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Statement of the Shadow Financial Regulatory Committee

on

Federal Reserve Proposals to Modify the Payments System Risk Reduction Program

September 18, 1989

In mid-June the Federal Reserve Board issued for public comment proposals to change its large-dollar payment system risk policy. According to the Federal Reserve, the primary objective is to reduce risk to the payments system and to the Federal Reserve due to large overdrafts on its Fedwire system. Such risk occurs because the Federal Reserve guarantees all Fedwire payments as "final."

The Federal Reserve proposes levying a fee of 25 basis points (annual rate) on average overdrafts on the Fedwire system that exceed a specified minimum.

The Committee believes this fee is not high enough to alter significantly the payments risk the Federal Reserve now faces. The proposed fee does not accurately reflect relevant credit costs and is not responsive to differences in insolvency risk. A preferable role for the Federal Reserve is to act as a "switch" in providing payment services, providing real-time clearing against "collected" funds only. An important goal of a fee schedule imposed on the Fedwire system by the Federal Reserve should be to avoid deterring the private sector from creating an alternative clearing and payments system.

This statement concentrates on pricing issues contained in the Federal Reserve proposal and concludes

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that problems of Fedwire mispricing are far from resolved. In addition, it reflects the Committee's doubt that significant risk reduction will be achieved.

Background. Fedwire is a large-dollar funds transfer clearing mechanism through which final settlement takes the form of credits and debits to reserve accounts held by banks at Federal Reserve Banks. During the course of a business day, considerable mismatching occurs in the timing of funds transfers and securities transactions, which often results in the extension of substantial intraday credit by the Federal Reserve. In recent years the Federal Reserve has undertaken to reduce the amount of intraday credit it extends by placing caps on the amounts of intraday credit available to individual banks. In turn, observance of cap constraints has prompted banks to monitor more closely intraday positions and undertake adjustments as needed.

The Federal Reserve now proposes to augment its program by levying a fee of 25 basis points (annual rate), phased in over three years in steps of 10, 10, and 5 basis points, for average intraday overdrafts on the Fedwire that exceed a deductible of 10% of capital as calculated under the new risk-adjusted method. The price and overdraft program affects primarily the largest Fedwire participants. According to the Federal Reserve, the 15 largest bank sources of overdrafts would pay almost 90% of the total proposed charges.

Analysis. In effect, the Federal Reserve's current operation of Fedwire provides, at public expense, interest-free credit plus (because payments are final) guarantees against insolvency. We calculate, using data furnished by the Federal Reserve and assuming an 8% federal funds rate, that the subsidization implied on the credit on funds transfers alone is on the order of $750 million annually.[1] To be complete, provision also should be made for the counterpart payment of interest on intraday credit balances. Indeed, it would not be inappropriate under the circumstances to consider the broader issue of payment of interest on Federal Reserve credit balances generally.

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[1] Calculated as 251/365 (average in number of days) x 9/24 (hours per day) x 8/100 (the federal funds rate) x $37.3 billion (measured overdrafts).

Under the Monetary Control Act of 1980, Federal Reserve payments services, including interest on items credited prior to collection, must fully reflect relevant costs. The current pricing proposal does not respond adequately to this requirement. Indeed, the Federal Reserve proposal does not provide information on how it concluded that a charge of 25 basis points is reasonable.

The 25 basis-point charge (to say nothing of the smaller phase-in increments) appears small when compared with existing pricing arrangements. One is the 100 basis-point fee now assessed by banks to brokers for intraday loans. Another is the overnight penalty rate on Federal Reserve overdrafts of the greater of 10 percent or the federal funds rate plus 2 percentage points. The subsidy will remain. At a minimum, pricing should reflect the overnight federal funds rates.

Moreover, no provision is made in the Federal Reserve proposal for differences in insolvency risk: one price fits all. Under the proposed cap program, it is unlikely that the Federal Reserve (and taxpayers) will be adequately compensated for bearing insolvency risk. This suggests at the very least the need for lower caps and for substantially improved risk evaluation programs, combined with early closure of insolvent institutions (see this Committee's Statement 41).

A preferable role for the Federal Reserve in payments services -- one resolving the subsidization questions posed here -- is to act as a "switch," providing real-time clearing only against collected funds. This would entail additional private-sector investment in technological capacity (including payments queueing facilities) and risk monitoring. Such a switching role would not foreclose discount window access.

Alternatively, if the Federal Reserve's current role in the payments system is to continue, it should more closely mimic market behavior. Subsidization of credit and insolvency risk will remain large if the proposed pricing is adopted.