

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 10654]
September 1, 1993]

PAYMENTS SYSTEM RISK REDUCTION
Comments Invited on Proposed Daylight Overdraft Penalty Fee and
Proposed Modifications to the Policy Statement on Payments System Risk

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

The Board of Governors of the Federal Reserve System is seeking comment on the rate at which Federal Reserve Banks will assess a penalty fee on the average daylight overdrafts of bankers' banks, Edge and agreement corporations, and limited-purpose trust companies. *Comments on the proposed penalty fee should be submitted by September 24, 1993.*

The Board of Governors has also requested comment on proposed modifications to its Policy Statement on Payments System Risk. The changes would (a) modify the procedures that depository institutions must use if they choose to complete a self-assessment to establish a daylight overdraft net debit cap, and (b) eliminate the requirement that U.S. branches and agencies of foreign banks provide information on U.S. funding capability and discount-window eligible collateral for use in determining their daylight overdraft net debit cap. *Comments on the proposed modifications to the Policy Statement should be submitted by October 8, 1993.*

In this connection, the Board has prepared a draft revision of its *Guide to the Federal Reserve's Payments System Risk Policy*, which includes a full description of the proposed new self-assessment procedures. Our Accounting Department will send a copy of the draft *Guide* to its daylight overdraft contacts at all depository institutions in this District that currently have self-assessed net debit caps. Others may obtain a copy from Paula Ferrara of that Department (Tel. No. 212-720-7767).

Printed below and on the following pages are the texts of the Board's official notices on these proposals, as printed in the *Federal Register* of August 24, 1993. Questions on these matters may be directed to Don Anderson, Manager, Accounting Department (Tel. No. 212-720-5250), or to Anthony Fressola, Chief, Accounting Control Division (Tel. No. 212-720-5803).

WILLIAM J. McDONOUGH,
President.

FEDERAL RESERVE SYSTEM

[Docket No. R-0693]

**Proposed Modification of the
Payments System Risk Policy;
Bankers' Banks, Edge Corporations,
and Limited-Purpose Trust Companies**

AGENCY: Board of Governors of the
Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board is seeking
comment on the rate at which Federal
Reserve Banks will assess a penalty fee
on the average daily daylight overdrafts

of bankers' banks that do not maintain reserves, Edge and agreement corporations, and limited-purpose trust companies. The Board proposes to assess the daylight overdraft penalty fee at a rate equal to the federal funds rate plus the overnight overdraft penalty rate, quoted on a 24-hour basis, for a 360-day year, and adjusted for the length of the Fedwire operating day. The penalty fee should create an incentive for institutions that do not have regular discount window access to avoid incurring daylight overdrafts in Federal Reserve accounts.

DATES: Comments must be submitted on or before September 24, 1993.

ADDRESSES: Comments, which should refer to Docket No. R-0693, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Comments addressed to Mr. Wiles also may be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m. and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in room B-1122 between 9 a.m. and 5 p.m.

FOR FURTHER INFORMATION CONTACT: Oliver I. Ireland, Associate General Counsel (202/452-3625) or Stephanie Martin, Senior Attorney (202/452-3198), Legal Division; Paul Bettge, Manager (202/452-3174), Division of Reserve Bank Operations and Payment Systems; for the hearing impaired only: Telecommunications Device for the Deaf, Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: In May 1990, the Board requested comment on modifications to its payments system risk policy that would assess penalty fees for daylight overdrafts in Federal Reserve accounts incurred by institutions that do not have regular discount window access. These institutions include Edge and agreement corporations¹ and bankers' banks² that do not maintain reserves, such as corporate credit unions. The purposes of the proposed modifications were twofold: First, the proposal would provide an incentive for institutions without discount window access to refrain from incurring daylight overdrafts. This would help Federal Reserve Banks to avoid situations where they may face the possibility of extending overnight credit when such an institution is unable to cover a daylight overdraft by the end of the business day. Second, for bankers' banks that do not maintain reserves, the proposal would reflect the *quid pro quo* for discount window access established in the Monetary Control Act of 1980.

Background

Under the Board's current daylight overdraft policy, most depository institutions may incur daylight overdrafts in their accounts at Reserve Banks up to a maximum, or cap, that is a multiple of their risk-based capital. If a depository institution incurs frequent and material daylight overdrafts in excess of its cap due to book-entry securities transactions over Fedwire, the institution must collateralize its entire book-entry-related overdraft on an ongoing basis. Effective April 14, 1994,

¹ Edge corporations are organized under section 25A of the Federal Reserve Act (12 U.S.C. 611-631). Agreement corporations have an agreement or undertaking with the Board under section 25 of the Federal Reserve Act (12 U.S.C. 601-604a). For the purposes of this docket, the term "Edge corporation" includes both Edge and agreement corporations.

² A bankers' bank is a financial institution that is not required to maintain reserves under the Board's Regulation D (12 CFR part 204) because it is organized solely to do business with other financial institutions, is owned primarily by the financial institutions with which it does business, and does not do business with the general public. A bankers' bank is not a depository institution as defined in the Board's Regulation A (12 CFR 201.2(a)).

the Reserve Banks will assess a fee on average daily daylight overdrafts.

