CUNA REGULATORY ADVOCACY

CUNA REGULATORY COMMENT CALL

July 2, 2001

(NOT A MAJOR RULE)

Payment System Risk Policy Changes Affecting Electronic Payments, Fedwire and Intraday Credits

EXECUTIVE SUMMARY

The Federal Reserve has issued several proposed changes to the Payments System Risk Policy (Policy) that come in the form of an interim policy statement effective immediately; three proposals with a short timeframe, and one long term prospective proposal. All of these are briefly described below:

1. Under the interim policy statement that was effective on May 30, 2001, the Federal Reserve (Fed) would still require depository institutions that use intraday credit from their Federal Reserve Bank (Reserve Bank) accounts to cap their allowed debit amounts. However, the new statement permits banks with net debit caps to use more credit than their limits allow if they voluntarily commit collateral to the Reserve Banks. Comments are due on this proposal on August 6, 2001.

2. The Fed issued three proposals that would promote changes to the Policy in the short-term. Comments on these proposals are due by August 6, 2001.

   2.1. The first would allow debits associated with electronic check presentment (ECP) to post later at 1 p.m. for purposes of calculating the overdraft. The Fed thought that this would encourage ECP by allowing paper and ECP to post at roughly the same time and eliminate the overdraft charges that may be created by different posting times.

   2.2. The second proposal would eliminate the current $50 million limit on book entry securities transfers on Fedwire. This which is a payment service operated by the Fed for transferring funds between banks that have either reserve or clearing accounts at Reserve Banks. The Fed proposed this earlier to a limited number of dealers and clearing banks that found that the limit served a useful function by forcing parties to accept partial deliveries of up to $50 million in settling securities trades. As a result, the Fed is disposed toward keeping the limit.

2.3. The third would change the criteria for determining what is the U.S. capital equivalent that would be required for the U.S. branches and agencies of foreign banking organizations (FBOs).

3. The Fed requests comments on changes that may be considered in the future. These comments are due October 1, 2001. These potential amendments would:

   3.1. Lower the single-day net debit cap to about the current two-week average cap level;
   3.2. Establish a two-tiered pricing policy for intraday overdraft credits that would have lower fees for intraday overdrafts with collateral than for those overdrafts without collateral;
   3.3. Call for settlement-day finality; and
   3.4. Reject payments that result in a bank exceeding its net debit cap.

4. The Fed is rescinding its interaffiliate transfer policy, effective January 1, 2002. The Fed states that other supervisory policies in place will accomplish the same goal as this policy.

Please send your comments to CUNA by July 23 for the proposals due on August 6 and for September 17 for the proposal due on October 1. Please feel free to fax your responses to CUNA at 202-371-8240; e-mail them to Associate General Counsel Mary Dunn at mdunn@cuna.com or to Assistant General Counsel Michelle Profit at mprofit@cuna.com; or mail them to Mary or Michelle c/o CUNA's Regulatory Advocacy Department, 805 15th Street, NW, Suite 300, Washington, D.C. 20005. For a copy of this proposal, which was published in the *Federal Register* on June 5, 2001, please press here http://www.access.gpo.gov/su_docs/fedreg/a010605c.html.

BACKGROUND

The Policy was introduced in 1985 to reduce payment systems risks. The Reserve Banks risk losses when depository institutions use credit from their Federal Reserve Bank accounts. This credit is referred to as "daylight credit" or "daylight overdrafts." Reserve Banks face risk if depository institutions are unable to sell their daylight overdraft before the end of the day. As a result, in 1985 the Policy required all depository institutions incurring daylight overdrafts in their Federal Reserve accounts as a result of Fedwire funds transfers to establish a maximum limit or net debit cap, on those overdrafts. In 1990, the Board established that a depository institution's funds and book-entry securities overdrafts would be combined for purposes of determining the institution's compliance with its cap.

PROPOSED RULE

<u>Interim Policy R-1107</u>

As stated above, the comments for this proposal are due on August 6, 2001.

The interim policy that allows depository institutions with self-assessed net debit caps to pledge collateral to take larger overdrafts affects other areas of the policy, including the Policy's treatment of US branches and agencies of foreign banks, book-entry securities transfers, and account monitoring procedures. Under the interim policy, a foreign bank that has a self-assessed net debit cap and that would like to access daylight credit above its net debit cap level may consult with it Administrative Reserve Bank to discuss an appropriate overdraft limit. This Policy differs from current policy that places maximums on overdraft capacity based on certain formulas.

The interim policy changes the requirements for book-entry securities overdrafts. The interim policy would allow Reserve Banks to require collateral from self-assessed depository institutions that frequently exceed their caps because of transactions with settlement-day finality. The collateral only needs to cover overdrafts above the net debit cap level. Previously, the former policy stated that depository institutions with book-entry securities overdrafts that meet the frequency and materiality thresholds must have their collateral cover all overdrafts and not just the amount that exceeds the debit cap. The interim policy eliminates the frequency and materiality distinction.

