Six commenters addressed the question whether the Reserve Bank should debit a paying bank's account before physical presentment of the checks. Three commenters from the west coast were opposed to such a practice because the paying bank would not be able to verify receipt or examine the cash letter totals before settlement. One California bank noted that setting a uniform settlement time without regard to the time of presentment would likely put east coast banks at a comparative advantage because they normally receive presentment earlier than west coast banks and would likely have more time to inspect the cash letter before settling. Three commenters suggested that the Board consider requiring settlement before physical presentment, perhaps based on electronic notification of cash letter information.

Section 609(b)(1) of the Expedited Fund Availability Act (12 U.S.C. 4008(b)(1)) provides that the Board shall consider requiring regulation that banks be charged based upon notification that a check or similar instrument will be presented for payment. The Federal Reserve studied the feasibility of mandatory and voluntary electronic presentment in the Electronic Clearinghouse Study, submitted to Congress in August 1988. Although electronic presentment is feasible given current technology, the study concluded that the benefits of mandatory electronic presentment would be outweighed by

the potential risks borne by the paying banks. Paying banks may wish to participate in voluntary electronic presentment arrangements with Reserve banks or other presenting banks. Absent such an arrangement, the Board believes it is appropriate to require settlement only after physical presentment so that the paying bank will have the opportunity to verify receipt of the cash letter.

Accountability and Banking Day Definition.

The amendments to § 210.9(a)(1), as proposed, provided that as long as either the proceeds of a settlement for presented checks are available to the Reserve Bank by close of Fedwire on the day the paying bank receives the check or the paying bank returns the check before the close of its banking day,⁸ the paying bank would not be accountable for the check and would be able to exercise deferred posting. The Board also proposed a technical revision to the definition of "banking day" to correspond to the definition in UCC § 4-104(a)(3) (1990 version). The Board has adopted the proposed amendments with two substantive changes: (1) the paying bank may avoid accountability by returning a check by the later of the close of its banking day or the close of Fedwire, and (2) the paying bank will be accountable as of the close of its banking day or the close of Fedwire, whichever is earlier, if it fails to settle or return by the deadline established in § 210.9(a)(1). The former change was made in response to a commenter's suggestion, as explained below. The latter change was made to ensure that, if a paying bank fails to settle for a check presented by a Reserve Bank and becomes insolvent after the close of business but before the close of Fedwire, the failed paying bank's accountability for the check would be fixed at its close of business and prior to its insolvency. The Board has also reformatted § 210.9(a)(1) for clarity, adopted the proposed definition of "Fedwire," added a definition of "clock hour," and revised the definition of "item" to correct an erroneous cross-reference.

Three commenters suggested that a paying bank should be free from accountability if it returns a check without settling for it by the close of Fedwire, rather than by the close of its

⁸ The deadline for returning a check without settling for it may be extended in certain cases in accordance with § 229.30(c) of Regulation CC (12 CFR 229.30(c)).

banking day as proposed. The commenters argued that, under the previous version of Regulation J, a paying bank's banking day could be interpreted to close at the close of Fedwire, but the proposed incorporation of the UCC definition of "banking day" would negate such an interpretation, requiring a paying bank to take action before the time it closes its lobby, often 2 p.m. or 3 p.m., if it wanted to return a check without settling for it. As noted above, the Board amended the proposed regulation to allow a paying bank to avoid accountability by returning a check by the close of Fedwire or the close of its banking day, whichever is later.

Three commenters suggested that Regulation J incorporate the Regulation CC, rather than the UCC, definition of banking day. The Regulation CC definition mirrors and UCC banking day definition except that Regulation CC requires a banking day to be a part of a business day, which is generally defined to be all weekdays except federal holidays (see 12 CFR 229.2(f) and (g)). Three commenters requested clarification that the Reserve Banks would not present checks on banking days that are not business days under the Regulation CC definition.

The Reserve Banks are not open on days, such as weekends and federal holidays, that are not business days under Regulation CC. Paying banks will not receive presentment of checks on such days, except in rare circumstances when a cash letter that is mailed to a paying bank arrives on a Saturday or when a Reserve Bank closes early due to an emergency but Federal Reserve couriers continue to deliver checks. Thus, in the vast majority of cases, a Reserve Bank banking day under Regulation J will always be a Regulation CC banking day.