If an institution fails to cover a daylight overdraft by the close of the business day, it may either obtain a discount window loan (if it has access to the discount window) or carry the overdraft overnight. If an institution incurs an overnight overdraft, the Reserve Bank charges a penalty fee (the higher of 10 percent or the federal funds rate plus 2 percent (annual rate)),³ and the institution must make up for any reserve or clearing account deficiency by subsequently holding additional overnight balances equal to the overdraft.

The Federal Reserve Act exempts bankers' banks from reserve requirements,⁴ and Regulation A explicitly excludes bankers' banks from regular discount window access.⁵ Nevertheless, the Board has permitted bankers' banks to have access to the discount window if they choose to maintain reserves voluntarily. Bankers' banks that choose to maintain reserves voluntarily may establish a cap and incur daylight overdrafts under the payments system risk policy to the same extent as depository institutions. Generally, bankers' banks for commercial banks have chosen to become member banks and to maintain reserves. They have made this choice because section 19(e) of the Federal Reserve Act provides that a member bank may deposit only 10 percent of paid-up capital and surplus in an institution other than a depository institution eligible for discount window advances. Most corporate credit unions have chosen not to maintain reserves and thus do not have the option of covering an overdraft with a discount window loan.

The Federal Reserve has long been concerned that bankers' banks that do not maintain reserves and are unable to borrow at the discount window may nevertheless incur overnight overdrafts. To address the risks arising from such overdrafts and to avoid the extension of overnight credit to institutions with no discount window access, current policy provides that these bankers' banks should refrain from incurring daylight overdrafts. If such institutions do incur daylight overdrafts, however, they are required to collateralize the overdrafts.

³ The overnight overdraft penalty fee is assessed on the negative overnight balance as a penalty for poor reserve management and is not related to the length of time the overdraft exists. The "regular" daylight overdraft fee, effective in April 1994, incorporates a factor to account for the length of the Fedwire operating day.

⁴ 12 U.S.C. 461(b)(9).

⁵ 12 C.F.R. 201.2(a)(2).

Edge corporations are subject to reserve requirements, but do not have access to the discount window on the same basis as depository institutions. Instead, Edge corporations generally are funded by their parent depository institutions, which have discount window access. Current policy permits Edge corporations to establish a cap and to incur overdrafts within that cap, provided that they post collateral for the overdrafts. Edge corporations also may incur book-entry securities overdrafts above their cap, provided the overdrafts are collateralized.

Board's 1990 Proposal

Under the 1990 proposal, bankers' banks that did not maintain reserves and Edge corporations would have been expected to pre-fund their funds and book-entry securities activity. The proposal would have treated the use of intraday credit in the form of daylight overdrafts much like the use of overnight credit in the form of overnight overdrafts. Under the proposal, Reserve Banks, absent unusual circumstances, would have charged bankers' banks that do not maintain reserves and Edge corporations an amount equal to the overnight overdraft penalty fee, levied against the maximum daylight overdraft for the day. If the daylight overdraft were not fully repaid by the end of the day, the institution would have continued to be subject to the overnight penalty fee and the requirement to hold excess reserve or clearing account balances on a subsequent night.

Policy Adopted by Board

The Board has adopted a modified version of the proposed policy, but has determined to seek further comment on the rate at which the daylight overdraft penalty fee will be assessed. The policy adopted by the Board provides that the daylight overdraft penalty fee will be levied on the daily average, rather than maximum, daylight overdraft of institutions that do not have regular discount window access. The daylight overdraft penalty fee will apply to limited-purpose trust companies as well as bankers' banks that do not maintain reserves and Edge corporations. The Board will continue to require that, in the event a bankers' bank or Edge corporation incurs a daylight overdraft, the overdraft should be collateralized.⁶

⁶ As these institutions may not normally maintain collateral pledged to the Federal Reserve on an ongoing basis, if a bankers' bank or Edge corporation incurs a daylight overdraft the Reserve Bank generally requests a pledge of collateral (that would be eligible collateral for a discount window loan) for an appropriate period.

As proposed in 1990, the overnight penalty rate and excess balance requirements will continue to apply to overnight overdrafts incurred by these institutions. Reserve Banks will have the ability to waive the daylight and overnight charges, as well as the holding of excess balances if, for example, the overdraft resulted from a Reserve Bank error.

Average Daily Overdraft

Some commenters to the 1990 proposal noted that the fee should apply to the average rather than the peak daily overdraft to provide an incentive for institutions to cover the overdraft as quickly as possible. Also, use of an average overdraft is consistent with the "regular" pricing scheme for depository institutions' daylight overdrafts, effective in April 1994. The Board believes it would be appropriate to apply the penalty fee to the average daily daylight overdraft rather than the peak daily overdraft. Although the peak overdraft represents the maximum exposure to the Federal Reserve during the day, an institution would have little incentive to reduce its overdraft significantly during the day once it reaches its peak, thereby potentially exposing the Federal Reserve to a greater degree of risk due to prolonged large overdrafts. The Reserve Banks will calculate the average daily daylight overdraft used to compute penalty fees in the same manner as the average overdraft used to compute "regular" daylight overdraft fees (except that the penalty fee will not incorporate a deductible, as does the "regular" fee). The average daylight overdraft will equal the sum of the negative Federal Reserve balances at the end of each minute of the scheduled Fedwire operating day (with credit balances set to zero) divided by the total number of minutes in the scheduled Fedwire operating day.