The interim policy does not apply to institutions with exempt-from-filing or de minimis net debit caps. Under the interim policy, the Board plans to continue to allow depository institutions with exempt-from-filing or de minimis caps to collateralize voluntarily all or part of their book-entry securities overdrafts. The Board also intends to continue the following practices:

- Requiring depository institutions with exempt-from-filing or de minimis caps that frequently exceed their caps, even if only partly because of book-entry securities transactions, to collateralize all of their book-entry securities overdrafts.
- Prohibiting depository institutions with exempt-from filing or de minimis caps to pledge collateral to increase their daylight overdraft capacity for funds overdrafts.
- Requiring depository institutions with zero caps that have access to the discount window to collateralize fully all book-entry securities overdrafts.

However, when the Board adopts the final policy statement, the Fed plans to eliminate the current policy's separate treatment of book-entry securities overdrafts. The policy will require any depository institution with an exempt-from-filing or de minimis cap to apply for a higher net debit cap if the institution frequently exceeds its cap because of transactions with settlement-day finality.

The Fed clarified the Policy with regard to monitoring the account of depository institutions at Reserve Banks. First the Reserve Banks will monitor the net debit positions of depository institutions with self-assessed caps that choose to voluntarily pledge collateral to gain additional overdraft protection. The Reserve Banks will monitor the net debit position of these institutions against these institutions' daylight overdraft capacity levels and not their net debit cap levels. Second, Reserve Banks may require depository institutions with self-assessed net debit caps that frequently exceed their daylight overdraft protection limit to provide collateral for the difference between their peak daylight overdrafts and their net debit cap levels. The Policy will continue to allow administrative counseling flexibility for institutions that frequently exceed their net debit caps due to the posting of transactions that doe not have settlement-day finality, such as checks and ACH debit originations.

Short Term Policy on Electronic Check Presentment (ECP) R-1109

As stated above, the comments for this proposal are due on August 6, 2001. According to the Fed, the posting times for ECP transactions often create a disincentive for depository institutions to use Fed electronic check services. Under the current rules, ECP debit usually occurs at 11:00 AM because the Reserve Banks deliver the majority of ECP in the morning, and they constitute presentments that must be posted on the next clock hour beginning at 11:00 AM and no later than 3:00 PM. As a result, the posting times for ECP are earlier than the posting times associated with their paper check presentments. These earlier debit-posting times have caused some institutions to incur daylight overdrafts earlier in the day and for longer periods of time. This situation increases fees for those institutions because the Reserve Banks charge institutions a fee for the amount and duration of their daylight credit use. As a result, some of these institutions have asserted that the increases in their daylight overdraft charges have reduced or eliminated the benefits of using Fed electronic check services.

To encourage ECP, the Fed proposes to allow debits associated with ECP transactions to post at 1:00 PM local time in order to remove the disincentive created by the current posting rules for ECP services. The primary drawback of posting ECP debits later in the day is the associated shift in posting credit to depository institutions. In these situations financial institutions must choose one of two check credit posting options: (1) all credits posted at a single float-weighted posting time or (2) fractional credits posted throughout the day. The option selected by an institution applies to all of its check deposits including those for its respondents. This would cause some institutions to receive their check credits somewhat later than they do today. Also, these changes might create some costs for financial institutions associated that would have to change the internal monitors and controls they created to manage the earlier posting times.

Short Term Policy $50 Million Fedwire Securities Transfer Limit R-1110

As stated above, the comments for this proposal are due on August 6, 2001. In 1988, the Board imposed a $50 million limit on the par value of individual book-entry securities transfers on the Fedwire system. The $50 million system was to encourage government securities dealers to split large trades into multiple partial deliveries. This splitting thereby reduces subsequent book-entry securities related daylight overdrafts. By imposing a limit the Fed hoped to encourage dealers to accept $50 million partial payment installments on securities trades. When the Fed began imposing a fee for daylight overdrafts in 1994, most clearing banks decided to pass on these charges to their securities dealers who began to send securities trades earlier in the day instead of stockpiling these trades until later in the day to make a full payment. The Fed requests comments on whether it should keep its current policy limiting the size of individual book-entry security transfers on Fedwire to $50 million in par value.

Short Term Policy on Foreign Banking Organizations R-1108

As stated above, the comments for this proposal are due on August 6, 2001. The proposal would modify the criteria used to determine the U.S. capital equivalency for foreign banking organizations (FBOs). Specifically, the proposed policy would (1) eliminate the Basel Capital Accord (BCA) criteria used in the current policy to determine U.S. capital equivalency for FBOs, (2) replace the BCA criteria with the strength of support assessment (SOSA) rankings and financial holding company (FHC) status in determining U.S. capital equivalency for FBOs, and (3) raise the percentage of capital used in calculating U.S. capital equivalency for certain FBOs.