Reserve Bank or Paying Bank Closed

Proposed § 210.9(a)(3) addressed the situation in which either the Reserve Bank or the paying bank is closed on the day of presentment. One commenter supported these provisions without discussion. One commenter suggested that these provisions would be more appropriate in the Reserve Bank's operating circulars than in Regulation J. Although these occasions may be rare, the Board believes that they should be addressed in Regulation J. The Board has adopted the substance of the amendments as proposed, but has reformatted the regulatory language for purposes of clarification.

Under § 210.9(a)(3) (proposed § 210.9(a)(3)(ii)), if the paying bank

voluntarily closes on a day the Reserve Bank is open, either for the entire day or before it receives its check presentment from the Reserve Bank, it must either (1) return or settle for checks by the next clock hour that is at least one hour after it would ordinarily receive the checks, or by one hour after the scheduled opening of Fedwire, whichever is later, or by such later time as is provided in the Reserve Bank's operating circular; or (2) settle by one hour after the scheduled opening of Fedwire on the next day on which both the paying bank and the Reserve Bank are open, or by such later time as is provided in the Reserve Bank's operating circular, and compensate the Reserve Bank for the interday float. Failure to settle by these times could result in the imposition of daylight overdraft charges, but for accountability purposes, the checks will not be considered received until the paying bank's next banking day.

One commenter requested clarification as to what constitutes a "voluntary" closing. The commenter stated that if closing is mandated by state law, the paying bank should not be assessed overdraft fees if the Reserve Bank debits its account for check presentments on that day. Closings mandated by state law are not voluntary, and thus the paying bank would not be liable for interest compensation or overdraft charges under Regulation J. However, most state holidays are not mandatory bank holidays, and if a bank chooses to close on such a holiday, its closing would be considered voluntary under Regulation J.

Under § 210.9(a)(4) (proposed § 210.9(a)(3)(i)), if the Reserve Bank is closed on the day the paying bank receives presentment of a check, the paying bank will be accountable for the check unless it returns the check by midnight or settles for the check by the close of Fedwire on the Reserve Bank's next banking day. In addition, if the Reserve Bank is closed on the day the paying bank receives presentment of a check, the paying bank will be subject to any applicable daylight overdraft charges on the day the Reserve Bank charges the paying bank's account unless the paying bank either returns the check by midnight on the day of presentment or settles for the check by one hour after the scheduled opening of Fedwire on the Reserve Bank's next banking day or by such later time as provided in the Reserve Bank's operating circular.

One commenter stated that the Reserve Banks should not present checks on days that are not Federal Reserve banking days because the

possibility of a daylight overdraft caused by the early morning settlement time for such checks (one hour after the opening of Fedwire on the next Reserve Bank banking day or such later time as provided in the Reserve Bank's operating circular) would discourage banks from offering services on weekends and holidays. As discussed above, paying banks will ordinarily not receive presentment of checks on days the Reserve Bank is closed, except in rare circumstances where a cash letter that is mailed to a paying bank arrives on a Saturday or when a Reserve Bank closes due to an emergency. The Board does not believe that requiring the paying bank to settle for such checks on the next day the Reserve Bank is open will discourage weekend or holiday service in most cases.

Amendment to Subpart B

To implement pricing of overdrafts, the Board proposed an amendment to Subpart B of Regulation J, Wire Transfers of Funds. Under the amendment, an account at a Reserve Bank would be subject explicitly to any applicable overdraft charges resulting from funds transfers.

The Board received seven comments on the proposed Subpart B amendment. Three commenters voiced reservation about the amendment based on their concerns regarding the proposed posting procedures and their doubts about their ability to reconcile their internal accounting systems with those of the Federal Reserve. Two commenters supported the amendment if pricing is eventually adopted. One commenter suggested that the Board seek public comment on pricing again before adopting the amendment. One commenter suggested that the amendment would be more appropriate in the Reserve Bank's operating circulars than in Regulation J. The Board believes that it is appropriate to amend Subpart B to implement overdraft pricing and thus has adopted the amendment.