Limited-Purpose Trust Companies and Other Zero-Cap Institutions

The Board requested comment in 1990 on whether the proposed policy should apply to depository institutions that have been assigned an overdraft cap of zero by the Federal Reserve, including certain trust companies. The Board received no comments on the proposal as it would apply to these institutions. Institutions with zero caps imposed by the Federal Reserve generally fall into two categories: limited-purpose trust companies and "problem" institutions. The Federal Reserve Act permits the Board to grant Federal Reserve membership to limited-purpose trust companies subject to

conditions the Board may prescribe pursuant to the Act. As a general matter, member limited-purpose trust companies do not accept reservable deposits and do not have regular discount window access. The Board believes that limited-purpose trust companies with daylight overdraft caps of zero should be subject to the same daylight overdraft penalty fees as bankers' banks that do not maintain reserves and Edge corporations. Such a policy would ensure consistent treatment for daylight overdrafts incurred by institutions that do not have regular discount window access.

The Federal Reserve occasionally imposes a daylight overdraft cap of zero on "problem" institutions. For example, a depository institution may have a zero cap imposed by a Reserve Bank because the Reserve Bank believes the institution presents excessive risk or because the institution has not complied with the payments system risk policy. Under the Board's policy, depository institutions with imposed zero caps that have access to the discount window are able to incur book-entry securities-related overdrafts if collateral is posted, but they generally may not incur overdrafts caused by other activity. These institutions will not be subject to the penalty fee that would be applicable to institutions with no discount window access. The Board believes these "problem" institutions are best handled on an individual basis through collateralization and real-time monitoring when the Reserve Bank deems necessary.

Request for Comment—Penalty Rate Calculation

The Board requests comment on a revised rate for the daylight overdraft penalty fee. The revised rate proposed by the Board would make the treatment of daylight overdrafts incurred by institutions without regular discount window access more comparable to the treatment of overnight overdrafts. As noted above, for overnight overdrafts, all institutions are charged a penalty fee and are required to make up their overnight reserve or clearing account deficiencies on a subsequent night. Thus, the full penalty assessed for overnight overdrafts is the overnight penalty fee plus the lost interest on the excess funds that must be held the following night. If an institution without discount window access incurs a daylight overdraft, the Board's policy does not require the institution to hold "excess" daylight balances on the following day. Therefore, to equalize the treatment of overnight and daylight overdrafts by these institutions, the

Board proposes that their daylight overdrafts be subject to a penalty fee at a rate equal to the overnight penalty rate plus the federal funds rate (e.g., given a 10 percent overnight penalty rate and a 3 percent federal funds rate, the daylight penalty rate would be 13 percent).⁷

The Board also proposes to adjust the manner in which the penalty fee is calculated to make it similar to the calculation of the "regular" daylight overdraft fee. The "regular" daylight overdraft fee is quoted on a 24-hour basis, for a 360-day year, and adjusted for the length of the Fedwire operating day. This adjustment maintains a constant per-minute charge in the event that Fedwire hours change. The proposed daylight penalty rate would be quoted on a similar basis. To calculate the daylight penalty rate, the "full" overnight rate (overnight rate plus federal funds rate) would be converted to a 24-hour rate, then adjusted to take account of the Fedwire operating day. This conversion would be accomplished by (1) dividing the "full" overnight rate by 14, the number of hours in a hypothetical "night," and multiplying by 24 to obtain the 24-hour rate, then (2) multiplying the 24-hour rate by the fraction of the day Fedwire is scheduled to operate (10/24 given the current 10-hour Fedwire day). Assuming an overnight overdraft rate of 10 percent, a federal funds rate of 3 percent, and thus an "full" overnight penalty rate of 13 percent (penalty plus lost interest), the annual 24-hour daylight penalty rate would be 22.3 percent (13 percent x (24/14)). The corresponding annual daylight penalty rate for a 10-hour Fedwire operating day would be 9.3 percent (22.3 percent x (10/24)), and the daily rate would be 2.6 basis points (9.3 percent / 360 days).

The Board anticipates that the cost to affected institutions, particularly those that incur occasional large book-entry securities-related overdrafts, would be significantly lower under the proposed revised rate as opposed to the cost under the Board's 1990 proposal. However, the Board seeks a penalty rate at a level high enough to provide a substantial incentive for institutions with no regular discount window access to avoid daylight overdrafts.

⁷ As an intraday funds market has not yet developed, the Board believes that the federal funds rate, rather than the "regular" annual daylight overdraft price of 60 basis points, more accurately reflects the cost of the funds that an institution would have to hold during the day to make up for the previous day's daylight overdrafts.

Summary of Comments on 1990 Proposal

The Board received 29 comments on its 1990 proposal, categorized as follows:

Corporate credit unions	11
Bankers' banks (commercial banks) ^a	7
Trade associations	4
Commercial banks	3
Credit unions	2
Bank holding companies	2
Total	29

^aThis category refers to bankers' banks that maintain reserves and thus have access to the discount window.

