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March 12, 2007

Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Attention: Jennifer J. Johnson, Esq.,
Secretary

Re: Docket No. OP-1257
Consultation Paper on Intraday Liquidity
Management and Payment System Risk

Governors:

The Clearing House Association L.L.C. (“Association”) and The Clearing House Payments Company L.L.C. (“PaymentsCo,” collectively, with the Association, “The Clearing House”) and their member banks¹ are pleased to comment on the Board’s consultation paper seeking “information from financial institutions and other interested parties on their experience in managing intraday liquidity, credit, and operational risks relating to Fedwire and associated transactions” and on potential changes to the Board’s policy statement on payment-system risk (“PSR Policy”).²

The Board’s major concern is that “intraday liquidity management strategies of depository institutions, coupled with other factors, have increased the amount of large Fedwire payments made late in the day,” with the aggregate value of Fedwire payment

¹ The Association is an association of the nation’s leading banks and is the banking industry’s preeminent voice on payment-system and other banking issues. PaymentsCo operates the Clearing House Interbank Payments System (“CHIPS”), a high-value funds-transfer system; Electronic Payments Network (“EPN”), an automated clearing house; and other payment and clearing systems. The members of the Association and PaymentsCo are listed in Appendix A.

² 71 Fed. Reg. 35,679 (Jun. 21, 2006).

orders sent after 5:00 P.M.,³ growing from 20% in 1998 to 30% in 2005.⁴ The Board is concerned about this trend because “the larger the number and value of Fedwire and other payments that are made late in the day, the greater the risk to financial markets that payments will not settle in a timely manner if significant operational disruptions were to occur late in the day.”⁵ In addition, the Board is concerned that if banks delay sending funds-transfer payment orders until they receive payments as a way to preserve liquidity, this could lead to “gridlock.”⁶

As part of the consultative process, the Board has suggested a number of possible changes to its PSR Policy, and it is seeking public comment on these suggestions, as well as the views of the banking industry and other interested parties on other strategies that might be of assistance to the Federal Reserve and depository institutions as they manage the risks associated with intraday liquidity-management practices.

The Clearing House and its member banks share the Board’s concerns. We agree that some of the strategies taken by banks to respond to the daylight-overdraft fees imposed by the Board’s PSR Policy, along with certain practices that have developed in the capital markets, have shifted many large payments to late in the day, and that this shift results in some risks that payments might not be made if some disruption were to occur late in the day. The present situation does result in significant costs and inefficiencies because banks have to devote substantial resources to keeping track of and managing their daylight-overdraft positions. On the other hand, late-day payments have arisen as a result of a number of structural characteristics of the market that may not be easy to change, and while these late payments do present some real challenges, they have been, and continue to be, made in a timely fashion with little or no disruption to the payments system or the broader market. In that sense, the concentration of large payments late in the day is a reality of the market that banks have been coping with successfully. From this perspective, the Federal Reserve should take care to ensure that any solutions it considers to deal with late-day payments over Fedwire are cost-effective and do not risk unforeseen disruptions to financial markets.

³ Unless noted, all times are eastern time.

⁴ 71 Fed. Reg. at 35,681.

⁵ *Id.*

⁶ *Id.* at 35,682.

Our letter will summarize why we think that payments are shifting to later in the day and whether any of the possible changes to the PSR Policy that the Board has proposed provide any workable solutions to the challenges presented to late-day Fedwire payments. In preparing this letter we have had the benefit of the Report of the Joint Task Force on the PSR Consultation Paper prepared by a task force of the Payments Risk Committee and the Federal Reserve Banks' Wholesale Customer Advisory Group,⁷ and we shall have occasion to cite the report throughout this letter.