Final Regulatory Flexibility Analysis

Two of the three requirements of a final regulatory flexibility analysis (5 U.S.C. 604), (1) a succinct statement of the need for and the objectives of the rule and (2) a summary of the issues raised by the public comments, the agency's assessment of the issues, and a statement of the changes made in the final rule in response to the comments, are discussed above. The third requirement of a final regulatory flexibility analysis is a description of

significant alternatives to the rule that would minimize the rule's economic impact on small entities and reasons why the alternatives were rejected.

The amendments will apply to all banks that receive presentment of checks from Federal Reserve Banks, regardless of size. The economic impact of the Regulation J amendments on small banks should be minimal. There are no significant alternatives to the amendments that will minimize the effect on small banks, given the Board's adoption of a daylight overdraft pricing program that applies to all banks. The Board's pricing program includes a percent-of-capital deductible and the waiver of fees that do not exceed \$25 over a two-week reserve maintenance period. The Board expects that small overdrafts incurred by many small banks (relative to their capital) will be covered by the deductible or the waiver and, therefore, exempt from pricing. In addition, the amendments should not require operational changes by small banks that incur small or no overdrafts.

Competitive Impact Analysis

The Board has established procedures for assessing the competitive impact of rule or policy changes that have a substantial effect on payments system participants.⁹ Under these procedures, the Board will assess whether a change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services due to differing legal powers or constraints, or due to a dominant market position of the Federal Reserve deriving from such legal differences. If no reasonable modifications would mitigate the adverse competitive effects, the Board will determine whether the anticipated benefits are significant enough to proceed with the change despite the adverse effects.

The Board believes that, when considered alone, the amendment to Regulation J might have a direct and material adverse effect on the ability of other service providers to compete effectively with the Reserve Banks' payments services. The amendment will enable Reserve Banks to obtain settlement in immediately available funds for checks presented to paying banks as early as one hour after presentment. In turn, Reserve Banks will

be able to give credit for checks they collect earlier in the day without incurring intraday float. Private-sector collecting banks ordinarily can not obtain settlement within a comparable time or in a comparable form without entering into an agreement with the paying bank or paying presentment fees, or both. The Board requested comment, in light of the other modifications to the payments system risk reduction program and its proposal on same-day settlement for private-sector presentment (56 FR 4743, February 6, 1991), on whether the ability to use check credits during the day outweighs the negative effects of being charged for checks intraday under the proposed Regulation J amendment. (The Board has recently adopted a same-day settlement rule—see docket R-0723, elsewhere in today's *Federal Register*.)

Fourteen commenters addressed the competitive impact of the proposed amendment to Regulation J. Nine commenters urged the Board to adopt similar settlement times in both Regulation J and the proposed amendments to Regulation CC regarding same-day settlement. These commenters stated that consistent settlement times in Regulations J and CC would aid in providing for more competitive equality between the Reserve Banks and private-sector presenting banks. Five commenters opposed applying the proposed Regulation settlement time to the same-day settlement rules. They believed that doing so would significantly increase their risk exposure under same-day settlement because they would be forced to accept presentment from and settle within a short time frame with banks with which they have no established relationship.

One commercial bank stated that the advantage the Regulation J amendment would provide to the Reserve Banks in the check collection business far outweighs other mitigating factors, such as the ability for clearing houses to set their own settlement time and the same-day settlement proposal. The commenter argued that the total effect of all of the proposals will hurt private sector collecting banks to a greater extent than the Reserve Banks, giving the Reserve Banks a significant competitive advantage.

A check transportation corporation argued that the Regulation J amendments would give a competitive advantage to the Reserve Banks because it is difficult for banks and clearing houses to establish settlement mechanisms that are independent of Fedwire. The commenters stated that

competing with Fedwire is difficult because Fedwire pricing doesn't include a cost component for the intraday value of money or credit risk, and the Reserve Banks do not pay interest on reserve or clearing account balances.

The Board believes the Regulation J amendment should be considered within the context of the modifications to the risk reduction program regarding pricing and overdraft measurement and the Board's recent amendment to Regulation CC regarding same-day settlement for private-sector collecting banks. In this context, the Board believes that the benefits of the Regulation J amendment in facilitating the risk reduction program and enabling Reserve Banks to accelerate availability of check deposits are significant enough to outweigh the adverse effects.