<u>Long Term Policy Exposures R-1111.</u>
The comments for these proposed changes to the Policy are due on October 1, 2001. The Fed requests comments on the following changes: (1) lowering single-day net debit cap levels to approximately the current two-week average cap levels and eliminating the two-week average cap; (2) implementing a two-tiered pricing regime for daylight overdrafts such that institutions pledging collateral to the Reserve Banks pay a lower fee on their collaterziled daylight overdrafts than on their uncollateralized daylight overdrafts; and (3) monitoring in real time all payments with settlement-day finality and rejecting those payments that would cause an institution to exceed its net debit cap.

The Reserve Banks set limits or net debit caps on the maximum amount of uncollateralized daylight credit that depository institutions may incur in their Reserve Bank Accounts. These caps are calculated by applying a cap multiple from one of six cap classes to a depository institution's capital measure. A Reserve Bank may assign the exempt-from-filing cap without a depository institution taking any action. A depository institution may request a de minimis cap by submitting a board-of-directors resolution to its Reserve Bank, or the institution may request a self-assessed cap by completing a self-assessment. Reserve Banks may assign a zero cap in certain circumstances or a depository institution may request a zero cap to restrict its use of daylight overdrafts. The Fed implemented two cap multiples for depository institutions with self-assessed caps: one for the maximum allowable average on any day (single-day cap) and one for the maximum allowable average of the peak daily overdrafts in a two-week period (two-week average cap). The two-week cap is lower than the single-day cap, because the former is supposed to limit the overall level of overdrafts while allowing for daily payment fluctuations.

According to the Fed, about twenty percent of depository institutions would exceed their single-day net debit cap if it were reduced to the two-week average levels. For those institutions that would use collateral to boost their net debit cap, only about twelve percent would regularly exceed their debit caps.

The Fed is considering the benefits and drawbacks of implementing a two-tiered or differential pricing regime for daylight overdrafts, which would charge more for those overdrafts that do not have collateral. Under this proposal, depository institutions that have pledged collateral with the Fed would receive the collateralized price for intraday credit used up to the level of the collateral. In addition, while the interim policy statement does not permit depository institutions with exempt or de minimis caps to increase their daylight overdraft capacity by pledging collateral to the Reserve, these institutions would be allowed to pledge collateral in order to receive the lower daylight overdraft fee. In addition, the largest users of daylight credit, in general depository institutions with assets greater than $10 billion, pay more than 95 percent of aggregate daylight overdraft fees.

The Fed is also evaluating the benefits and drawbacks of universal real-time monitoring (URTM), which is defined as using the Reserve Banks' Account Balance Monitoring System (ABMS) to reject any payment with settlement-day finality that would cause any account holder's overdrafts to exceed its net debit cap. Payments with settlement-day finality include Fedwire funds and book-entry securities transfers, enhanced net settlement service (NSS) transactions, automated clearing house (ACH) credit transactions, and cash withdrawals. The Fed is considering URTM for payments with settlement-day finality because they represent greater credit risk to the Federal Reserve than payments without settlement-day finality. According to the Fed, approximately 97 percent of all account holders use less than 50 percent of their net debit caps for their average peak overdrafts. Even if net debit caps were reduced to the two-week average level, as described previously, most institutions should not experience rejected payments under URTM. Furthermore, allowing institutions to pledge collateral as is allowed in the interim policy statement should minimize payment disruptions.

In particular, monitoring ACH credit origination raises unique issues. The most important is that URTM could compromise ACH value dating. Value dating allows depository institutions to originate credit transactions one or two days in advance of the settlement date. Under current rules, only a subset of credit originators is required to prefund. Under a URTM environment, all ACH credit originators would have to prefund. If depository institutions that send files one or two days in advance, decide prefunding is costly, they may attempt to avoid prefunding by originating their ACH files in the early morning hours of settlement day instead of beforehand. Later originations could cause an originating depository institution to miss the close of the ACH processing cycle. Some institutions have suggested that the Fed allow use of collateral to substitute for prefunding. However, the Fed would have to alter its system to monitor collateral in accounts over several days. The Fed will consider instituting URTM for all payments or only a subset of payments.