Scope

Twenty-three respondents commented on the scope of the proposal's coverage. One trade association and seven bankers' banks asked the Board to clarify that the penalty fee does not apply to bankers' banks that are members of the Federal Reserve System, maintain reserve accounts at their respective Reserve Banks, have access to the discount window, and have established caps under the payments system risk policy. As stated above, the penalty fee does not apply to bankers' banks that maintain reserves. These bankers' banks are treated in the same manner as commercial banks under the payments system risk policy.

Corporate Credit Union Comments

Thirteen commenters, including nine corporate credit unions and one trade association (collectively, "the CCU commenters") strongly objected to the proposal, which they claimed would unnecessarily undermine the corporate credit unions' ability to provide payments services to credit unions nationwide. Their primary objections were:

1. Discount Window Access for Corporate Credit Unions

The CCU commenters argued that the Board should not base its policy on the fact that corporate credit unions do not have regular discount window access because the Federal Reserve Act specifically grants access to individuals, partnerships, and corporations on the collateral of government securities. They stated that the health of the corporate credit union network has obviated the need for the corporate credit unions to seek credit from the Federal Reserve and that the corporate credit unions have access to the National Credit Union Administration's central liquidity facility in the event they need emergency funding.

The Monetary Control Act ("MCA") subjected all depository institutions to

reserve requirements and provided that nonmember depository institutions shall have the same discount window borrowing privileges as members,⁹ but the Act specifically exempted bankers' banks from these requirements and privileges.¹⁰ Nevertheless, the Board has permitted bankers' banks to have access to the discount window if they choose to maintain reserves. The Board's policy is consistent with Congress' purpose in the MCA to allow all depository institutions access to the discount window and other System services as a *quid pro quo* for maintaining reserves.

The Board, in its Regulation A, explicitly excluded bankers' banks and member banks that do not have reservable deposits, such as certain trust companies, from the defined group of depository institutions that have regular discount window access.¹¹ This exclusion was based on the premise that the discount window is meant to be a benefit for those institutions that bear the burden of maintaining reserves and an aid to the implementation of monetary policy.

The Federal Reserve Act provides that the Reserve Banks may make emergency discount window loans to individuals, partnerships, and corporations in certain circumstances or may make advances secured by U.S. government obligations to these entities subject to any limitations the Board may prescribe. The Board's Regulation A authorizes the Reserve Banks to make emergency discount window loans to individuals, partnerships, and corporations only in unusual and exigent circumstances if, in the judgment of the Reserve Bank, credit is not available from other sources and failure to provide credit would adversely affect the economy. These emergency loans require consultation with the Board, and if the loan is to be secured by collateral other than securities backed by the United States or its agencies, an affirmative vote of five Board members. Thus, although it may be possible for bankers' banks to obtain discount window access under the emergency provisions of Regulation A, such loans are seldom made and, by regulation and in some cases by statute, require Board attention.

2. Pyramiding of Reserves

The CCU commenters argued that reserve maintenance by corporate credit unions would result in reserve "pyramiding" because their member credit unions are already subject to reserve requirements under the Board's

⁹ 12 U.S.C. 461 (b)(2) and (b)(7).

¹⁰ 12 U.S.C. 461(b)(9).

¹¹ See 12 CFR 201.2(a)(2).

Regulation D. However, there would be no "pyramiding" or double-counting of reserves if corporate credit unions maintained reserves. Credit unions, when calculating their reservable liabilities, can take a "due from" deduction for deposits subject to immediate withdrawal held at corporate credit unions. For example, if a credit union deposits \$1 million in a demand account at a corporate credit union, the corporate credit union would maintain reserves on that amount and the credit union would deduct \$1 million from the amount on which it must maintain reserves.

3. Equal Access to Services

The CCU commenters asserted that the Board's proposal to treat corporate credit unions differently from other institutions violates the MCA principle that the Federal Reserve should provide depository institutions equal access to Federal Reserve services. There is no indication in the MCA, however, that Congress intended the allowance of overdrafts to be a Federal Reserve service. On the contrary, the MCA specifically provides that "nonmembers shall be subject to any * * * terms, including a requirement of balances sufficient for clearing purposes, that the Board may determine are applicable to member banks." The purpose of such balances would be to avoid overdrafts. (The maintenance of clearing balances does not give rise to discount window access under Regulation A.)

4. Competitive Inequities

Twenty respondents commented on the negative effects that an absolute prohibition of daylight overdrafts would have on bankers' banks and Edge corporations. Twelve commenters, mainly corporate credit unions, stated that a prohibition of overdrafts would place them at a competitive disadvantage vis-a-vis other market participants. The corporate credit unions were particularly concerned that the proposal would force credit unions to do business with commercial banks, their direct competitors, if they wished to continue to offer book-entry securities services to their customers.

The commenters may be correct in their assessment that penalty fees on daylight overdrafts will affect their competitive position vis-a-vis depository institutions. For example, daylight overdraft data for U.S. Central Credit Union show frequent daylight overdrafts in the early morning hours. The possibility of early-morning overdrafts might be increased by the new posting procedures that go into effect in October 1993. U.S. Central

funds itself largely through ACH debit transactions. Under the new procedures, the funds from the ACH debit transactions will be posted at 11 a.m., as opposed to the current posting of net-positive ACH debit transactions at the opening of business. Under the Board's policy, U.S. Central will pay a penalty fee on its daylight overdrafts.

