JPMorgan

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Managing Director

April 16,2004

Jennifer J. Johnson
Secretary
Board of Governors of the Fcdcral Reserve System
20'"Street and Constitution Avenue, N.W.
Washington, D.C. 20551

RE: Policy Statement on Payments System Risk
<u>Federal Reserve Docket No. OP-1182</u>

Dear Ms. Johnson:

J.P. Morgan Chase & Co. ("JPMorgan"), appreciates the opportunity to comment on the Board's announced changes to its Policy Statement on Paymcnts System Risk (the "Policy"). The Policy changes: (1) modify the daylight overdraft posting rules for principal, interest and redemption payments ("Payments") on securities issued by entities for which the Reserve Banks act as fiscal agents but whose securities are not obligations of, or issued by, the United States ("GSEs") and certain international organizations; and (2) align the Policy's treatment of the general corporate account activity of GSEs with the treatment of account activity of other account holders that do not have regular access to the Federal Reserve's discount window. Our comments primarily relate to the first of the proposed changes.

We understand that, under the Policy changes, beginning in July 2006 the Reserve Banks will discontinue the current practice of posting Payments to depository institutions' Fcdcral Reserve accounts by 9:15 a.m. Eastern Time, regardless of whether the relevant GSE has fully funded its Payments. Instead, Reserve Banks will release Paymcnts only when a GSE's Federal Reserve account contains funds equal to or in excess of the Payments to be made. The Board has requested comment on how best to promote a smooth market adjustment while implementing this change. In particular, the Board has asked for comments on whether the Policy change should be filly implemented on a specified date or through a phased approach and, if the latter, what the specific structure and objectives of any suggested phased approach should entail.

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Background and Summary of Comments

JPMorgan strongly supports a phased approach ta implementation of the Policy change.

JPMorgan and its affiliates are significantly involved in the GSE markets and thus our comments are based on a breadth of experience at many levels. Through one of its US. broker dealers, J.P. Morgan Securities Inc., JPMorgan is involved in the underwriting of and dealing in GSE issues. JPMorgan's flagship banking subsidiary, JPMorgan Chase Bank (the "Bank"), invests in GSE securities for its own account and acts as an agent on behalf of its custody and securities lending customers who purchase and lend GSE securities. As one of the two primary U.S. clearance banks, the Bank also acts as a clearance agent for dealers and investors in GSE securities. And in conjunction with its clearance business, the Bank acts as a triparty repurchase custodial agenl for such clients in GSE securities.

The Board has acknowledged that various Policy changes implemented in the past, over time, have had desirable effects on market behavior, promoting a more orderly flow of market transactions and the reduction of credit exposure and risk. Given the present day volume of transactions in the GSE securities market, JPMorgan believes that un incrcinentul and orderly implementation of the current Policy change is necessary to permit market participants, at all levels, to evaluate and adjust to the concomitant changes. While we are unable at this time without further information to fully quantify the impact of the **Policy** changes, we believe that they may have a significant impact on JPMorgan as a core clearing and settlement organization and as a major player in the global marketplace, as well as other institutions similarly situated. The changes may affect the way in which core clearing and scttleinent organizations currently provide services, including credit, to customers. In turn, this may affect customers' expectations and behavior, which could impact the financial markets globally as a whole. It is difficult, however, to assess the nature and magnitude of that impact al this point in time without details about how many depository institutions are affected, the dollar amounts involved, and the duration of the potential liquidity need. JPMorgan, therefore, supports a phased approach to the Policy change that would provide data points around which to evaluate full implementation of the Policy change with the least disruption to markct participants.

Principal Considerations

At this stage, among the principal factors to be evaluated, in our view, are the **following:**

1. ***Market Liquidity.*** Liquidily is a central component of the global financial markets and any reduction in that liquidity will have effects on markct behavior and on the costs of doing business. Dealers, investors, dcpository and other financial institutions may rely upon the early availability of thc Payments currently credited by the Reserve Banks by 9:15 a.m. Easlern Time. These funds are uscd to provide liquidity to the financial markets at all levels. To the cxtent that this liquidity needs to be replaced, there may be pressure on overnight investment markets, including the triparty repo market, causing investors to seek earlier return of their funds, thereby putting additional stress on the payments systcm. The actual impact of the Policy changes on market liquidity, however, can only be fully dimensioned if we have facts around such variables as the number of depository institutions currently receiving Payments, the aggregate size of the Paymcnts, and thc duration over which Payments remain less than fully fundod.

