How much risk lurks in the shadows of daylight overdraft?

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With the U.S. banking system in financial distress, the Fed provides payments services to a greater number of problem banks. So how much of an issue is the credit risk associated with retail payments today? As you know, financial institutions, much like the commercial and retail customers they serve, from time to time experience the need for overdraft credit—short-time loans to accommodate the management of incoming and outgoing funds. The Fed provides daylight overdraft protection to financial institutions that experience timing differences in ACH service offerings so that they can meet their cash flow obligations, in the same way a financial institution provides overdraft protection. The Fed, like any prudent lender, also maintains a responsibility to carefully manage the credit risk exposure from these provisions of credit. The need for the Fed to monitor ACH activity for overdraft exposure becomes critical when a financial institution's health is in question.

How does the Fed monitor the financial health of financial institutions?
It is important to remember that the Fed is also a bank regulator, and it works collaboratively with other bank regulators to monitor bank conditions. When a bank's financial condition deteriorates, the agencies communicate the institution's regulatory rating and other relevant information to the Fed in its U.S. payments oversight role. Wearing that hat, the Fed may choose to restrict lending in a number of ways, such as limiting access to daylight credit.

Real-time monitor
One tool that can be used to restrict daylight credit access is "real-time monitoring" (RTM), which is implemented through the Account Balance Monitoring System (ABMS). With RTM, the Fed can reject certain transactions from posting to an institution's account if that posting would cause the institution to exceed its daylight credit limits. Under RTM, any funds transfers from the account or ACH credit originations (which are required to be prefunded) that would cause an institution to exceed its daylight credit capacity would be rejected.

Interest on reserves and daylight overdrafts
One conundrum in this equation is that the need for overdrafts has diminished recently as banks began maintaining higher reserves, prompted by the Fed's decision to start paying interest on reserve balances. Before, banks were reluctant to hold too many reserves because they were a nonearning asset. Since the Fed didn't compensate banks for holding the reserves, banks could find more rewarding uses for their funds. With more reserves in the system, the need for intraday borrowing from the Fed has decreased. Whether that trend will continue as the economy improves and the financial condition of the banking sector stabilizes, thereby creating more lucrative uses for excess reserves, remains to be seen—but then maybe we won't have as many high-risk banks as the economy improves. Let's hope not.

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