



FEDERAL RESERVE BANK *of* NEW YORK

# The Federal Reserve's Role as Credit Provider

Payment System Policy and Oversight Course  
May 16, 2016

# Agenda

- Intraday Credit
  - Purpose and Overview
  - Payment System Risk (PSR) Policy
    - Objectives and Scope
    - PSR Policy Tools
    - Peak and Average Daylight Overdrafts
  
- Overnight Credit
  - Discount Window (DW) Basics
    - Governance
    - Facilities
    - Reasons for Borrowing
    - Acceptable Collateral
  - Public Disclosure
  - Crisis Initiatives



# Intraday Credit: Purpose and Overview

- The Federal Reserve may allow institutions that are account holders to use intraday credit or “daylight overdrafts”
  - Purpose/Objective of providing intraday credit is to ensure smooth functioning of the overall payment system
  - Daylight overdrafts result when an institution’s Federal Reserve account balance becomes negative at any time during the Fedwire operating day (21.5 hours, 9:00 pm to 6:30 pm ET)
  - Last major revisions to the PSR policy were in March 2011



# PSR Policy Objectives and Scope

- The PSR Policy is a Federal Reserve Board policy
- Objective:
  - To foster the safety and efficiency of payment, clearing, settlement, and recording systems and to promote financial stability more broadly
- Scope:
  - Part I: sets out the Board's views, and related standards, regarding the management of risk in financial market infrastructures, including those operated by the Reserve Banks
  - Part II (focus):
    - Outlines the general methods used by the Federal Reserve to control intraday credit exposures
    - Governs the provision of intraday credit, or "daylight overdrafts," in Federal Reserve accounts



# PSR Policy Tools

- Net debit caps
- Pricing
- Collateral
- Monitoring and Counseling



# PSR Policy Tools: Net Debit Caps

- What is a net debit cap?
  - The maximum dollar amount of collateralized and uncollateralized daylight overdrafts an institution may incur in its Federal Reserve account at any point in the Fedwire operating day
- How is the cap calculated?
  - Net debit cap = cap multiple x capital measure
  - Max cap = net debit cap + additional collateralized capacity
- How is the cap category determined?
  - Unhealthy depository institutions (DIs) – zero cap assigned
  - Entities without regular access to the DW – zero cap assigned
  - Healthy DIs – exempt, de minimis, or “self-assessed” cap



# PSR Policy Tools: Net Debit Caps (continued)

Cap Categories	Cap Multiples	Key Facts
Zero	0	<ul style="list-style-type: none"> <li>Used for unhealthy DIs and entities w/out regular access to the DW</li> <li>Daylight overdrafts not allowed</li> <li>Other risk controls apply</li> </ul>
Exempt	\$10M or .20	<ul style="list-style-type: none"> <li>The lesser of \$10M or 20% of the capital measure</li> <li>No documentation from DI or renewal needed</li> <li>For small users of intraday credit</li> </ul>
De minimis	0.40	<ul style="list-style-type: none"> <li>Requires annual board of directors resolution</li> </ul>
Average	1.125	<ul style="list-style-type: none"> <li>Three caps referred to as “self-assessed”</li> <li>Require annual self-assessment and board of directors resolution</li> <li>Eligible to apply for additional capacity, above the net debit cap (max cap)</li> </ul>
Above-average	1.875	
High	2.25	



# PSR Policy Tools: Pricing

- Voluntary collateralization regime for intraday credit
  - No fee assessed for fully collateralized daylight overdrafts
  - Fee for uncollateralized daylight overdrafts provides incentive to pledge collateral
    - 50bps (annual rate) fee assessed for uncollateralized daylight overdrafts
    - Fee based on daily average uncollateralized overdraft amount
    - Fee waiver of \$150
- The majority of daylight overdrafts are collateralized



# PSR Policy Tools: Collateral

- The Federal Reserve accepts a wide range of assets as collateral:

Securities (Investment Grade)	Loans
US Treasuries and Agencies	Commercial Loans
Foreign Sovereign Debt*	Commercial Real Estate
Corporate Bonds*	1-4 Family Mortgage Loans
Municipal Securities*	Consumer Loans
Asset-Backed Securities	Agency Guaranteed Loans
Agency Mortgage-Backed Securities	
CDOs, CMBS, Private-Label CMOs (AAA)	

\* Foreign currencies: Japanese Yen, Euro, Australian Dollar, Canadian Dollar, British Pound, Danish Krone, Swedish Krona, and Swiss Franc.

