360 Madison Avenue
New York, NY 10017-7111
Telephone 646.637.9200
Fax 646.637.9126
www.bondmarkets.com

1399 New York Avenue, NW
Washington, DC 20005-4711
Telephone 202.434.8400
Fax 202.434.8456

St. Michael's House
1 George Yard
London EC3V 9DH England
Telephone 44.20.77 43 93 00
Fax 44.20.77 43 93 01

THE BOND MARKET ASSOCIATION

April 16, 2004

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

RE: Docket No. OP-1182, Policy Statement on Payments System Risk

The Bond Market Association ("we" or the "Association"[1]) appreciates the opportunity to comment on the proposed changes by the Federal Reserve Board to its Payments System Risk (PSR) policy, specifically its proposal to release interest and redemption payments on securities issued by government-sponsored enterprises (GSEs) and international organizations only when the issuer's Federal Reserve account contains sufficient funds to cover such payments (referred to herein as the "PSR Policy Proposal").[2] The Association believes that, without substantial changes in the manner in which the financial markets operate today, the implementation of the PSR Policy Proposal would have a severe and adverse market impact. Given the numerous implications of the PSR Policy Proposal, the Association sets forth below some initial recommendations as to how to potentially mitigate such market impact, including the gradual implementation of the PSR Policy Proposal starting in July 2006. In addition, were the Federal Reserve to form a working group to address the issues raised by the implementation of the PSR Policy Proposal, the Association strongly recommends that such group involve representatives from all affected market participants, including dealers, investors, depository institutions, and the GSEs.

---

[1] The Association represents securities firms and banks that underwrite, distribute and trade fixed-income securities, both in the U.S. and globally. The Association's member firms are actively involved in the government and agency, funding and MBS markets. This letter was drafted based on the input of members of the Association's PSR GSE Task Force. Further information regarding the Association and its members and activities can be obtained from our web site (www.bondmarkets.com).

[2] The Association is not commenting at this time on the proposed alignment of treatment of GSEs and certain international organizations with the treatment of account activity of other account holders that also do not have regular access to the Federal Reserve's discount window in connection with these entities' general corporate payment activity, as set out in the PSR Policy Proposal.

Potential Impact of the PSR Policy Proposal

Background

The current extension of intraday credit by the Federal Reserve to the GSEs early in the trading day serves a crucial role in ensuring the orderly functioning of the financial markets and preventing systemic risk. By allowing all principal and interest (P&I) and redemption payments to be made by the GSEs on their securities every morning of every trading day, such extension of intraday credit provides a reliable and substantial injection of liquidity early in the day. More specifically, the predictable payment of P&I and redemption funds by GSEs early in the day ensures that market participants will have access to intraday funds needed to meet their financial obligations. In addition, given the relatively light flow of funds into depository institutions early in the trading day, such injection of liquidity helps counteract the level of overdrafts that would otherwise occur at depository institutions during this time as a result of the payments of funds and delivery of securities.

The magnitude of the potential impact of the PSR Policy Proposal is highlighted by the enormous amount of liquidity currently provided by the payment of P&I and redemption payments on GSE-issued securities. Based on conversations with the Federal Reserve, it is our understanding that the average daily amount of intraday liquidity currently extended to the GSEs and international organizations to support their P&I and redemption payments total approximately $18 billion and that such amount reached a high of ***$145 billion*** on at least one trading day in 2003. Further, based on publicly available data on and discussions with GSEs, the Association estimates that average daily payments from three GSEs alone total approximately $40 billion.[3] It is apparent from these figures that, while the intraday liquidity needs of the GSEs may vary widely from day to day, a substantial amount of intraday liquidity is needed on even an "average" trading day to support their P&I and redemption payment activity.

The Association believes that the withdrawal of intraday liquidity currently provided by the Federal Reserve to support the large influx of P&I and redemption payments early in the trading day, as contemplated by the PSR Policy Proposal, may generally precipitate two alternate results, depending on the manner in which GSEs adapt to the PSR Policy Proposal.[4, 5] As described in more detail below, given the manner in which the markets currently operate, both alternatives would give rise to significant problems.

---

[3] Source: Fannie Mae 2003 Annual Report, Freddie Mac 2002 Annual Report, discussions with FHLB. Fannie Mae and Freddie Mac average daily P&I is calculated by taking the sum of annual payments "to redeem debt" and annual interest payments as reported in the "Statements of Cash Flow" in the annual reports and dividing that total dollar amount by 5 days and 50 weeks to account for holidays and other days in which agency transactions do not take place.

[4] At the time this letter was drafted, those GSEs the Association had contacted were still reviewing the PSR Policy Proposal in order to determine how they would adapt to the changes contemplated therein.

[5] We have not explored the potential impact of GSEs obtaining funding the night before each trading day to support P&I or redemption payments being made early the following morning; given the potential costs involved with this alternative, we believe it is highly unlikely GSEs will pursue this option.

