BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

March 22, 2002

Mr. Julius L. Loeser
Senior Vice President and Deputy General Counsel
Comerica Tower at Detroit Center
Corporate Legal Department
500 Woodward Avenue, 33rd Floor
Detroit, Michigan 48226

Dear Mr. Loeser:

This is in response to your January 9, 2002 letter to Heatherun Allison of my staff concerning an "arbitrage loan program" in which your California bank, Comerica Bank-California, a State member bank, engages. Specifically, your letter sought the confirmation of Board staff that the described program complies with the Board's Regulation Q, "Prohibition Against Payment of Interest on Demand Deposits," 12 CFR Part 217. In responding to your letter, Board staff also took into consideration the February 1, 2002 draft memorandum to Ms. Allison from Oliver Ireland, Esquire, submitted on Comerica's behalf.

We understand the facts to be as follows. Comerica Bank-California (the "Bank") is a wholly owned subsidiary of Comerica Incorporated, a bank holding company. The Bank offers loans at below-market interest rates to certain customers maintaining large demand deposit balances at the Bank. The borrowers use the loan proceeds to purchase interest-yielding investments issued by persons other than the Bank, which investments are pledged as security for the loans. In determining how much to lend and what interest rate to charge for any particular borrower, the Bank takes various factors into account. The Bank reviews the borrower's past demand deposit transactions, considering the average balance in the borrower's demand deposit accounts at the Bank and the amount of earnings credit each account might have earned. The Bank also takes into account any anticipated deductions for payments to third party vendors providing services to the customer on behalf of the Bank and the extent to which a customer wishes to utilize part or all of its earnings credit balance. The Bank further takes into account the returns available to the borrower from various investment instruments with terms of no more than thirty days. The borrower uses the loan proceeds to purchase investment instruments and pledges them as collateral for the loan. Comerica's "Credit and Security Agreement" contemplates four kinds of permitted investments for that purpose: debt securities issued or fully guaranteed by the U.S. Government; open market commercial paper acceptable to Comerica; CDs issued by a Comerica affiliate; or money market funds managed by Comerica Securities (a Comerica affiliate). The investment ordinarily matures on the same date as the loan becomes due, and the proceeds of the maturing investment may be used to re-pay the loan. Any proceeds

of the maturing investment that exceed the amount due on the loan are credited to the borrower's account, and the borrower's earnings allowance is reduced by the amount of that excess.

Section 3 of Regulation Q, 12 CFR 217.3, provides that "[n]o member bank . . . shall, directly or indirectly, by any device whatsoever, pay any interest on any demand deposit." Section 2(d) of Regulation Q provides, however, that "[a] member bank's absorption of expenses incident to providing a normal banking function or its forbearance from charging a fee in connection with such a service is not considered a payment of interest." 12 CFR 217.2(d). Thus the absorption or reduction of charges for banking services generally would not constitute the payment of interest on a demand deposit, "since the bank does not actually pay funds to the depositor, although the customer does benefit from the charges absorbed." FRRS ¶ 2-543 (Staff Opinion of Oct. 27, 1978). In this regard, the distinction between an actual payment on the one hand, and a forbearance from charging a fee on the other hand, has been significant. "Any actual payment or credit to or for the account of a depositor, as distinguished from a bank's not charging for normal banking services, is regarded as an indirect payment of interest." FRRS ¶ 2-540 (Staff Opinion of Jan. 3, 1974).

In a 1988 staff opinion, Board staff evaluated a bank's loan programs, similar in some respects to the Bank's program, for compliance with Regulation Q. FRRS ¶ 2-545.1 (June 28, 1988) (the "1988 Staff Opinion"). The customers in the 1988 Staff Opinion used the proceeds of these loans to purchase investment instruments that were subsequently pledged as collateral for the loans. Before extending credit, the bank would review the history of each demand deposit account to determine the average balance in each account and the earnings credit it would allow each account. For every dollar that the average exceeded amounts necessary to meet reserve requirements and compensating balance requirements to pay associated account service charges, the bank would extend new credit at a favorable rate. New credit extended in excess of the foregoing amount would be lent at a market rate of interest. Board staff concluded that these transactions would not result in the payment on interest on demand deposit accounts in violation of Regulation Q, because there were no payments to or for the accounts of the depositors. "Rather," Board staff stated, "the banks would be absorbing expenses incident to providing a normal banking function or forbearing from charging a fee in connection with the provision of a normal banking service. The earning [sic] credits attributable to any demand deposit account would not be used to offset interest charges already incurred by the depositors." *Id.* at ¶ 2. In contrast, an earlier Board interpretation of Regulation Q found a loan "rebate" program based on compensating balances to constitute a violation of Regulation Q. FRRS ¶ 2-443 (May 14, 1965) (the "1965 Board Interpretation"). In the 1965 Board Interpretation, a bank's automobile loan customers who maintained specified balances in their demand deposit accounts at the bank received, when the loans were fully paid, a rebate in the form of a cashier's check drawn on the bank. If the customer paid loan installments when due and maintained an average monthly balance of $100 during that time, the customer received a rebate of ½% to 1% per year of the amount of the initial loan. The customer received a rebate computed at twice that rate if the customer maintained a demand deposit balance of $1,000 or more. The Board found that the program constituted a payment of interest on a demand deposit in violation of Regulation Q because "the rebate plan being offered by [the bank] involves a direct payment to a depositor as compensation for the use of funds in a demand deposit." *Id.* at ¶ 3.