However, corporate credit unions currently have a significant advantage over competing depository institutions because they do not have to maintain reserves. The Board believes that the disadvantages of the proposal to corporate credit unions would be offset by the advantages they currently enjoy.

Eight commenters asserted that, given the infrequency and small size of bankers' bank overdrafts, the relatively low degree of risk does not justify the burden of a flat overdraft prohibition for these institutions. One commenter claimed that risk to the Federal Reserve would be increased if corporate credit unions were obligated to open Federal Reserve accounts in order to incur overdrafts. Two commenters noted that credit union customers would experience a decreased service level and worse funds availability under the proposal.

As noted above, the new policy does more than address risk. The penalty fee helps ensure that institutions that do not have regular discount window access will not receive extensions of Federal Reserve credit in the form of daylight or overnight overdrafts.

Edge Corporations

Given the sender-controlled nature of the book-entry securities system, five Edge corporation affiliates and a trade association favored a continuation of the present policy of allowing Edge corporations to establish a cap and incur collateralized book-entry securities overdrafts. The commenters argued that Edge corporation intraday overdrafts that are limited by a cap and backed by sound collateral are relatively risk-free. Another commenter requested that Edge corporations be allowed to pledge the securities in transit as collateral for a book-entry securities overdraft. One corporate credit union suggested that the present Edge corporation policy be extended to bankers' banks. One Edge affiliate commented specifically on the proposal as it applied to "problem" institutions with imposed zero caps. The commenter stated that the proposal may be appropriate for these zero-cap institutions, but drew a distinction between these entities and an Edge corporation with a financially sound parent that incurs daylight overdrafts for a short period of time.

The Board agrees that many imposed-zero-cap institutions, especially those that have been assigned a zero cap due to their financial problems, pose more of a risk than Edge corporations with financially sound parents. Such Edge corporations, however, could arrange to obtain funding intraday from their parents or channel all their payments activity through their parents, thus avoiding daylight overdrafts themselves. Should an Edge corporation incur a daylight overdraft, there is a possibility that its parent could be unable or unwilling to cover the Edge corporation's overdraft at the end of the day.

In addition, 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. The daylight overdraft penalty fee is designed to create economic incentives to eliminate the use of daylight credit by institutions without regular discount window access. The Board believes that their lack of access to the discount window suggests that Edge corporations should be subject to the same policy as bankers' banks that do not maintain reserves.

Overdraft Measurement Procedures

Seven commenters argued that the proposal was particularly unfair in light of the overdraft measurement procedures originally proposed by the Board under which ACH and other non-wire payments would be posted at the end of the business day (54 FR 26094, June 21, 1989). The commenters stated that the late posting combined with the daylight overdraft penalty fee would eliminate many overnight investment opportunities for corporate credit unions, while banks could continue to make investments by incurring daylight overdrafts. One corporate credit union supported the Board's proposal as long as non-wire transaction posting is not moved to the end of the day.

The Board adopted posting procedures for measuring daylight overdrafts (see 57 FR 47093, October 14, 1992) that provide for posting ACH credit transactions at the opening of business, ACH debit transactions at 11 a.m. Eastern Time, and check transactions throughout the day. The Board believes that this intraday posting alleviates many of the concerns regarding investment opportunities raised by the commenters.

Penalty Fee

Eight commenters specifically opposed the proposed penalty fee. The

commenters generally believed the proposed fee to be excessive and onerous, particularly given the uncontrollable nature of book-entry securities overdrafts. The commenters questioned whether the penalty fee would deter daylight overdrafts. Three commenters suggested that the fee be brought in line with the 60 basis point annual fee proposed by the Board for daylight overdrafts by other institutions. Two commenters suggested that the penalty fee be applied to the average overdraft rather than the maximum overdraft to provide an incentive for institutions to cover the overdraft as soon as possible. Two commenters suggested the fee be tailored to overdraft size and frequency. One Edge corporation affiliate suggested that the amount subject to the penalty fee be subject to a deductible of 10 percent of the capital of the Edge corporation's parent bank to offset overdrafts that occurred due to circumstances beyond the institution's control. Another commenter suggested that Reserve Banks allow a one hour grace period before assessing a penalty fee to allow a reasonable time for the institution to cover an inadvertent overdraft.

As discussed above, the Board is requesting comment on a modified proposal to assess a fee at the overnight overdraft penalty rate plus the federal funds rate, adjusted for the length of the Fedwire operating day, against the average daily daylight overdraft. Under the policy adopted by the Board and the proposed rate revision, the cost to overdrawing institutions will be substantially lower than under the 1990 proposal.

Alternatives

The Board received several comments offering alternative methods of addressing daylight overdrafts by bankers' banks and Edge corporations. Seven CCU commenters believed that the Board's requirement that an institution hold reserve or clearing balances at a Reserve Bank in order to have discount window access should not apply to corporate credit unions, as long as they maintain an "overdraft protection accounts" at U.S. Central Credit Union or at Reserve Banks that could be accessed by the Reserve Banks in the event of an overdraft. The CCU commenters proposed that each corporate credit union's account be funded in the amount of 10 percent of the corporate credit union's risk-based capital. The commenters argued that their suggested overdraft collateralization method is consistent with other aspects of the Board's payments system risk policy.