Reasons for the Late Shift in Large Payments

Our member banks report that late-day Fedwire payments result from a number of causes, many of which are related to market practices, although current Federal Reserve daylight-overdraft policies also play a significant role in shifting Fedwire payments to the end of the day. Some large banks have adopted practices to regulate their release of payments to save on daylight-overdraft costs, save liquidity for time-sensitive payments, and keep funds in reserve in case there are problems later in the day. While some banks provide liquidity to the system in the early morning hours by releasing a significant amount of payments early in the day, not all of the banks that receive this liquidity put it back into the system—sometimes for the simple reason that they have no payments to send. When these receiving banks do not make payments, they soak up liquidity, and the liquidity is not available to the banks that need it. The result is a slowing of payments and a trend toward later payments.

One reason for the concentration of large payments in the afternoon stems from the operation of the commercial-paper market. Commercial-paper issuance and redemption, which amounts to \$40-50 billion each day, is done through The Depository Trust Company ("DTC"), with the net amounts flowing when DTC settles at 4:30 P.M. As a result, nothing moves in the commercial-paper market until late in the day.

The Board also points to the need for banks to fund risk-management regimes at the Clearing House Interbank Payments System ("CHIPS"),⁸ DTC, and CLS Bank

⁷ Payments Risk Committee and Wholesale Customer Advisory Group, Report of the Joint Task Force on the PSR Consultation Paper (Feb. 2007) ("PRC-WCAG Report").

⁸ CHIPS is a service of PaymentsCo. "CHIPS" is a registered service mark of PaymentsCo.

International as creating demand for central-bank money in the form of balances at the Federal Reserve that now averages \$50 billion and can at times reach as high as \$150 billion.⁹ The Clearing House recognizes that this is a concern, but notes that the CHIPS contribution to this amount is only about \$3 billion daily and that consequently CHIPS does not contribute substantially to this situation. We also note that, as the Board recognizes, the adoption of intraday finality by CHIPS, which contains as an essential component prefunding an account at the Federal Reserve Bank of New York, “substantially reduced systemic risk.”¹⁰

The PRC-WCAG Report noted that most banks send all CHIPS-eligible payments to CHIPS as soon as they can, but that about \$100 billion remains in the CHIPS queue for an extended period throughout the day. On an average day, banks remove about 35 payments from CHIPS (totaling \$23 billion) just before CHIPS closes at 5:00 P.M., and these payments are likely rerouted through Fedwire. The remaining \$70 billion in CHIPS payments are settled through the final prefunding process, with banks that have a closing position requirement making payments through Fedwire totaling an average of \$35 billion; this \$35 billion is then paid to the banks with positive closing positions. The resulting \$70 billion in payments get credited to customer accounts shortly after the CHIPS end-of-day procedures are completed (usually around 5:10 P.M.), and this provides the liquidity needed for additional payments to be made over Fedwire before that system closes. Banks reported to the PRC-WCAG task force that the number of Fedwire transfers in their internal queues remains relatively constant between 3:00 and 5:00 P.M., but that it declines dramatically after 5:15 P.M.¹¹ The PRC-WCAG task force makes a number of recommendations with respect to CHIPS, including that CHIPS and its participants work to find ways to reduce the amount of time that some large payments wait in the CHIPS queue before being released. We agree that earlier release of these payments would benefit the system by providing earlier liquidity allowing even more CHIPS and Fedwire payments to be released before the end of the day. The Clearing

⁹ 71 Fed. Reg. at 35,680-81.

¹⁰ *Id.* at 35,680.

¹¹ PRC-WCAG Report at 4, 7–10. The report noted that on September 29, 2006, Fedwire released 1,160 payment orders totaling \$178 billion between 5:00 and 5:15 P.M. *Id.* at 3.

House has been working with the CHIPS participants on this issue and will continue to do so.

