Cullen/Frost Bankers, Inc.

Phillip D. Green
Group Executive Vice President and
Chief Financial Officer

April 22, 2011

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Docket No. R-1413

IN RE: Regulations D, Q, and DD – Prohibition Against Payment of Interest on Demand Deposits

Dear Ms. Johnson:

Cullen/Frost Bankers, Inc. (Cullen/Frost) is a financial holding company, headquartered in San Antonio, with assets of $17.6 billion as of December 31, 2010. We provide a full range of commercial and consumer banking products, investment and brokerage services, insurance products and investment banking services. We appreciate the opportunity to comment on the proposed rule to repeal the Board's Regulation Q.

We oppose the elimination of Regulation Q because of the significant negative effects it will have on the nation's community banks, small business lending, municipalities and, ultimately, the U.S. economy.

Regulation Q has prohibited paying interest on commercial checking accounts for nearly 75 years. While most provisions of Regulation Q disappeared over time, the business demand-deposit interest rate prohibition remained. Banks compete not on interest rates but on the strength of customer relationships, customer service, credit support, credit pricing and lower costs for bank services.

This created the foundational relationship-based product in most banks' balance sheets, provided community banks with their largest source of long-term fixed-rate funding, and delivered value to business depositors through services. Recognizing this, regulators have encouraged banks to increase their relative level of core deposits, such as business demand deposits, at the expense of some other rate-sensitive deposits. They know this reduces risk in the banking system.

The elimination of Regulation Q will radically change this system to the detriment of the nation's community banks. Today's competitive model for demand deposits is a level playing field based on service and relationships, two things community banks excel at compared to "Too Big To Fail" (TBTF) banks. Once interest is paid on these deposits, the deposits are at risk of moving to the competitor with the biggest funding need, including TBTFs, which will be eager to offset community banks' service advantages through aggressive pricing, supported by costly ad campaigns smaller banks cannot match.

More critically, the elimination of Regulation Q will likely move most community banks to a liability-sensitive position, exposing their net interest margins to losses from higher interest rates just as rates are poised to rise significantly from their historical lows. It does this by eliminating community banks' largest single source of long-term fixed-rate funding.

The S&L crisis of the 1980s, one of the most expensive bailouts in our nation's history, was precipitated by a pervasive interest rate mismatch where individual institutions took on long-term, fixed rate exposure in the form of fixed-rate mortgage lending and funded it with interest-sensitive deposits during a protracted period of rising interest rates. The impact of funding changes means that community banks will have to have fewer fixed-rate loans, mortgages and municipal securities on their balance sheets.

Unlike community banks, the TBTFs have multiple sources of long-term funding available, which will give them an advantage in lending and investing for longer maturities. Notwithstanding their flexibility in funding, recent changes to the Federal Deposit Insurance Corp. assessment base could lead TBTFs to be more aggressive in accumulating demand-deposit funding even with an interest rate component.

With banks facing so many regulatory changes, it's understandable they have not focused on Regulation Q, particularly since historically low rates will understate the initial impact of this change in 2011. However, given that rates traditionally rise 400 basis points coming out of a recession, it's easy to see how the Regulation Q repeal could quickly have a multimillion-dollar impact on the typical community bank.

Consider a community bank with $600 million in assets, 25% of which are in non-interest-bearing deposits, or $150 million. If $100 million of this is business deposits and subject to interest under the repeal of Regulation Q, and interest paid is 1%, the interest expense hit will be $1 million; at 2%, it's 2 million, and so on. As interest rates rise, that impact could be dramatic on a community bank. A well-run bank with a 1% ROA could see its profitability and market value decline by 10% for every 1% it pays in demand-deposit interest.

To the extent the change blurs the line in the mind of depositors between time deposits such as money market deposit accounts and interest bearing demand deposits, the amount of funds in the banking system for lending or investing will be <u>directly</u> reduced. This is because every dollar that moves from an interest bearing time account into an interest bearing demand deposit account will result in an immediate loss of ten cents in investible/loanable funds because ten percent of demand deposits are required to be kept in reserves at the Federal Reserve Bank while no reserves are required on time accounts.

With regard to the issue that this is a quid pro quo for banks receiving interest on their reserves at the Fed, keep in mind that the interest paid on reserves is only about a tenth of the interest lost from the elimination of Regulation Q. As far as businesses receiving a benefit from the payment of interest on demand deposits, it will be offset by cash fees to pay for services which the demand deposit balances would have previously afforded them, and from higher loan rates from borrowing customers.

There's a better way to pay businesses interest on deposits. By amending Regulation D to increase the limit on the number of allowable intra-bank money market account transactions, lawmakers/regulators could retain the industry's core relational DDA. Banks could then more easily sweep excess customer funds to an interest bearing MMA while still meeting the customer's funding needs. This option leaves the core relational DDA in place without having to sweep funds into an alternative off-balance-sheet product that is typically only available to larger business accounts.

We ask that the Board delay implementation of Regulation Q until these and other issues and their impact on community banks can be adequately studied.

Sincerely,

Phillip D. Green
Group Executive Vice President & CFO