As discussed above, the exclusion of bankers' banks that do not maintain reserves from discount window access was based on the premise that discount window access is a *quid pro quo* for the burden of maintaining reserves and is an aid to the Federal Reserve in the implementation of monetary policy. A deposit of collateral by bankers' banks at the Federal Reserve or at U.S. Central, as suggested by the CCU commenters, would not meet the MCA or Regulation A requirements for regular discount window access and would be contrary to the Board's policy that bankers' banks must maintain reserves in order to have discount window access.

Six commenters suggested that, instead of charging a penalty fee, a more effective way to reduce risk would be to place bankers' banks and Edge corporations on the real-time monitor and to refuse unfunded transfers. Two commenters suggested that the book-entry system be redesigned so that deliveries could be rejected if they cause an overdraft. One commenter also suggested that a standard posting time be established for all book-entry security debits and credits.

At an institution's request, a Reserve Bank will monitor its account in real time and reject outgoing funds transfers that would cause an overdraft. However, automatic rejection or queuing of securities transfers and a standard securities posting time would require significant changes in the operations of the Federal Reserve's book-entry security system. The Federal Reserve is currently studying various long-term improvements to its book-entry system.

Competitive Impact Analysis

The Board assesses the competitive impact of changes that have a substantial effect on payments system participants.¹² 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 CCU commenters stated that the new policy would put them at a competitive disadvantage vis-a-vis other payments system participants, particularly in book-entry security settlement and safekeeping services. The CCU commenters asserted that daylight overdraft penalty fees would drive corporate credit unions out of the securities services and would force

credit unions to do business with other service providers. Such other service providers could be private institutions, such as commercial banks, or credit unions could choose to establish accounts directly with a Federal Reserve Bank.

The Board does not believe that its policy adversely affects the ability of corporate credit unions to compete with the Reserve Banks in providing payments services. The policy places controls on the use of the Federal Reserve Banks' funds and book-entry transfer services, which are consistent with controls used in private clearing and settlement systems. Corporate credit unions have the ability to establish caps and collateralize book-entry securities overdrafts if they voluntarily maintain reserves, as commercial banks are required to do. By voluntarily maintaining reserves, the corporate credit unions would avoid the penalty fees that, according to their comments, would cause their customer credit unions to go the Reserve Banks or elsewhere for payments services.

By order of the Board of Governors of the Federal Reserve System, August 18, 1993.

William W. Wiles,

Secretary of the Board.

[FR Doc. 93-20406 Filed 8-23-93; 8:45 am]

BILLING CODE 6210-01-P

[Docket No. R-0806]

Proposals To Modify the Payments System Risk Reduction Program; Self-Assessment Procedures, Caps for U.S. Branches and Agencies of Foreign Banks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board is requesting comment on proposed modifications to its Policy Statement on Payments System Risk. The Board is proposing to modify in two ways the procedures that depository institutions must use if they choose to complete a self-assessment to establish a daylight overdraft net debit cap. First, effective for self-assessments performed on or after January 1, 1995, the Board is proposing that depository institutions evaluate their operating controls and contingency procedures in addition to the three existing components of the self-assessment (creditworthiness, intraday funds management and control, and customer credit policies and controls). Second, the Board is proposing that depository institutions use a simplified "Creditworthiness Matrix" to determine

their creditworthiness rating, except in certain limited circumstances, effective January 1, 1994. In addition to these two changes to the self-assessment procedures, the Board is proposing to eliminate the requirement that U.S. branches and agencies of foreign banks provide information on U.S. funding capability and discount window eligible collateral for use in determining their daylight overdraft net debit caps, effective January 1, 1994. Overall, the proposals would decrease the burden of complying with the Board's policy, improve the consistency of net debit caps across institutions, and reduce risks by encouraging depository institutions to focus attention on operational risks in the provision of payment services.

DATES: Comments must be submitted on or before October 8, 1993.

ADDRESSES: Comments, which should refer to Docket No. R-0806, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551. Comments addressed to Mr. Wiles also may be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m. and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in room B-1122 between 9 a.m. and 5 p.m.

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

SUPPLEMENTARY INFORMATION:

Background

The Federal Reserve first issued a policy statement on risks in large-dollar wire transfer systems in 1985. This policy required that depository institutions incurring daylight overdrafts in their Federal Reserve accounts as a result of Fedwire funds transfers establish a maximum limit, or net debit cap, on overdrafts incurred in those accounts. To implement the original policy, a document entitled Users' Guide to the Policy Statement, was prepared and distributed to depository institutions in 1985.

The original policy has been expanded and enhanced since 1985. The Users' Guide was updated

¹² These assessment procedures are described in the Board's policy statement entitled "The Federal Reserve in the Payments System" (55 FR 11648, March 29, 1990).

accordingly and reissued in 1988. In 1992, the Board issued a comprehensive statement of its previously adopted policies regarding payments system risk. The Federal Reserve is currently in the process of updating the Users' Guide to incorporate changes in the policy since 1988, including the modifications approved by the Board in late 1992 regarding intraday posting of transactions and fees for daylight overdrafts. The updated Users' Guide would also include the amendments to the 1992 comprehensive policy statement that are proposed in this notice, if ultimately adopted by the Board. The Board expects to issue the Guide to the Federal Reserve's Payments System Risk Policy once public comments on this notice's proposals have been received and considered. (The Board is also proposing to update the introductory section to its policy statement to reflect the availability of the Overview, discussed below, as well as the Guide's new title.) Once issued, the Guide to the Federal Reserve's Payments System Risk Policy will supersede previously issued versions of the Users' Guide. A draft copy of the Guide to the Federal Reserve's Payments System Risk Policy is available from any Reserve Bank for review. The Federal Reserve has also prepared a new

summary document, entitled Overview of the Federal Reserve's Payments System Risk Policy, which is intended to describe the requirements of the policy for institutions that incur minimal daylight overdrafts.