Banks put a lot of effort into managing the end-of-day process. Key to this process are the credit officers who decide whether to allow the release of payment orders for customers who do not have sufficient balances to cover their payments. Operational or other problems late in the day may complicate this end-of-day process because the credit officers may not know where the payments to fund the customers' accounts will come from, and this may cause some of payments to be delayed further. Nevertheless, the efforts that banks put into this process have ensured that the process works well. Late-day payments have consistently been completed, even in times of market stress, for example on September 11, 2001, and the days immediately following, when all but a handful of payments were completed on the payment date. While there may be ways to shift some payments to earlier times, a great many payments occur late in the day for reasons that relate to the structure of the financial markets, such as the payment flows in the commercial-paper market referred to earlier. These payments will continue to be made late unless there are changes to the underlying market practices. Given this reality, it may be necessary for the Board to realize that (i) some payments will always be scheduled for late in the day, (ii) efforts to shift those payments to earlier in the day are not likely to meet with success, and (iii) the Federal Reserve should direct some of its efforts toward gaining a better understanding of the banks' management of the end-of-day process and developing the tools to support the banks in this process in times of stress.

Potential Market, Operational, or Policy Changes

The Board has suggested several changes that could be made to its PSR Policy and other market and operational changes that could be encouraged in order to alleviate the problems associated with late-day payments and the lock-up of liquidity that is associated with the current situation.

Multiple Settlements for Private-Sector Systems. The Board suggests that one solution would be to “[e]nhance private settlement systems to economize further on the use of

central bank money, for example, by developing multiple settlement periods to release liquidity earlier in the day.”¹² Although CHIPS is not expressly mentioned in the discussion of this point, it is clear that the Board has CHIPS in mind.

CHIPS does in fact have multiple settlements throughout the day, with each payment settled at the time it is released by CHIPS to the receiving participant. Thus the Board’s proposal is not to introduce multiple settlements on to CHIPS, but to clear the queue several time a day by running the final prefunding, netting, and release phase that CHIPS currently does at the end of the day several times throughout the processing day. While The Clearing House may consider an additional prefunding phase earlier in the day to support its business purposes (e.g., to provide a close for Asian payments), we think that there is no reason to do so as a pure liquidity-saving mechanism.

CHIPS typically has about 300 payments (\$90 billion in gross, \$36 billion net) in its queue at the end of the day. We do not believe that this presents a substantial risk to the payments system or to the broader market. Multiple settlements on CHIPS may actually increase the number and value of CHIPS payment messages that remain to be completed at the end of the day.

The balanced-release algorithm works best when there are a large number of payments in the queue to allow the system to select the optimal batch for netting. Multiple prefunding, netting, and release procedures throughout the day would periodically clear the queue, with the result that payments sent to CHIPS after the periodic clearing would not have in place a set of payments against which they could be netted. As a result, these payments would remain in the queue longer than they would under the present procedures of continuous settlement and release followed by a final prefunding, netting, and release procedure after the close of the system.

The PRC-WCAG Report makes several suggestions for improving the CHIPS balanced-release algorithm and reducing the end-of-day positions at CHIPS. These include:

1. Removing the maximum current position limit on CHIPS (currently done at 5:00 P.M.) earlier in the afternoon.
2. Increasing a participant’s maximum current position on CHIPS.

¹² 71 Fed. Reg. at 35,682.

3. Increasing the amount of each participant's opening position requirement.
4. Allowing participants that are long in Fedwire but short in CHIPS to pay their CHIPS closing position requirements before 5:00 P.M.
5. Forming a task force to find ways to release all payments from the queue within a specified time frame.
6. Allowing for earmarking time-sensitive payments for immediate release.
7. Building a preference flag to look for and to settle the largest number of transactions.¹³

The Clearing House has considered many of these options for improving CHIPS. For example, The Clearing House has approved a test of removing the current position cap earlier in the day. The Clearing House welcomes the task force's recommendations and will continue to work with the banks that are members of the task force and with our CHIPS participants on ways to increase the efficiency of CHIPS and to reduce risk in the payments system.

