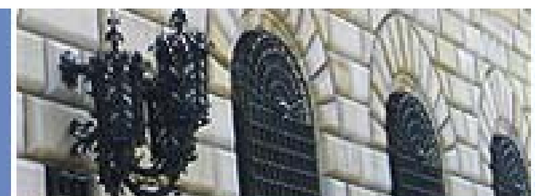
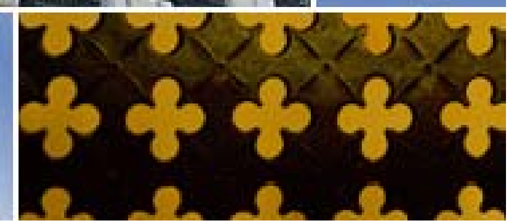
Federal Reserve Payment System Oversight: Recent Developments and Prospects





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Recent Developments and Prospects: Highlights

- U.S. Department of the Treasury's "Blueprint for a Modernized Financial Regulatory Structure"
- Innovations in Federal Reserve liquidity provision

“Blueprint” Recommendation

- Payment and Settlement Systems Oversight
  - “[A] federal charter for systemically important payment and settlement systems should be created and should incorporate federal preemption. The Federal Reserve should have primary oversight responsibilities for such payment and settlement systems, should have discretion to designate a payment and settlement system as systemically important, and should have a full range of authority to establish regulatory standards.”

Current Situation

- Federal Reserve has broad objectives and interests in the payments system
- Federal Reserve uses a variety of tools to address these broad interests
- Gaps in our current oversight “authority”
  - Current “authority” is derived from other authorities
  - No explicit mandate to address systemic risk in the payment system
  - No explicit authority to collect oversight information
  - No explicit authority to oversee systemically important organizations

Possible Statutory Framework

- Explicit Federal Reserve oversight mandate
  - To promote safety and soundness of the payment system
- Authority to compel and to protect "oversight" information
  - To identify payment and settlement activities of potential "systemic importance"
  - Collected from individual financial institutions and special-purpose utilities
- Authority to designate activities/organizations "systemically important"
  - Conducted by individual financial institutions and/or special-purpose utilities
- Authority to set standards and requirements
  - For designated "systemically important" activities and organizations
- Authority to enforce standards and requirements
  - Via direct Fed authority or through other supervisors/regulators
  - Employ the full range of supervisory/regulatory tools (e.g., approvals, penalties, MOUs, cease and desist orders)
- Authority to grant access to Federal Reserve accounts, services, intra-day credit, and lending facilities, as appropriate
  - In support of designated "systemically important" activities and organizations
- New Fed charter for special-purpose payment and settlement utilities
  - Subject to exclusive Federal Reserve supervision/regulation/oversight

Issues and Challenges in Developing a Statute

- Defining “systemic risk” and “systemic importance”
  - More qualitative than quantitative
  - Will evolve over time
- Determining the scope of authority to collect information
  - Will need to be broad and flexible, yet not unlimited
- Setting and enforcing standards and requirements
  - Potential regulatory overlap
    - Many systemically important activities are carried out by individual financial institutions that are not under exclusive Fed authority
  - Will need to set respective regulatory roles/authorities/relationships
- Treatment of major utilities for retail payments
  - Crucial for the economy, but not necessarily “systemically important”

Innovations in Federal Reserve Liquidity Provision

- Federal Reserve introduced a series of changes since August 2007 to help improve market liquidity and overall market functioning
  - Substantial modification of the discount window (DW)
  - Introduction of four new lending facilities
    - Term Auction Facility (TAF)
    - Primary Dealer Credit Facility (PDCF)
    - Term Securities Lending Facility (TSLF)
    - TSLF Options Program (TOP)
- These initiatives alter several dimensions of the Fed's liquidity facilities:
  - Lengthen the duration of access to liquidity
  - Broaden the types of eligible collateral
  - Expand the range of eligible counterparties for some activities
  - Reduce the cost of borrowing from the Fed relative to the Federal Funds rate
- Eligible depository institutions and primary dealers now have access to two complementary types of facilities.