Self-Assessment Procedures

Under the Board's policy, an institution's net debit cap (for a single day and on average over a two-week period) is based on its cap category. The three cap categories that permit the highest use of intraday credit are the Average, Above Average, and High cap categories. An institution that wishes to establish a cap in one of these categories must complete a self-assessment of its creditworthiness, intraday funds management and control, and customer credit policies and controls.

The Board is proposing to add a fourth component, operating controls and contingency procedures, to the self-assessment procedures. This component is critical to a thorough self-assessment because institutions could incur significant financial losses as a result of fraud and because operational failures at payment system participants could disrupt financial markets.

As a result of the potential added burden placed on depository institutions, the Board anticipates that implementation of this requirement, if

approved, will be delayed until January 1, 1995 in order to provide institutions sufficient time to adopt procedures for evaluating this component. The Board would welcome comments on whether it is appropriate to incorporate a component on operational controls and contingency procedures into the self-assessment procedures as well as any potential administrative burden of including this additional requirement.

The Board is also proposing a change in the procedures for completing the creditworthiness component of the self-assessment. These new procedures are described fully in the draft Guide to the Federal Reserve's Payments System Risk Policy, which is available from any Reserve Bank. Since the inception of the self-assessment process for establishing net debit caps, concerns have been raised regarding the administrative burden raised by the self-assessment procedures. In an attempt to reduce burden on institutions electing to complete a self-assessment, the Board has developed a matrix that combines an institution's supervisory rating and Prompt Corrective Action capital category into a creditworthiness rating.¹ This "Creditworthiness Matrix" is shown below.

Creditworthiness Matrix

Capital level	Supervisory composite rating		
	Strong	Satisfactory	Fair
Well Capitalized	Excellent	Very Good	Adequate
Adequately Capitalized	Very Good	Very Good	Adequate
Undercapitalized	Full Assessment	Full Assessment	Below Standard.

Note: Institutions with a capital level or supervisory rating not shown in the matrix would receive a creditworthiness rating of "below standard."

While institutions electing to complete a self-assessment would still be required to perform a full self-assessment in other areas, use of the Creditworthiness Matrix should result in a substantial reduction in the regulatory compliance burden for these institutions. In addition, the use of the Matrix achieves greater objectivity in rating creditworthiness, and the resulting creditworthiness ratings and overall net debit cap categories are likely to be more consistent across institutions than under current procedures.

The Board is proposing that, in nearly all circumstances, depository institutions completing a self-

assessment use the Creditworthiness Matrix to determine their creditworthiness rating. In certain limited circumstances, however, an institution may be permitted to perform a full assessment of its creditworthiness. For example, an institution whose condition has changed significantly since its last examination, or that possesses additional material information regarding its financial condition, may reasonably be permitted to use these factors to support a higher creditworthiness rating that would be derived using the Creditworthiness Matrix alone. Additionally, U.S. branches and agencies of foreign banks from countries that do not adhere to the

Basle Capital Accord would be required to perform a full assessment to determine their rating on the creditworthiness component. Procedures for conducting a full assessment of creditworthiness are provided in Appendix C of the draft Guide to the Federal Reserve's Payments System Risk Policy. If adopted, the Creditworthiness Matrix approach would be effective on January 1, 1994, although earlier implementation by institutions may be permitted.

The Board has determined that use of the Creditworthiness Matrix would, for certain institutions, result in a lower net debit cap. The Board, therefore, requests comment on whether mandatory usage

¹For U.S. branches and agencies of foreign banks that are based in countries that adhere to the Basle Capital Accord, risk-based capital ratios calculated according to home-country rules would be

compared to the Prompt Corrective Action capital categories, and the resulting capital level would be used in the Creditworthiness Matrix.

of the matrix approach would adversely affect the smooth functioning of the payments system.

Net Debit Caps for U.S. Branches and Agencies of Foreign Banks

The determination of net debit caps for foreign banks is based on essentially the same procedures as those for U.S.-based institutions. However, for foreign banks, the Federal Reserve also requires evidence of U.S. funding capability and discount window eligible collateral. Based on the evidence submitted, the Federal Reserve may adjust the dollar amount of an institution's net debit cap to a level below its cap multiple times its risk-based capital.

Experience with U.S. funding capability and potential collateral data has shown that a significant administrative burden is created to collect these data with sufficient precision and frequency. In addition, if the proposed Creditworthiness Matrix approach, also discussed in this notice, is adopted by the Board, net debit caps adopted by foreign banks will be based on more objective supervisory ratings and the additional data will be less relevant to determining appropriate net debit caps.