The Board's goal of achieving accurate measurement of daylight overdrafts without incurring intraday float could be met by posting credits and debits for checks presented by Reserve Banks after the close of business, as originally proposed in June 1989 (54 FR 26094, June 21, 1989). The Board's June 1989 proposal for overdraft measurement would not have required an amendment to Regulation J and therefore would not have caused adverse competitive effects. A majority of the commenters to the June 1989 proposal, however, requested that check credits and debits be posted earlier in the day to allow intraday use of funds by collecting banks. These commenters stated that earlier credits for checks were necessary to avoid disruption of cash management practices and to allow investment of excess reserve balances. These comments indicated that the benefits of early check credits would outweigh the adverse competitive effects of earlier check debits.

Many of the adverse effects on the Federal Reserve's competitors in the check collection system will be mitigated by the benefits of the overdraft measurement procedures. The primary benefit will be the intraday posting of check credits, so that banks may use those funds during the day. Correspondent banks that clear checks on behalf of respondents will be able to make payments to their respondents for any checks collected through the Federal Reserve on the settlement day without incurring daylight overdrafts, provided that the timing of payments to respondents followed the receipt of credit from the Federal Reserve. In addition, banks participating in private clearing houses will be able to establish

⁹ These procedures are described in the Board's policy statement "The Federal Reserve in the Payments System," as revised in March 1990 (55 FR 11648, March 29, 1990).

the time at which net settlement entries for the checks exchanged among participants will be posted to reserve and clearing accounts. Thus, the participants will be able to control the time at which credits and debits will be posted to their accounts.

The Board's same-day settlement rule gives private collecting banks rights to receive settlement from paying banks that are closer to the rights the Reserve Banks have under Regulation J. The same-day settlement rule mitigates some of the adverse competitive effects caused by the Regulation J amendment. The issues relating to the conformity of settlement times for checks presented by Reserve Banks under Regulation J and by private-sector banks under Regulation CC were raised in the context of the same-day settlement proposal and are addressed in Docket R-0723, elsewhere in today's Federal Register.

List of Subjects in 12 CFR Part 210

Banks, banking, Federal Reserve System.

For the reasons set out in the preamble, 12 CFR part 210 is amended as follows:

PART 210—COLLECTION OF CHECKS AND OTHER ITEMS BY FEDERAL RESERVE BANKS AND FUNDS TRANSFERS THROUGH FEDWIRE (REGULATION J)

1. The authority citation for part 210 continues to read as follows:

Authority: Federal Reserve Act, sec. 13 (12 U.S.C. 342), sec. 11 (i) and (j) (12 U.S.C. 248 (i) and (j)), sec. 16 (12 U.S.C. 248(o) and 360), and sec. 19(f) (12 U.S.C. 464); and the Expedited Funds Availability Act (12 U.S.C. 4001 *et seq.*)

2. Section 210.2 is amended by revising paragraph (d) and the last sentence of the undesignated paragraph following paragraph (g)(3) and adding new paragraphs (n) and (o) to read as follows:

§ 210.2 Definitions.

(d) *Banking day* means the part of a day on which a bank is open to the public for carrying on substantially all of its banking functions.

(g) *Item* does not include a check that cannot be collected at par, or a *payment order* as defined in § 210.26(i) and handled under subpart B of this part.

(n) *Clock hour* means a time that is on

the hour, such as 1:00, 2:00, etc.

(o) *Fedwire* has the same meaning as that set forth in § 210.26(e).

3. Section 210.9 is amended by revising the heading and paragraph (a) to read as follows:

§ 210.9 Settlement and payment.

(a) *Cash items.* (1) On the day a paying bank receives ² a cash item directly or indirectly from a Reserve Bank, it shall settle for the item such that the proceeds of the settlement are available to the Reserve Bank by the close of Fedwire on that day, or it shall return the item by the later of the close of the paying bank's banking day or the close of Fedwire. If the paying bank fails to settle for or return a cash item in accordance with this paragraph (a)(1), it is accountable for the amount of the item as of the close of its banking day or the close of Fedwire on the day it receives the item, whichever is earlier.

(2)(i) On the day a paying bank receives a cash item directly or indirectly from a Reserve Bank, it shall settle for the item so that the proceeds of the settlement are available to the Reserve Bank, or return the item, by the latest of:

(A) The next clock hour that is at least one hour after the paying bank receives the item;

(B) One hour after the scheduled opening of Fedwire; or

(C) Such later time as provided in the Reserve Bank's operating circular.