Liquidity-Saving Mechanism for Fedwire. The Board also suggests that the Reserve Banks could "explore establishing a liquidity saving mechanism for the Fedwire funds transfer system" that would allow depository institutions to "economize on the use of intraday central bank money, while retaining the existing (real-time gross settlement) functionality of Fedwire."¹⁴ For example, banks could designate certain payments to be placed in a central queuing system with the release of these payments controlled by an algorithm that uses netting and similar mechanisms to allow the liquidity provided by incoming payments to be used to clear and settle outgoing payments. The balanced-release algorithm used by CHIPS is one example of this kind of liquidity-saving mechanism.

The Clearing House believes that there could be a number of problems if Fedwire were to adopt something like the CHIPS balanced-release algorithm: It would change the

¹³ PRC-WCAG Report at 5, 9-10.

¹⁴ 71 Fed. Reg. at 35,683.

essential character of Fedwire as the U.S.-dollar system that provides very rapid, final payment. The Board may also be underestimating the queue-management problems that could result if the Fedwire moves away from the pure real-time, gross-settlement (“RTGS”) system currently in use. Fedwire’s great strength is that payments will be released within seconds of being delivered to the Reserve Bank. Banks require the ability to make payments this rapidly in order to satisfy customer and market demands. If Fedwire were to adopt a liquidity-savings mechanism, that quality could be lost. We therefore urge the Board not to take any steps that could jeopardize the status of Fedwire as an RTGS system.

The Board should also recognize that the throttling that some banks now do in response to Fed charging for daylight overdrafts works as an informal, *ad hoc* liquidity saving mechanism on Fedwire.¹⁵

Through-Put Requirements. The Board also suggests that it could consider procedural changes to affect the timing of payments, including through-put requirements for Fedwire, under which “participants could be expected to submit a certain percentage of their Fedwire payments volume by 10 a.m., another percentage by noon, and so on.”¹⁶ The Board does, however, recognize that it could be difficult for some banks to meet the through-put requirements and that it might be difficult for the Reserve Banks to enforce.

For many years, CHIPS has had a policy that requires CHIPS participants to meet certain minimum through-put requirements. The current policy provides that participants should deliver a volume of payment messages before noon that is at least equal to 65% of the number of its payments and 55% if its dollar volume.¹⁷ Although The Clearing House monitors each participant’s compliance with this policy, there are no penalties for violations. Nevertheless, this approach has been successful. While a few (usually smaller institutions) do not always meet the standard, the system as a whole does. For example, in January 2007, the system released by noon an average of 82% of the

¹⁵ *Id.* at 20.

¹⁶ 71 Fed. Reg. at 35,683.

¹⁷ CHIPS Admin. P. No. 12(b). The CHIPS Rules and Administrative Procedures are available at http://www.chips.org/reference/docs_rules/000720.pdf.

payment messages and 68% of the dollar value of the day's total CHIPS payment messages.

There are, however, a number of reasons why the moral suasion that has worked so well on CHIPS may not be translatable to Fedwire. CHIPS and Fedwire attract very different kinds of payments: A large percentage of CHIPS payments originate in overseas markets that close earlier than the New York market because of time-zone differences; this means that CHIPS participants get their instructions from customers early in the day. Most Fedwire payments are domestic in origin, and customers continue to originate payment instructions throughout the day (even after Fedwire closes for the day in the case of west-coast customers).

The Reserve Banks could also apply differential pricing of daylight overdrafts to encourage earlier release of payments. Under this approach, daylight overdrafts that are incurred earlier in the day would cost less than those incurred in the afternoon. The precise formula would have to be worked out in such a way as to make the pricing formula understandable and, at the same time, have the desired effect. It is also clear that this differential pricing would not be a complete solution to this problem.

Some banks who tie up liquidity during the day may not be amenable to differential pricing. They usually do not run large daylight overdrafts, so pricing may not provide them with a clear incentive to move payments earlier in the day, if, indeed, they have any payments to make.