- Collateral pledged for PSR purposes is margined based on a published table, which is typically updated each year
- Collateral eligibility and margins are the same for the DW
- Unencumbered collateral provides pricing relief for daylight overdrafts



# PSR Policy Tools: Collateral (continued)

- For risk control purposes:
  - Collateral may be required from problem institutions and institutions with poor policy compliance to serve as a:
    - Safeguard against impermissible overdrafts
    - Control in conjunction with permissible overdrafts
  - Collateral may also be required from certain types of institutions that do not have access to the DW
    - Bankers' banks
    - GSEs
    - Edge and agreement corporations
    - International organizations



# PSR Policy Tools: Monitoring

- When an institution exceeds its net debit cap, it is called a “cap breach”
  - Cap breaches are generally monitored and researched on an ex post basis
  - Cap breaches are a violation of the PSR policy
- The Federal Reserve has a number of tools available to manage the risks presented by cap breaches, especially for problem institutions
  - Monitor account balance in real time and set limit on size of daylight overdrafts permitted or require collateralization
  - Set account balance threshold at zero and require transactions to be pre-funded
  - In the most extreme case, the Federal Reserve can close the account, although we strive to find a solution that allows the Federal Reserve to manage the risks while continuing to provide services

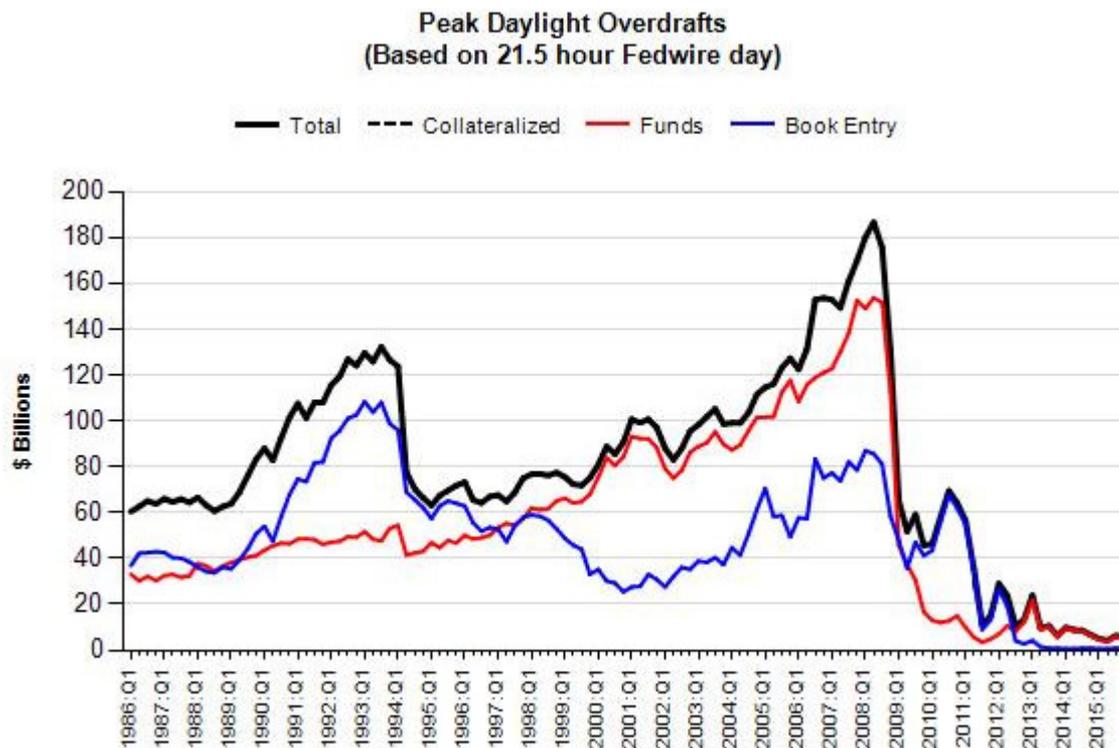


# PSR Policy Tools: Counseling

- The Federal Reserve can take a series of actions called “counseling” aimed at deterring future policy violations
  - Type of counseling depends on a number of factors
  - If breaches continue, the issue may be escalated
    - In some cases, institutions with zero caps may apply for daylight overdraft capacity
- Note: daylight overdrafts that are not funded by the close of Fedwire become overnight overdrafts and are charged a much higher fee

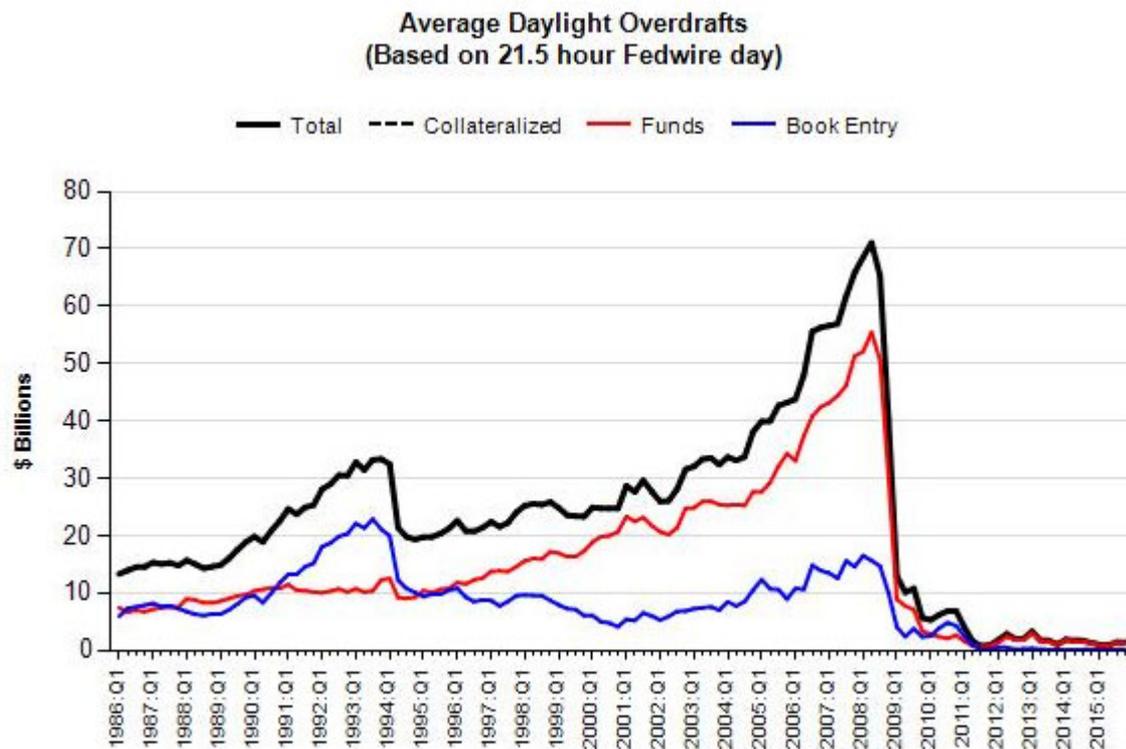


# Peak Daylight Overdrafts



Source: [http://www.federalreserve.gov/paymentsystems/psr\\_data.htm](http://www.federalreserve.gov/paymentsystems/psr_data.htm)