(ii) If the paying bank fails to settle for or return a cash item in accordance with paragraph (a)(2)(i) of this section, it shall be subject to any applicable overdraft charges. Settlement under paragraph (a)(2)(i) of this section satisfies the settlement requirements of paragraph (a)(1) of this section.

(3)(i) If a paying bank closes voluntarily on a day that is a banking day for a Reserve Bank, and the Reserve Bank makes a cash item available to the paying bank on that day, the paying bank shall either:

(A) On that day, settle for the item so that the proceeds of the settlement are available to the Reserve Bank, or return the item, by the latest of:

(1) The next clock hour that is at least one hour after the paying bank ordinarily would have received the item;

² A paying bank is deemed to receive a cash item on its next banking day if it receives the item:

(1) On a day other than a banking day for it; or
(2) On a banking day for it, but after a "cut-off hour" established by it in accordance with state law.

(2) One hour after the scheduled opening of Fedwire; or

(3) Such later time as provided in the Reserve Bank's operating circular; or

(B) On the next day that is a banking day for both the paying bank and the Reserve Bank, settle for the item so that the proceeds of the settlement are available to the Reserve Bank by the later of:

(1) One hour after the scheduled opening of Fedwire on that day; or

(2) Such later time as provided in the Reserve Bank's operating circular; and compensate the Reserve Bank for the value of the float associated with the item in accordance with procedures provided in the Reserve Bank's operating circular.

(ii) If a paying bank closes voluntarily on a day that is a banking day for a Reserve Bank, and the Reserve Bank makes a cash item available to the paying bank on that day, the paying bank is not considered to have received the item until its next banking day, but shall be subject to any applicable overdraft charges if it fails to settle for or return the item in accordance with paragraph (a)(3)(i) of this section. The settlement requirements of paragraphs (a)(1) and (a)(2) of this section do not apply to a paying bank that settles in accordance with paragraph (a)(3)(i) of this section.

(4)(i) If a paying bank receives a cash item directly or indirectly from a Reserve Bank on a banking day that is not a banking day for the Reserve Bank:

(A) The paying bank shall:

(1) Settle for the item so that the proceeds of the settlement are available to the Reserve Bank by the close of Fedwire on the Reserve Bank's next banking day; or

(2) Return the item by midnight of the day it receives the item.

If the paying bank fails to settle for or return a cash item in accordance with this paragraph (a)(4)(i)(A), it shall become accountable for the amount of the item as of the close of its banking day on the day it receives the item.

(B) The paying bank shall:

(1) Settle for the item so that the proceeds of the settlement are available to the Reserve Bank by one hour after the scheduled opening of Fedwire on the Reserve Bank's next banking day or such later time as provided in the Reserve Bank's operating circular; or

(2) Return the item by midnight of the day it receives the item.

If the paying bank fails to settle for or return a cash item in accordance with this paragraph (a)(4)(i)(B), it shall be subject to any applicable overdraft

charges. Settlement under this paragraph (a)(4)(i)(B) satisfies the settlement requirements of paragraph (a)(4)(i)(A) of this section.

(ii) The settlement requirements of paragraphs (a)(1) and (a)(2) of this section do not apply to a paying bank that settles in accordance with paragraph (a)(4)(i) of this section.

(5) Settlement with a Reserve Bank under paragraphs (a)(1) through (4) of this section shall be made by debit to an account on the Reserve Bank's books, cash, or other form of settlement to which the Reserve Bank agrees.

(6) If a cash item is unavailable for return, the paying bank may send a

notice in lieu of return as provided in § 229.30(f) of this title.

* * * * *

4. Section 210.28 is amended by adding a new paragraph (b)(5) to read as follows:

§ 210.28 Agreement of sender.

* * * * *

(b) * * *

(5) If a sender, other than a government sender described in § 210.25(d), incurs an overdraft in its account as a result of a debit to the account by a Federal Reserve Bank under paragraph (a) of this section, the account will be subject to any

applicable overdraft charges, regardless of whether the overdraft has become due and payable. A Federal Reserve Bank may debit a sender's account under paragraph (a) of this section immediately on acceptance of the payment order.

* * * * *

By order of the Board of Governors of the Federal Reserve System, October 6, 1992.

William W. Wiles,
Secretary of the Board.

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