

MEMO# 5773

April 11, 1994

DAYLIGHT OVERDRAFT PRICING

April 11, 1994 TO: ACCOUNTING/TREASURERS COMMITTEE NO. 16-94 INVESTMENT ISSUES COMMITTEE NO. 7-94 MEMBERS - ONE PER COMPLEX NO. 24-94 RE: DAYLIGHT OVERDRAFT PRICING

In the 1980's the Federal Reserve Board (the "Board") developed a payments system risk reduction program designed to reduce both the direct risk to the Federal Reserve of overdrafts at Reserve Banks and systemic risk stemming from the failure of a participant on a private large-dollar transfer network. In 1985, the Board established a policy of capping net intraday ("daylight") overdrafts of depository institutions. The Board adopted refinements to its policy in 1987 and 1990. Currently, depository institutions establish a maximum amount of intraday overdrafts that they may incur in their account at the Reserve Banks. This maximum, or net debit cap, is a multiple of a depository institution's risk-based capital and is based on the institution's assessment of its own creditworthiness, credit policies and operational controls. The self-assessment is done using guidelines established by the Board and is reviewed by the institution's primary supervisory agency examiners. Effective April 14, 1994, the Board is adopting a new component to its payments system risk reduction program, under which Reserve Banks will charge a fee for average daily intraday overdrafts in reserve and clearing accounts. The fee will be phased-in over a three year period. Under the current 10-hour Fedwire operating day, beginning on April 14, 1994, the fee will be 10 basis points (on an annual basis), rising to 20 basis points on April 13, 1995, and 25 basis points on April 11, 1996. The average daily overdraft will be calculated by dividing the sum of the negative reserve or clearing account balances at the end of each minute of the scheduled Fedwire operating day (with positive balances set to zero) by the total number of minutes in the scheduled Fedwire operating day. The Board has provided a de minimis level of free overdrafts by incorporating a deductible into its pricing policy. The deductible is an amount equal to 10 percent of the risk-based capital used by the institution in calculating its net debit cap. The gross fee will be reduced by the amount of the deductible, valued at the daylight overdraft fee for a 10-hour operating day. If you have not already done so, we urge you to contact your custodian bank(s) to discuss the potential impact of the Reserve Banks' daylight overdraft charges on your custody arrangement. We understand that some custodian banks have communicated to clients an intention not to pass daylight overdraft charges along to clients while others may consider passing charges only to clients to whom the bank's intra-day overdraft with its Federal Reserve bank can be attributed. Many funds and custodian banks are working cooperatively with their clients to minimize or prevent the occurrence of daylight overdrafts. One particular issue that you may want to address with your custodian bank(s), and with the dealers with whom your funds conduct repurchase agreements, is the impact of daylight overdrafts caused by the return of collateral on repurchase agreements. Collateral is ordinarily returned early in the day to the dealer's clearing bank triggering payment of the repurchase agreement proceeds to a fund's

custodian bank. The payment of the repurchase proceeds may create a negative balance in the dealer's account at the clearing bank. The negative balance will not be covered until the collateral as been reassigned to current day repurchase agreements. The dealer's clearing bank may pass the resultant daylight overdraft charges on to the dealer who will need to determine how to eliminate or cover these additional costs. Some dealers have approached fund groups with the following requests/solutions: 1. return collateral to the dealer's clearing bank later in the day 2. use triparty repos where the fund enters into an agreement with a dealer and a clearing bank so that all cash and securities movements take place within the clearing bank It has been suggested that the Institute hold a meeting to assure that members are fully informed about this matter and to take stock of members' experience in preparing for and adapting to the Fed's new daylight overdraft pricing policy. We would appreciate your returning the attached form to Diane Butler, Director - Operations & Fund Custody at fax # 202/326-5841 to help us determine the need for such a meeting. In any case, we will monitor this issue and keep you informed of developments. Thank you for your attention to this matter. Donald J. Boteler Vice President - Operations

Attachment INVESTMENT COMPANY INSTITUTE Daylight Overdraft Pricing [] Yes, I believe a meeting is necessary and I would either attend or send someone. [] No, I believe a meeting is not necessary at this time. NAME FIRM TELEPHONE Please return to: Diane Butler Director - Operations & Fund Custody FAX: 202/326-5841

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