Memorandum

To: Federal Reserve System
From: Bankers' Bank Northeast; Peter J. Sposito President & CEO
Date: **11/18/08**

Re: Docket No. R-1334; Regulation D Interim Final Rule 12 C F R Part 204

The recent changes in Reg D that enable the 12 Federal Reserve banks to pay interest on Excess Reserves threatens the viability of the private sector Fed Funds market that has operated so efficiently for a long time. This overnight market is at risk for many reasons:

1) During this stressful economic period wherein banks are averse to providing credit to each other, a natural reaction is to seek the safety of depositing at the Central Bank.

2) The E E S A has been applied to accelerate the payment of interest to the beginning of October 2008, 3 years before the planned implementation. Such a quick installation especially during stressful time does not allow the market to adjust in a measured fashion.

3) The untimely implementation is exacerbated by the removal of a "private sector adjustment factor" that was initially set at 75 basis points below the Fed target rate. Currently there is no adjustment factor in place.

4) The "Fed effective rate" has been running significantly below the Fed's target rate since inception. The intended result of attracting deposits to the Central Bank i.e. to close the gap between the target rate and the Fed effective rate is failing. It's failing because community banks are finding other sources of significantly better returns. They are paying off borrowings at the Federal Home Loan Banks; extending the maturities of their securities portfolios and reducing their daily liquidity position in a desperate effort to regain reasonable earnings rates. THE OVERALL EFFECT IS THAT THEY ARE LESS ABLE TO LEND. This phenomenon is in direct opposition to the goal of the E E S A. I would underline that there is no evidence that the changes are helping the Fed to achieve the target rate.

5) An unintended result of the Regulation D changes is that the country's largest banks are able to buy at extremely low rates and to sell at high rates with virtually no credit or interest rate risk. The large banks can do this because their balance sheets are huge and relatively unaffected by the funds they post.

Suggested solutions:

We respectfully that the Fed:

1) Enable correspondent banks, including bankers' banks to deposit overnight funds at the Fed with the caveat that the seller bank maintains ownership of the asset so that the correspondent can handle the transaction "off balance sheet". Such a process would come into play only in instances wherein the Fed effective rate trades below the target rate. In a normal rate environment the private sector would operate as it has historically without the need of Central Bank interference. This would allow the private sector to continue its role of distributing excess reserves in an efficient manner.
2) Apply the Fed Effective rate to the excess reserve interest calculation as opposed to the target rate. The Fed effective rate is the true value as determined by the market and as such would not artificially draw funds into a Central Bank account for reasons other than market valuation.

In summary the changes to Regulation D are detrimental to community banks and to their correspondent banks. Application of the Fed's Target Rate is not achieving the desired Fed Funds Target rate in the real market. Mega-banks are unintended benefactors of a failed market rate program. The Fed is unfairly competing with private sector correspondent banks.

The following provides additional detail as to how the Fed Funds as Agent program has worked over a long period of time:

The private sector Fed Funds market has been a stalwart component of inter-bank funds distribution for decades. The market has been heralded as an efficient mechanism to distribute excess reserves among banks. Over time the market has become a means for community banks to sell funds to the nation's largest banks. Community banks have evolved as net sellers of Fed Funds and large banks behave as net buyers. The reason for the pattern has to do with the differing values placed on liquidity by the two groups of banks.

Correspondent banks, including bankers' banks have evolved into aggregators for community banks. Our bankers' bank collects relatively small sales ranging in size from $50,000 to an average of $2,000,000. We have built extensive bank to bank communications systems that enable our client banks to easily direct excess funds through our Fed Funds desk.

The value of the service to our client banks is twofold: 1) By aggregating their total sales each day we are able to obtain market rates for them because we sell in much larger blocks than they can achieve on their own; 2) And more importantly we reduce their "buyer bank" risk by selling their funds to multiple banks thereby reducing their exposure to any one buyer bank.
We accomplish the above by operating a Fed-Funds-as-Agent program wherein we contractually sell client bank funds "off balance sheet"; i.e. we, as their correspondent do not take title to their "sells". Accordingly if our bank were to fail overnight the "buyer bank" would return the funds to our client, the seller bank. We keep accurate records as to which client bank has sold to each buyer bank each and every day.

Thank you for your attention to this important matter for community banks and their correspondents.

Sincerely,

Peter J. Sposito