<u>Interaffilaite Transfer Policy R-1106</u>

The Board is rescinding the interaffiliate transfer policy. This policy permits interaffiliate transfers that are intended to concentrate the daylight overdraft capacity of affiliated institutions in one or more institutions. They can do that provided that (1) each sending institution's board of directors specifically approves, at least once each year, the intraday extension of credit to the specified affiliates(s) and sends a copy of the directors' resolution to its Reserve Bank and (2) during regulator examination, each sending institution's primary federal supervisor reviews the timeliness of board-of-directors resolutions, the establishment by the institution of limits on credit extensions to each affiliate, the establishment by the institutions of controls to ensure that credit extensions stay within such limits, and whether credit extensions have in fact stayed within those limits. When this policy is rescinded, depository institutions will no longer be required to submit a board-of-directors resolution to their Reserve Bank; however, institutions are expected to comply with supervisory and regulatory requirements regarding affiliate relationships and exposures.

QUESTIONS

Questions on Interim Policy R-1107

1. What are the benefits and drawbacks of allowing depository institutions with self-assessed net debit caps to pledge collateral for additional daylight overdraft capacity?

2. Would a policy change that requires depository institutions with exempt-from-filing and de minimis caps to apply for higher net debit caps if they frequently exceed their caps because of book-entry securities transfers simplify the policy or create an undue burden?

3. Would the Policy cause institutions to pledge additional collateral to the Fed or would they primarily use collateral already pledged to a Reserve Bank?

Questions on R-1109

4. If the proposed policy changes are adopted, will the resulting net debit cap levels combined with the broader use of collateral outlined in the interim policy statement provide a reasonable and prudent level of daylight overdraft capacity to address the liquidity needs of FBOs?

5. Recognizing difference in risk between FBOs and domestic depository institutions, would the proposed policy provide FBOs appropriate access to the U.S. payments system?

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6. With regard to calculating U.S. capital equivalency, is "net due to related depository institutions" an appropriate proxy for SOSA 3 ranked FBOs' U.S. capital equivalency?

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<u>Questions on R-1108</u>

7. Are there significant benefits or drawbacks associated with an ECP posting time of 1:00 PM local time? Are there any not identified in this notice?

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8. Does the proposed posting time provide Reserve Banks an inappropriate competitive advantage relative to the ability of private-sector banks or other service providers to compete in the provision of check collection services? If so, how?

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Questions on R-1110

9. Should the $50 million limit on individual book-entry security transfers on Fedwire be kept?

Questions on R-1111

10. How would a reduction in the single-day debit cap affect the way institutions manage their Reserve Bank Accounts with respect to daylight overdrafts? Do institutions target a maximum level of daylight overdrafts that is at or below their two-week average caps? How much additional capacity between routine peak overdrafts and the current single-day net debit cap is prudent or necessary?

11. Would lowering the single-day net debit caps for self-assessed institutions cause depository institutions to delay sending payments, potentially increasing overdrafts at other depository institutions?

12. Should the Board consider a policy that gradually moves uncollateralized net debit caps to significantly lower levels (for example, to the levels associated with the de minimis net debit cap) and require all depository institutions to post collateral for overdrafts beyond the net debit cap?

13. What are the major drawbacks and benefits of a two-tiered pricing regime for collateralized and uncollateralized daylight overdrafts in Federal Reserve accounts? Would a two-tiered pricing policy cause institutions to pledge additional collateral to the Fed or would they primarily use collateral already pledged to a Reserve Bank? If collateralized daylight overdrafts were subject to a fee lower than the current 36-point basis-point fee, would institutions' daylight credit usage change from current levels?

14. Currently, Federal Reserve daylight credit is generally provided only to financially healthy depository institutions that have regular access to the discount window and are subject to supervisory examination. Does taking collateral from these depository institutions provide the Federal Reserve a sufficient reductions in risk to warrant a lower fee?

15. What would be the benefits and drawbacks of URTM? Would URTM lead to significantly greater payment delays, or would there be little effect?

16. If the Federal Reserve were to implement URTM, should it do so for all payments with settlement-day finality? If not, which payments should the Federal Reserve include under URTM? If the Federal Reserve implemented URTM for only Fedwire funds transfers and NSS transactions, would this action increase risk of large-dollar payments moving from Fedwire or NSS to the ACH? Would this provide the Federal Reserve with a competitive advantage in providing ACH services?

17. What are the most significant benefits and drawbacks of implementing URTM for only Fedwire funds transfers and NSS transactions initially and continuing to evaluate moving other payments to URTM as the Federal Reserve and the industry gain more experience with URTM? What disruptions in the government-securities market, if any, could occur if the Federal Reserve were to implement URTM for Fedwire book-entry securities transfers? What disruptions in settlement arrangements, if any, could occur if the Federal Reserve were to implement URTM for NSS transactions?

Eric Richard • General Counsel • (202) 218-7796 • erichard@cuna.com
Mary Mitchell Dunn • SVP & Associate General Counsel • (202) 218-7769 • mdunn@cuna.com
Jeffrey Bloch • Assistant General Counsel • (202) 218-7795 • jbloch@cuna.com
Michelle Profit • Assistant General Counsel • (202) 218-7766 • mprofit@cuna.com