# Average Daylight Overdrafts



Source: [http://www.federalreserve.gov/paymentsystems/psr\\_data.htm](http://www.federalreserve.gov/paymentsystems/psr_data.htm)



**Overnight Credit:  
The Discount Window**

# Discount Window Basics

- The DW functions as a safety valve in relieving pressures in reserve markets; extensions of credit can help relieve liquidity strains on a DI and in the banking system as a whole
- The DW also helps ensure the basic stability of the payment system more generally by supplying liquidity during times of systemic stress

# Discount Window Basics: Governance

- Board of Governors
  - Determines general policies
  - Reviews proposed DW rate changes
- Individual Reserve Banks
  - 12 regional Banks
  - Boards of Directors propose DW rate changes
  - Each has autonomy in lending and collateral decisions as they bear their own risk exposure
- Subcommittee on Credit Risk Management (SCRM)
  - Promotes consistency and coordination across Reserve Banks
- Section 10B of the Federal Reserve Act authorizes Reserve Banks to make extensions of credit to DIs



# Discount Window Basics: Facilities

<b>Primary Credit</b> For healthy banks	<ul style="list-style-type: none"><li>• Generally, no questions asked</li><li>• Penalty rate over fed funds target (currently 100 bps)</li><li>• Provide temporary liquidity</li><li>• Arbitrage is ok</li></ul>
<b>Secondary Credit</b> For troubled banks	<ul style="list-style-type: none"><li>• Questions may be asked</li><li>• Penalty rate over primary credit rate (currently 150 bps)</li><li>• Provide short-term funding when other sources of funds are not available at a reasonable rate</li></ul>
<b>Seasonal Credit</b> For <u>small</u> banks with seasonal funding needs	<ul style="list-style-type: none"><li>• Discount rate (currently 45 bps)</li><li>• Longer-term funding over periods of seasonal need (up to 9 months)</li><li>• Mostly small banks in agricultural regions with deposits less than \$500 million</li></ul>

# Discount Window Basics: Reasons

- Typical reasons for borrowing
  - To meet liquidity needs due to unexpected outflows of funds from an institution's Reserve account
  - Operational problems
  - Arbitrage opportunities
  - To satisfy reserve requirements
  - As a test to validate borrowing processes and loan applications
  - Institution cannot access funding markets due to financial condition



# Discount Window Basics: Acceptable Collateral

- Recall: collateral eligibility and margins are the same for the DW and PSR purposes
- Mandatory collateralization:
  - All DW loans must be fully collateralized
- Acceptable collateral:

Securities (Investment Grade)	Loans
US Treasuries and Agencies	Commercial Loans
Foreign Sovereign Debt*	Commercial Real Estate
Corporate Bonds*	1-4 Family Mortgage Loans
Municipal Securities*	Consumer Loans
Asset-Backed Securities	Agency Guaranteed Loans
Agency Mortgage-Backed Securities	
CDOs, CMBS, Private-Label CMOs (AAA)	

\* Foreign currencies: Japanese Yen, Euro, Australian Dollar, Canadian Dollar, British Pound, Danish Krone, Swedish Krona, and Swiss Franc.

# Dodd-Frank Act: Public Disclosure

- Dodd-Frank Act signed into law in July 2010
- The law requires public disclosure of DW loan and collateral information at the individual borrower level on a two-year lag
  - Stigma impacts