Alternative 1 – GSEs Attempt to Make Payments Earlier in the Day by Looking to Alternate Funding Sources

As an initial matter, it is unclear whether sufficient capacity exists in the financial markets to enable GSEs to obtain sufficient intraday liquidity from private sources to support paying P&I and redemption payments at the start of the trading day in the amounts such payments are currently made. One measure to determine the amount of intraday liquidity potentially available to the GSEs through depository institutions is to view the total amount of reserves kept at the Federal Reserve by depository institutions, plus their overdraft capacity. According to publicly available data from the Federal Reserve, as of March 31, 2004, total reserve balances with the Federal Reserve Banks totaled slightly under $12 billion.[6] The overdraft capacity at any depository institution is proprietary and therefore unknown. However, given the substantial intraday liquidity needs of the GSEs on any given trading day, it is by no means clear whether – between reserve amounts and overdraft limits - sufficient capacity exists at the depository institutions to support the GSEs liquidity needs.

The availability of sufficient capacity in the financial markets to support the GSEs intraday liquidity needs may be further limited if the overdraft impact of the PSR Policy Proposal is concentrated in the larger depository institutions such as the larger custodians and the two clearing banks, instead of dispersed among a range of depository institutions. For example, in the event that the GSEs would look to obtain a substantial amount of intraday liquidity from the dealer community through a relatively limited number of the larger depository institutions, it is unclear whether sufficient total capacity (i.e. overdraft and reserve balances) would exist in such circumstances to accommodate the GSEs liquidity needs. It should also be noted that the overdraft capacity that the GSEs would have available to them would be further limited by overdraft capacity utilized as a result of normal market activity exclusive of the payment of P&I and redemption payments on GSE-issued securities which took place early in the day. As such, it is at best unclear whether sufficient capacity currently exists early in the day to allow the GSEs to obtain sufficient intraday liquidity to support P&I and redemption payments during such time.

Even if one assumes that sufficient capacity existed to support the intraday liquidity demands of GSEs early in the trading day, the level of overdrafts incurred would likely result in significant overdraft costs incurred by the depository institutions, which would be passed along to their participants. Such additional costs would be exacerbated by the fact that, as noted above, no offsetting influx of funds would exist to mitigate the overdraft impact of GSEs obtaining funds early in the trading day until the P&I and redemption payments such funds were supporting were made.

---

[6] H.3. Report, Table 2, "Aggregate Reserves Of Depository Institutions and the Monetary Base," available here: http://www.federalreserve.gov/releases/h3/Current/.

Alternative 2 – GSEs Make Payments Later in the Day

If GSEs were to delay making their P&I and redemption payments until later in the day when they obtained sufficient funds to support such payments, such actions would also potentially result in a number of adverse consequences. As an initial matter, market participants would no longer be able to access the significant amount of funds resulting from the start-of-day influx of P&I and redemption payments. Given the withdrawal of such a substantial amount of liquidity early in the trading day, it is at best unclear if financial institutions would be able to access alternate sources of liquidity in amounts sufficient to support their activities and meet their obligations at the start of a trading day. A lack of requisite liquidity would cause severely illiquid conditions to occur in the financial markets, and potentially "gridlock." Such gridlock, at worst, would render financial institutions unable to meet their financial obligations, raising the possibility of systemic risk. Even were such gridlock not to materialize, the fact that increased payment activity would take place later in the day also increases the possibility of overnight exposure to depository institutions, given the increased possibility of a market participant being unable to obtain requisite intraday funding to meet its financial obligations before the close of the trading day.

In addition, securities or funds transactions conducted earlier in the trading day before the delayed influx of P&I and redemption payments took place would likely have significant overdraft consequences at depository institutions, given that such payments would no longer be available at the beginning of the day to offset such overdrafts. In one potential scenario, the resulting illiquidity caused by the implementation of the PSR Policy Proposal (as described above), coupled with actions taken by the GSEs to obtain funding later in the day (e.g. settlement of securities), could cause even more severe overdraft consequences at depository institutions: such illiquid conditions at the start of the trading day would prevent the normal flow of funds into depository institutions, thereby eliminating the possibility that such funds could help offset the potentially severe overdrafts that GSE activity later in the day would cause. Further, similar to the capacity constraints GSEs may face in attempting to obtain funds earlier in the day as described above, it is again unclear under this scenario whether sufficient capacity would exist to accommodate their liquidity needs.

Recommendations for Mitigating the Market Impact of the PSR Policy Proposal

Changes in the Manner in Which P&I and Redemption Amounts are Paid Should be Accommodated

Currently, the extension of intraday credit by the Federal Reserve allows the combined total of all the GSE's and international organization's P&I and redemption payments to be paid out in one aggregate sum early in the trading day. As noted above, the size of such aggregate sum, while varying daily, is generally substantial. The payment of such a large amount of funds either early or later in the trading day, without the extension of intraday credit by the Federal Reserve, will likely result in a number of significant and adverse consequences as detailed above. As such, the Association believes that the

Federal Reserve must ensure that the necessary operational and systemic changes are made to allow GSEs to make P&I and redemption payments separate from one another, and further accommodate the ability of each GSE to separate payments by security or category of securities. In making such operational and systemic changes, the Federal Reserve should also examine the impact on its Repo Tracking functionality offered on the Fedwire, which currently applies to Fannie Mae, Freddie Mac and Ginnie Mae securities.[7]

We believe that allowing the GSEs to make separate P&I or redemption payments by GSE, and within each GSE by product type, as they obtain sufficient funds to support such separate payments, may mitigate the market impact the implementation of the PSR Policy Proposal would otherwise have by dividing – and thereby reducing the size of – such payments. Needless to say, to what extent such separation will take place will ultimately be dictated by how GSEs adapt to the implementation of the PSR Policy Proposal. However, we anticipate that this approach will be supported by market participants, including the GSEs, given its potential to mitigate the PSR Policy Proposal's potential adverse impact on the financial markets generally, and more specifically the marketplace for GSE-issued securities.