2. ***Credit Implications.*** The Board has acknowlcdged that, to the extent the Reserve Banks will no longer provide credit to fund GSE Payments, GSEs will need to identify other sources of intraday credit to fund their positions. It is possible that the GSEs will look to their depository institutions as sourccs of such credit. It is also possible that foreign central banks and other institutions will look to the money center banks to replacc diminishcd liquidity, giving rise to payments system constraints and credit concentration. Depending upon the willingness of depository institutions to makc such credit availablc, this may in turn impact the management of daylight overdrafts and net debit cap considerations as mentioned below in itcm #3.

   In this connection, we note the Board's statement that the cut-off hour for funding of principal, interest and redemption Payments by thc CSEs would be 4:00 p.m. Eastern T h e in order to avoid disruptions in the closing out of other elements of the Fedwirc Securities and Fund Services. Howcver, since non-receipt of Payments by market participants would be considered a technical GSE default, we suggest that, to the cxtent the Reserve Banks reccive funds prior to the closc of the cash wire, that Payments bc distributed, consistent with the intention to align the treatment of the GSEs' obligations with those of other account holders at the Reserve Banks.

3. ***Management of Daylight Overdrafts and Net*** Debit Cup ***Issues.*** Due to potential increased intraday credit demand, depository institutions may nccd to re-examine thc way in which they manage daylight overdrafts against their net debit caps. An assessment of the impact of the Policy change on these issucs will depend on the extent to which depository institutions currently rely on Payments and the manncr in which GSEs adapt to the proposed Policy

changes. These factors could potentially iiicrease daylight overdraft costs to depository institutions **and** their customers. Additionally, the reduction of intraday liquidity in thc marketplace resulting from implementation of this policy could disrupt other non-GSE related payment **flows over** the Fed wire.

4. ***Operations and Systems Impact.*** Implementation **of** thc Policy changes **will** have an impact on thc configuration and operation of depository institutions' current systems, including accounting for such features as repo tracking. Necessary adjustments lo these systems **will** requirc time **and will** entail additional costs which cannot be estimated **at** thc present time.

<u>Possible Anproaches to a Phased Implementation</u>

Assuming that the Board **is** receptive to adopting a **phased** approach to implementation of lhe Policy changes, recommendations as to the specific structure and objectives involved **will** be dependent upon **Further** information regarding (i) thc number of financial participants thul **will** be affected **by** the Policy; (ii) lhe dollar amounts involved; **and (iii)** the duration over which **GSE** accounts **will** typically remain less than **fully** funded, *i.e.*, at what point in the day the **GSEs will have fully** funded their accounts so that Payments can be rclcased. In order to **form** further recommendations based upon this information, JPMorgan asks thc Board to consider **the following** interim approaches:

1. ***Selective Implementation by Agency.*** The Board might consider phasing in implementation on an entity by entity basis. If the Board were to implement thc Policy gradually **by** beginning, for example, with one **or** two **GSEs** at a time, JPMorgan believes this could promote stability and permit market participants to make adjustments in policies **and** behaviors prior to full implementation that **would** include all GSEs.

2. ***Partial Implementation by Payment Types.*** While ultimately the **Policy will** apply to both principal **and** inlercst Payments **and** redemption Payments, the funding **sources** for these Payments **differ.** Presumably, principal **and** interest Payments are accrued over **time** and are invested, so that **funds** representing principal **and** interest distributions should bc available on payment date. Redemptions, on the other hand, are generally funded from the proceeds of new issues, which typically occur later in the day on **which** redemptions arc payable. The Board might consider continuing to fund one category ***of*** Payments initially, while phasing-in the Policy changes **with** respect to the other.

3. ***Delayed Implementation***. Under this approach, the Board might consider continuing to fund the GSE's accounts at opening of business , for some pre-determined interim period, on the same terms and conditions as "other account holders that do not have regular access to the Federal Reserve's discount window". This could lessen the impact on daylight overdraft management and give the depository institutions the ability to gauge the further impact of the Policy changes.

The merits of these proposals would be to allow market participants and the Board to gain further information as to the potential impact of the Policy changes, and therefore lay a groundwork for more meaningful comment and decisions as to specific structures for full implementation. However, even if the Board adopts a phased approach, there will still be systems implications for depository institutions and potentially other market participants that need to be factored into the selection of any specific strwcture for implementation.

Conclusion

In conclusion, JPMorgan encourages the Board to institute a gradual implementation of the Policy changes beginning in July 2006, taking into account the considerations raised in this letter. Based upon the experience of market participants during an interim phase, JPMorgan would be pleased to offer further comment regarding full implementation, which we believe can be made with greater predictability at that time. In the interim, a phased approach would enable affected market participants to adjust more easily to the changes in the Payments System Risk Policy overall.

Very truly yours,