The Board requests comment on the current limitation on net debit caps for U.S. branches and agencies of foreign banks and the data collection effort it entails. The Board is proposing that, effective January 1, 1994, for purposes of determining net debit caps for U.S. branches and agencies of foreign banks, data on U.S. funding capability and discount window eligible collateral no longer be required, provided that the Creditworthiness Matrix proposal is also approved.

None of the proposed amendments would affect a Reserve Bank's ability to prohibit an institution from using intraday Federal Reserve credit, if the institution's use of such credit is deemed unsafe or unsound by its supervisor or if the institution poses an excessive risk to a Reserve Bank.

Federal Reserve System Policy Statement on Payments System Risk

The Board proposes to amend its "Federal Reserve System Policy Statement on Payments System Risk" under the heading "I. Federal Reserve Policy" by replacing the last three sentences of the Introduction, part (C)(2) under the headings "C. Capital" and "2. U.S. Agencies and Branches of Foreign Banks," and the first paragraph of part (D)(1) under the headings "D. Net Debit Caps" and "1. Cap Set Through Self-Assessment" as set forth below:

Introduction

* * * * *

To assist depository institutions in implementing the Board's policies, the Federal Reserve has prepared two documents, which are available from any Reserve Bank: the Overview of the Federal Reserve's Payments System Risk Policy and the Guide to the Federal Reserve's Payments System Risk Policy. The Overview provides a summary of the Board's policy on payments system risk, including daylight overdraft net debit caps and fees. The Overview is intended for use by institutions that incur only small and infrequent daylight overdrafts. The Guide explains in detail how the policies apply to various types of institutions and includes procedures for completing a self-assessment and filing a cap resolution, as well as information on other aspects of the payments system risk policy.

* * * * *

I.C. Capital

2. U.S. Agencies and Branches of Foreign Banks

For U.S. agencies and branches of foreign banks, net debit caps on daylight overdrafts in Federal Reserve accounts are calculated by applying the cap multiples for each cap category to consolidated "U.S. capital equivalency."⁴

For a foreign bank whose home-country supervisor adheres to the Basle Capital Accord, U.S. capital equivalency is equal to the greater of 10 percent of worldwide capital or 5 percent of the total liabilities of each agency or branch, including acceptances, but excluding accrued expenses and amounts due and other liabilities to offices, branches, and subsidiaries of the foreign bank. In the absence of contrary information, the Reserve Banks presume that all banks chartered in G-10 countries meet the acceptable prudential capital and supervisory standards and will consider any bank chartered in any other nation that adopts the Basle Capital Accord (or requires capital at least as great and in the same form as called for by the Accord) eligible for the Reserve Banks' review for meeting acceptable prudential capital and supervisory standards.

For all other foreign banks, U.S. capital equivalency is measured as the greater of: (1) The sum of the amount of capital (but not surplus) that would be

⁴ The term "U.S. capital equivalency" is used in this context to refer to the particular capital measure used to calculate daylight overdraft net debit caps, and does not necessarily represent an appropriate capital measure for supervisory or other purposes.

required of a national bank being organized at each agency or branch location, or (2) the sum of 5 percent of the total liabilities of each agency or branch, including acceptances, but excluding accrued expenses and amounts due and other liabilities to offices, branches, and subsidiaries of the foreign bank.

In addition, any foreign bank may incur daylight overdrafts above its net debit cap up to a maximum amount equal to its cap multiple times 10 percent of its worldwide capital, provided that any overdrafts above its net debit cap are collateralized. This policy offers all foreign banks, under terms that reasonably limit Reserve Bank risk, a level of overdrafts based on the same proportion of worldwide capital. Consequently, banks chartered in countries that follow the Basle Accord and whose net debit cap is based on 10 percent of worldwide capital are not permitted to incur overdrafts above their net debit cap. All other foreign banks may incur overdrafts to the same extent as banks from Basle Accord countries, that is, up to their cap multiple times 10 percent of their worldwide capital, provided that sufficient collateral is posted for any overdrafts in excess of their net debit cap. In addition, foreign banks may elect to collateralize all or a portion of their overdrafts related to book-entry securities activity.

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I.D. Net Debit Caps

1. Cap Set Through Self-Assessment

In order to establish a net debit cap category of Average, Above Average, or High, an institution must perform a self-assessment of its own creditworthiness, intraday funds management and control, customer credit policies and controls, and, effective January 1, 1995, operating controls and contingency procedures. The assessment of creditworthiness should be based on the institution's supervisory rating and Prompt Corrective Action capital category. An institution may be permitted to perform a full assessment of its creditworthiness, in certain limited circumstances, for example, if its condition has changed significantly since its last examination, or if it possesses additional material information regarding its financial condition. Additionally, U.S. branches and agencies of foreign banks from countries that do not adhere to the Basle Capital Accord would be required to perform a full assessment to determine their rating on the creditworthiness component. The institution should also assess its intraday funds management

procedures and its procedures for evaluating the financial condition of and establishing intraday credit limits for its customers. Finally, the institution should ensure that its operating controls and contingency procedures are sufficient to prevent losses due to fraud or operational failures. The Guide to the Federal Reserve's Payments System Risk Policy, available from any Reserve Bank, includes a detailed explanation of the steps that should be taken by a depository institution in performing a self-assessment to establish a net debit cap.

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By order of the Board of Governors of the Federal Reserve System, August 18, 1993.

William W. Wiles,

Secretary of the Board.

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