Increased Use of Collateral for Daylight Overdrafts and Different Pricing for Collateralized and Uncollateralized Overdrafts. The Board also reviews certain policy changes that could be implemented to reduce the risks to the Reserve Banks. These include “[g]reater use of collateral to cover daylight overdrafts coupled with two-tiered pricing.”¹⁸ These ideas were first exposed in the Board’s 2001 request for comment on the benefits and drawbacks of various policy options for its payment system risk policy.¹⁹

In our comment on that release, The Clearing House supported the greater use of collateral so long as (i) banks would be allowed to use discount-window collateral to

¹⁸ 71 Fed. Reg. at 35,683.

¹⁹ 66 Fed. Reg. 30,708 (Jun. 5, 2001).

secure daylight overdrafts; (ii) there would be no charges for collateralized daylight overdrafts; and (iii) the Reserve Banks revised the pricing mechanism to provide that a bank would run through its free, collateralized overdraft line before running into its uncollateralized, priced overdrafts.²⁰ At that time, the Board acknowledged this comment, but deferred further consideration.²¹

The Clearing House continues to believe that the policy changes to the Board's collateral and pricing policies outlined in our 2002 letter would yield substantial benefits. It would encourage banks to make payments earlier in the day, thus conserving liquidity and reducing risk to the Reserve Banks. Greater liquidity would also mean greater flexibility in dealing with any crises that may occur toward the end of the day. It would also allow banks to put to productive use one of their greatest underutilized assets: discount-window collateral.

We urge the Board to seriously consider this option and to formulate a solid proposal and put it out for public comment so that all the issues regarding the expanded use of collateral and differential pricing can be fully vetted in the public-comment process.

Intraday Funds Market. The Board also requests comment on possible market changes to foster an intraday fed funds market that would allow institutions to exchange intraday liquidity.²²

The Board has been discussing the development of an intraday funds market for many years (at least since the mid-1980s), and there was some discussion that pricing of daylight overdrafts (introduced in 1994) could lead to an intraday market. Yet such a market has never developed. Banks have occasionally done one-off intraday fed funds sales, more frequently since the change to the rules for crediting principal and interest payments of government-sponsored enterprises and international organizations in July 2006. Thus far, however, nothing like a robust intraday market has developed.

²⁰ Letter from Jeffrey P. Neubert, President and Chief Executive Officer, N.Y. Clearing House Assoc., to Board of Governors of the Federal Reserve System (Feb. 12, 2002), available at http://www.theclearinghouse.org/reference/comment_letters/2002cl/000451.pdf.

²¹ 67 Fed. Reg. 54,424, 54,426 (Aug. 22, 2002) (“the Board will continue to analyze the benefits and drawbacks of two-tiered pricing, taking into consideration the issues raised by commenters”).

²² 71 Fed. Reg. at 35,682.

Our member banks do not believe that a robust, formal intraday funds market would be feasible because the economics of such a market would make it very unattractive for banks. First, there would be a very costly infrastructure to set up and maintain. Second, banks would have to establish agreements on what each party's obligations and rights would be in an intraday sale of fed funds. Third, banks would have to set up comprehensive tracking systems so that they could tell when intraday fed funds were delivered and received. Finally, rules would have to be established for compensation for late deliveries, returns, and fails. Add to this the fact that the service would have to be priced below the Reserve Banks' fee for daylight overdrafts. In short, while our member banks find the idea of an intraday funds market to be an interesting concept that they would like to support, because of the high cost of maintaining a presence in an intraday funds market and the limited revenues it would generate, it does not seem likely that banks could make money in this market, and without the prospect of profits, no bank will make the expenditures necessary to get the market off the ground.

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We hope these comments are useful. If you have any questions, please contact Joseph R. Alexander, Senior Counsel, at joe.alexander@theclearinghouse.org or 212-612-9334.

Very truly yours,

A handwritten signature in dark ink, appearing to read "J. Alexander", written in a cursive style.