Phased-In Approach Starting on July 2006 is Necessary

As detailed above, the impact of the PSR Policy Proposal is likely to be severe unless significant changes in several areas of the financial markets are made. As such, the Association believes it is imperative that the Federal Reserve, starting in July 2006, phase in the implementation of the PSR Policy Proposal. Such phased-in implementation will allow the diverse array of market participants affected by the PSR Policy Proposal to better coordinate their response to the significant changes they will have to make in order to adopt to its implementation.

One possible phase-in approach would involve gradually pushing back the time at which intraday credit is extended by the Federal Reserve until it is ultimately withdrawn. During the phase in period under this approach, market participants would have an interim "safety net" that would ensure, at a minimum, that P&I and redemption payments would be made. By providing such safety net, this approach would allow market participants the ability to react to the implementation of the PSR Policy Proposal during the earlier part of the trading day while at the same time ensuring that P&I and redemption payments would ultimately be made. In addition, the GSEs and the Federal Reserve, as their fiscal agent, would be able to better gauge and address trading, operational, overdraft or payments system issues which may arise upon the withdrawal of intraday credit early in the trading day, while ensuring that a safety net is in place to prevent such issues from precipitating broader systemic problems.

---

[7] The Repo Tracking functionality credits depository institutions with the P&I on Fannie Mae, Freddie Mac and Ginnie Mae securities early in the trading day based on which repo buyers at such depository institutions hold such securities, and debits such amounts later in the trading day for payment to the appropriate depository institutions based on which repo sellers at such depository institutions repoed such securities to the repo buyer. Assuming that the PSR Policy Proposal will precipitate the separation of P&I payments as discussed above, the Repo Tracking functionality will also necessarily be impacted.

Any Working Group Formed under the Auspices of the Federal Reserve Should Include Broad Market Representation

If the Federal Reserve were to form a working group to identify and address the issues precipitated by the PSR Policy Proposal, as discussed above, the Association strongly recommends that such group be composed of representatives from all affected market participants, including the dealer community, depository institutions, GSEs and buy-side participants. These market participants could utilize the working group as a forum to ensure that the various market responses (e.g. market practice, operational, etc.) were conducted in a coordinated and transparent manner. Coupled with a gradual phase-in of the PSR Policy Proposal beginning in July 2006, such coordination could help ensure that any potential adverse market impact of the PSR Policy would be minimized.

Conclusion

As set out above, the implementation of the PSR Policy Proposal will likely precipitate a significant change in the manner in which market participants access the intraday liquidity necessary to engage in financial transactions and meet their financial obligations. Given the numerous implications the PSR Policy Proposal will likely have on a diverse array of market participants, the Association believes that the relatively brief comment period provided for the PSR Policy Proposal necessarily precludes the in-depth analysis that is needed to identify the numerous necessary changes to implement it in a manner designed to minimize its adverse market impact. However, we hope that the initial analysis that we have provided herein proves useful in addressing several of the issues raised by the PSR Policy Proposal. In this regard, the Association looks forward to continued dialogue with the Federal Reserve on the implementation of the PSR Policy Proposal.

The Association sincerely appreciates the opportunity to comment on the PSR Policy Proposal. If you have any questions, please do not hesitate to contact Nadine Cancell (646.637.9228 or ncancell@bondmarkets.com), Eric L. Foster (646.637.9222 or efoster@bondmarkets.com) or Omer Oztan at (646.637.9222 or ooztan@bondmarkets.com).

Sincerely,

Omer Oztan
Vice President
Assistant General Counsel

cc: Linda Knight, Senior Vice President/Treasurer, *Fannie Mae*
Louise Herrle, Vice President/Treasurer, *Freddie Mac*
Jamie Stewart, First Vice President, *Federal Farm Credit Banks Funding Corporation*
John Darr, Managing Director, *Federal Home Loan Bank Office of Finance*
Dara Hunt, Senior Vice President, *Federal Reserve Bank of New York*
Daryll Hendricks, Senior Vice President, *Federal Reserve Bank of New York*
Paul Bettge, Associate Director, *Federal Reserve Board*
The Bond Market Association

- Agency Committee
- Credit and Risk Committee
- Funding Division Executive Committee
- Government Division Executive Committee
- Government Operations Committee
- MBS/ABS Division Executive Committee
- MBS/ABS Division Operations Committee
- Primary Dealers Committee
- PSR GSE Task Force
- Selected Staff