Staff at the Federal Reserve Bank of San Francisco (the "Reserve Bank") raised concerns about the compliance of the Bank's program with Regulation Q and in particular with the 1988 Staff Opinion. The Reserve Bank questioned whether the Bank's methodology for calculating various loan terms fell within the 1988 Staff Interpretation, since the Bank calculates the loan amounts, the interest rate thereon, and the investment selected for the loan proceeds. The Bank calculates these terms so that, when the investment matures and the loan is due, the investment has generated sufficient funds not only to pay off the loan with interest, but also to provide the customer with funds equaling the amount of the customer's unused earnings credits. Board staff believes, however, that the calculation methodology in and of itself does not make an otherwise permissible program impermissible. Rather, Board interpretations and staff opinions interpreting Regulation Q have focused on whether there is (1) a payment by the bank, (2) "to or for the account of" a demand deposit holder, and (3) that directly or indirectly constitutes interest, i.e., compensation for the use of funds in a demand deposit. In the case of Bank's program, there clearly is a payment "to or for the account of" a demand deposit holder that is related to the amount of the demand deposit to the extent that the account balance is a factor in calculating the earnings credits and therefore the terms of the loans in question. The remaining question is whether those payments are made by the Bank.

The payments made to the depositor in the Bank's program are made by the issuer of the security in which the depositor invests its loan proceeds. Two of the four permitted investments involve issuers that are presumably unrelated to Comerica (government issued or guaranteed securities, or open market commercial paper). The other two permitted investments, however, would involve payments made by Comerica affiliates. If the loan proceeds were "invested" in a time deposit held by the Bank, the interest paid on the time deposit would be likely to be viewed as a payment of interest on the demand deposit, because of the direct relationship of the terms of the loan and of the time deposit interest rate to the balance in the demand deposit account. *See* FRRS ¶ 2-444 (Board Interpretation of May 22, 1972) (payment of interest on time deposit deemed to include payment of interest on demand deposit where time deposit interest rate calculated to yield specified rate of return on all time deposit and demand deposit balances of depositor; incremental increase is paid as compensation for use of demand deposit funds). The question of whether a payment to the depositor made by an affiliate of the bank should be treated as a payment by the bank itself has not been expressly addressed in a published interpretation or staff opinion.

In evaluating payments to depositors by depository institutions, Board staff in the past has distinguished between payments to wholly owned subsidiaries and payments to affiliates. Payments by a depository institution to a wholly owned subsidiaries of the depositor have been presumed to be payments to the depositor itself because "[p]ayment to a wholly owned subsidiary of the depositor is imputed to the depositor because it is a direct financial benefit to the depositor." FRRS ¶ 2-545.2 (Staff Opinions of Apr. 26, 1994 and May 5, 1994); *see* FRRS ¶ 2-543.1 (Staff Opinions of Sep. 28, 1993 and Nov. 24, 1993). Payments to an affiliate of the depositor, however, have not been considered to be payments to the depositor where the payment was not a direct financial benefit to the depositor. Board staff noted that, "[e]ven if the affiliate is wholly owned by a person or company that wholly owns the depositor, the affiliate would not appear in a consolidated financial statement of the depositor, and payment

to the affiliate would not benefit the depositor, although it would benefit the owner of the depositor." FRRS ¶ 2-545.2.

Staff believes that similar logic may be applied when a bank affiliate makes a payment to a depositor. In the Bank's program, Comerica has represented that the depositors' investments of their loan proceeds in products of Comerica affiliates are made on market terms, in the same manner and to the same extent as if the investment were made by another party with funds obtained from independent sources. Accordingly, absent evidence that an affiliate arrangement is essentially a sham in which the affiliate is serving as a conduit for the depository institution holding the demand deposit (for either the deposited loan proceeds or the interest or other gain paid on the time deposit or investment), staff believes that the affiliate of a depository institution should not be treated as the depository institution's wholly owned subsidiary. Accordingly, staff believes that absent evidence of a sham arrangement, the payment, on market terms, by an affiliate of a depository institution to a depositor of the depositor's investment of loan proceeds in the affiliate's product would not constitute payment by the depository institution to the depositor for purposes of Regulation Q.

Sincerely,

Stephanie Martin
Assistant General Counsel

c: Oliver Ireland, Esquire