Facilities for Depository Institutions

- Discount Window
  - Available every business day
    - Designed to ensure that sound depository institutions can meet their funding needs, even if those needs occur unexpectedly or late in the day.
  - From January 2003 to August 2007
    - Overnight borrowing rate was set at 100 basis points over the targeted federal funds rate
  - August 17, 2007
    - Maximum term for borrowing was extended to 30 days
    - DW loan became renewable at the request of the borrower
    - “Penalty” spread was lowered to 50 basis points
  - March 16, 2008
    - Maximum term for borrowing was extended to 90 days
    - “Penalty” spread was further reduced to 25 basis points

Facilities for Depository Institutions

- Term Auction Facility
  - Established on December 12, 2007
  - Provides term funding through an auction to the same eligible DI's, secured by the same DW-eligible collateral
  - Term of initial lending facility set at 28 days
  - On July 30, 2008, Fed added an additional 84-day term lending facility
- TAF versus Discount Window
  - Total amount of funds available at any TAF auction is set and announced in advance by the Fed, rather than at the request of the borrowers
  - The TAF borrowing rate is variable, as determined by competitive auction
  - Limits are imposed on the share of available funds an individual DI can bid for in the TAF auction
  - Unlike DW, TAF is not designed to satisfy a DI's immediate need for funding
    - DW funds are paid on the day they are requested
    - TAF auctions are held on a Monday or Tuesday, for payment on Thursday
  - In TAF, DIs can only bid up to 75% of their pledged collateral value
    - Designed to ensure DIs have continued ability to borrow at the DW, if needed

Facilities for Primary Dealers

- Primary Dealer Credit Facility
  - The Fed conducts open market operations (OMO) with a set of banks and securities firms that constitute the Fed's designated "primary dealers"
  - The PDCF was established on March 16, 2008, following a Fed determination that "unusual and exigent circumstances" existed in financial markets
    - This included a severe lack of liquidity that threatened to impair the functioning of a broad range of markets
  - On July 30, 2008, the Fed extended the PDCF until at least January 30, 2009
- PDCF is similar in spirit to the DW facility
  - The amount of funds being lent is determined at the request of the borrower
  - The PDCF interest rate is equal to the DW rate
  - The PDCF is available every day to address an immediate need for funding
- Why PDCF?
  - Poor liquidity conditions might limit the ability of a dealer to fund certain classes of its securities holdings in the broader repo market
  - In this situation, the PDCF will help to prevent the forced sale of such securities by providing the dealer with temporary financing
  - By granting dealers access to such funding, the PDCF is intended to improve market liquidity and to encourage dealers to continue to make markets and provide credit to customers

Facilities for Primary Dealers

- Term Securities Lending Facility
  - Established on March 11, 2008
  - Acts as a term lending facility for primary dealers
- TSLF is an auction facility
  - Unlike TAF, which auctions ***funds*** in exchange for securities, the TSLF auctions ***securities*** in exchange for securities
    - TAF allows dealers to offer relatively illiquid securities as collateral in exchange for a loan of US Treasury securities
  - TSLF loan is for 28 days
  - The rate on the loan is set through a competitive auction process
    - As with the TAF auctions, there is a minimum bid rate and limits are imposed on the share of the auction available to each winning bidder

Facilities for Primary Dealers

- TSLF Options Program (TOP)
  - The newest facility, announced on July 30, 2008
  - The Fed will auction options that give the buyer the right to borrow under the TSLF at a fixed fee of 25 basis points
    - The option can be exercised over short periods of traditional collateral market dislocation, such as at the end of a quarter
  - While the price of the loan is fixed, the price of the option is determined through an auction
  - The first auction was conducted August 27, and the second auction is being conducted today, September 10
  - Both of these auctions offer options on TSLF loans that can be exercised over the September quarter-end
    - Winning bidders will have the right to initiate a 7-day TSLF loan on September 24
  - The terms and conditions for a TOP that will cover the December year-end will be announced by November 3
    - This will allow an evaluation of the results from the September operation before finalizing year-end terms
    - The Fed has not yet committed to offering TOP options other than for the September quarter-end and the December year-end
    - However, other periods may be considered based on auction results and market conditions.

Innovations in Federal Reserve Liquidity Provision

- Outlook
  - The Federal Reserve will keep this new array of liquidity facilities in place for as long as is necessary
  - The Federal Reserve will also continue to consult with market participants and will adapt these facilities as necessary to enhance their effectiveness as market conditions evolve