From: "Tim Eischen" - 11/07/2008 12:00:08 PM

Subject: Reserve Requirements of Depository Institutions

To Whom It May Concern:

One of the downstream affects of paying interest on reserves is that it renders the "As of Adjustment" process useless for the correction of errors from previous periods.

In the past, the as of adjustments worked as intended as an increase in the required reserve balance would penalize an institution for receiving credits in error in the past by requiring a larger reserve requirement for a future period. The institution required a larger balance for their reserves which meant those funds were not available to invest elsewhere. Likewise, the institution that was debited for funds in error was given an adjustment to lower their two week reserve requirement, in effect giving them excess funds in the future reserve period which allows the institution to invest excess funds and to earn back the lost float.

Under the current system, with the FRB paying interest on reserves, the As-Of-Adjustments no longer works to correct the inequities of an error to an institutions FRB account. A new system needs to be developed to correct the compensation related to errors in the FRB system that works on actual interest debits and credits to the institutions involved.

For example:

Institution A and B each have a 100 MM daily average reserve requirement, ($1,400,000,000 total) for a two week period.

An encoding error causes Institution A to have $50,000,000 in their account over night that they were not entitled to.
Institution B was short $50,000,000 because of the error.

The error is corrected the next day and an As of Adjustment is created to adjust the reserve requirement for the next reserve period.

Institution A – Increase of $50,000,000, to $1,450,000,000 total for the next two week period, (Assuming the same base requirement)
Institution B – Decrease of $50,000,000 to $1,350,000,000 total over the next two week period.

Under the old method, (no interest on reserves), this error was corrected as institution A needed to increase their reserves by $50,000,000 which cost them the opportunity to earn interest in other investments and gave institution B a lower reserve which allowed them to invest an additional $50,000,000 over the two week period. This in effect corrected the error for each institution.

Under the new system with the Federal Reserve paying interest on the reserve requirements, there is no monitory gain or loss for either institution under the As-of-adjustment process. The original inequity is not corrected by the use of an as-of –adjustment.

If I am institution B, I was short $50,000,000 on the day the error occurred, which means I incurred a real loss because I either had to borrow an additional $50 Million to cover my position at the FRB, or I was short $50 Million that I could invest overnight to earn additional Interest. The As-of-Adjustment does not correct the situation now that the FRB is paying interest on reserves. Since the FRB is paying interest on reserves, lowering my reserve balance to $1,350,000,000 has no benefit. There is no difference to me financially by reducing my two week requirement.

Requirement at $1,350,000,000 – allows me to utilize $50,000,000 somewhere else over the two week period of time. The interest would be equal to the interest earned for funds left in the FRB.
In effect the decrease in the Reserve Requirement to $1,350,000,000 + Int. on $50,000,000 held elsewhere equals $1,400,000,000, (no adjustment) held at the FRB.

If you look at institution A, - They gain the use of funds of $50,000,000 on the day the error occurs, all the as-of adjustment does is increase the balance they need to keep at the next reserve period by $50,000,000, ($1,450,000), now that interest is received on the additional reserves, they do not lose anything.

Please call or email me to comment.

Thanks for considering my changes.

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