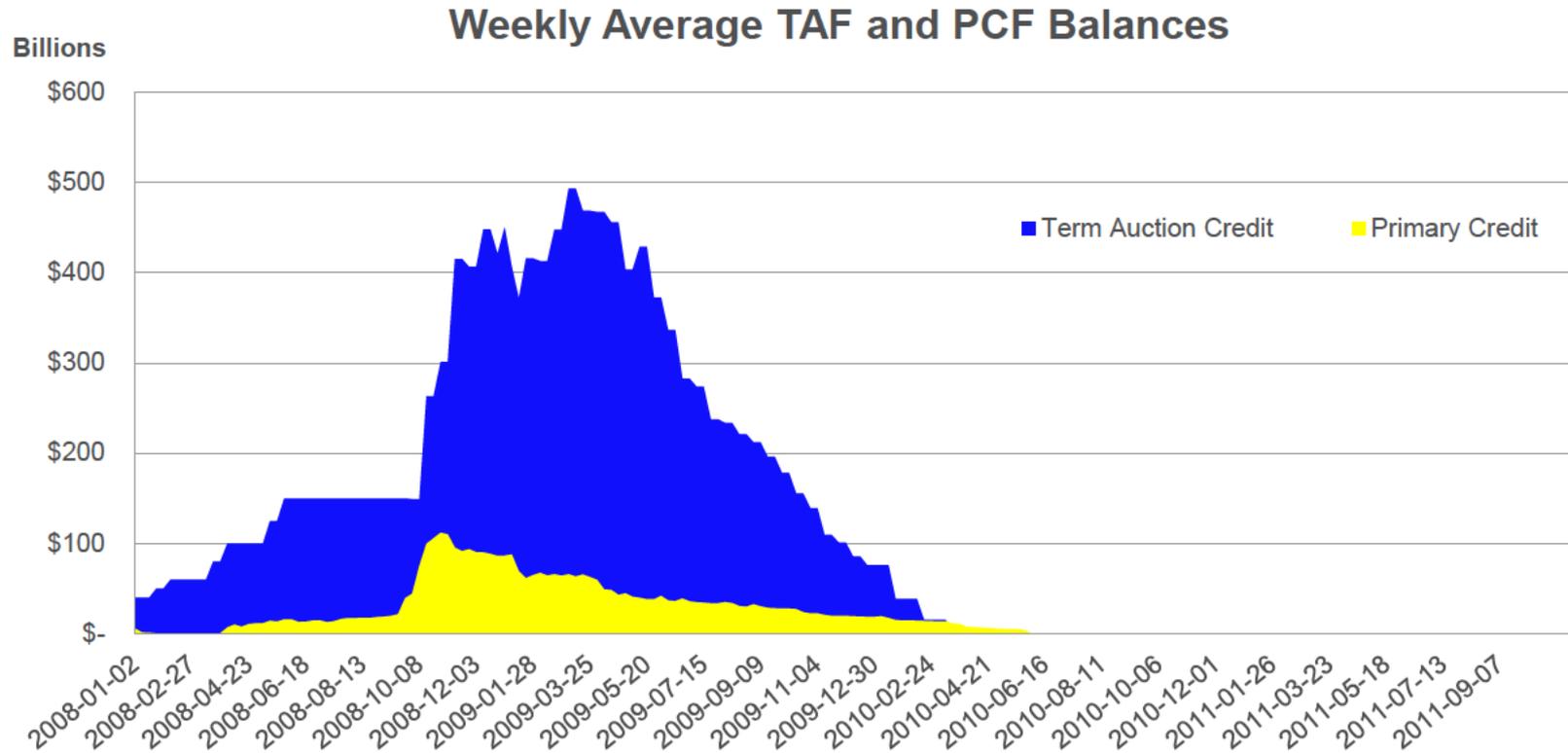


# Crisis Initiatives

- Term DW lending
- Rate cuts
- Term Auction Facility (TAF), creation and expansion



# Crisis Initiatives: DW & TAF Borrowing



Source: H.4.1. Report, Factors Affecting Reserve Balances

# Resources

- System Discount Window Website  
<http://www.frbdiscountwindow.org>
- New York Discount Window Website  
<http://www.newyorkfed.org/banking/discountwindow.html>
- Discount Window Margins Table  
<http://www.frbdiscountwindow.org/discountmargins.xls>
- Collateral Eligibility Guidelines  
<http://www.frbdiscountwindow.org/FRcollguidelines.pdf>
- Lending Details (Quarterly, with 2-year Lag)  
[http://www.federalreserve.gov/newsevents/reform\\_discount\\_window.htm](http://www.federalreserve.gov/newsevents/reform_discount_window.htm)