American Bankers Association
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By electronic delivery to:
Mr. Michael Lewandowski
Associate Secretary of the Board
Board of Governors of the Federal Reserve
regs.comments@federalreserve.com

Re: Regulation D: Reserve Requirements for Depository Institutions
Docket No. R-1513, RIN 7100-AE31

Dear Mr. Lewandowski;

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the issues raised by the Federal Reserve's notice of proposed rulemaking, Regulation D: Reserve Requirements for Depository Institutions.

ABA is supportive of the Federal Reserve's exercise of its monetary policy authority, and shares the objective of a prospering economy, which includes a competitive marketplace for excess balance accounts (EBAs). As regulations are proposed, however, we are concerned by the potential for harm to private markets and the role of the banking industry in supporting them. The possibility of aggregate negative effects and unintended consequences necessitate Federal Reserve and banking industry collaboration to navigate thoughtfully the competing regulations and disincentives in a post-Dodd Frank Act marketplace.

I. EBAs and Federal Funds Are Monetary Policy Tools, and Important Funding Sources for the Banking Industry.

As the Federal Reserve prepares to return to a normal interest rate environment, it appears that increases in the rates on interest bearing reserves may be an integral early step—a departure from traditional means of selling securities through open market operations. To some extent this will encourage retention of funds at the Federal Reserve, and although it may be temporary, we believe that the long term goal should be greater employment of these funds by the private sector. As implemented on October 9, 2008, revisions to Regulation D interest calculations required reserves to be paid at 10 basis points below the average targeted federal funds rate during a maintenance period,[2]

[1] The American Bankers Association is the voice of the nation's $15 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $11 trillion in deposits and extend more than $8 trillion in loans. Learn more at aba.com.

[2] Reserve Requirements of Depository Institutions, 73 Fed. Reg. 59,482 (2008). "The Board has established the initial rate of interest for required reserve balances to be the average targeted federal funds rate over the reserve maintenance period less 10 basis points. Setting this rate below the targeted federal funds rate reflects the fact that

and EBAs paid at 75 basis points below.[3] An eventual return to this treatment would work to revitalize the federal funds market as EBA deposits would flow out of the Federal Reserve Banks as market conditions improve. However, if the Federal Reserve pays EBA at the targeted rate, and continues paying interest in perpetuity, then the Federal Reserve Banks may accumulate significant excess balances that otherwise would be put to work in the private sector.

II. Industry Needs to Understand the Purpose of the Activity and Pricing Strategy.

If managing EBA interest is an essential monetary policy tool in the early stages of normalizing interest rates, the purpose of Federal Reserve action and private market activity needs to be better understood. The purpose for Interest on Required Reserves (IORR),[4] Interest on Excess Reserves (IOER),[5] and EBA[6] pricing complexity is not obvious when the Federal Reserve Board of Governors could simply reprice EBAs to encourage their use or disuse. Is the goal eventually to lower EBA rates below the federal funds rate to encourage funds to return to the private sector? How can the Federal Reserve encourage reallocation of the federal funds market to assure all banks, including nonmember community banks, have access to overnight liquid funds?

ABA encourages the Federal Reserve to communicate clearly the intended policy use and long term goals of interest bearing reserves. Such a dialogue, which did not occur when the Federal Reserve began setting EBA rates in 2008, is timely and would be of great value to markets if made sometime before the Federal Reserve began normalizing interest rate policies. Potentially, the use of EBAs as a monetary policy tool could significantly impact the deployment of excess funds, and as a result, could adjust customer demands of traditional correspondent banking. The Federal Reserve should clarify (1) whether the monetary policy expectation is eventually to sunset interest-bearing EBAs, (2) whether the pricing goal is to pin EBAs below federal funds, and (3) whether the intent is to return EBA pricing to pre-2008 targets.

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federal funds loans are uncollateralized and carry some counterparty risk, whereas deposits at the Federal Reserve Banks are free from such risk."

[3] "The Board has established the rate of interest for excess balances to be the lowest targeted federal funds rate during the reserve maintenance period less 75 basis points. The Board believes the rate on excess balances should be set sufficiently low to provide an incentive for eligible institutions to trade funds in excess of required reserve balances and clearing balances in the federal funds market, but to provide a disincentive to trade funds at rates far below the targeted federal funds rate." Id. at 59,483.

[4] Regulation D: Reserve Requirements for Depository Institutions, 80 Fed. Reg. 20,448, 20,449 (2015) (to be codified at 12 C.F.R. pt. 204).

[5] Id.

[6] See id.

III. Consider the Aggregate Impact and Unintended Consequences of EBA Interest Payments, Payment Systems Risk Policy, and Liquidity Coverage Ratio.

The impact of interest-bearing EBAs must be examined alongside the introduction of a new settlement deadline under the Federal Reserves' new Payment Systems Risk Policy,[7] and Liquidity Coverage Ratio (LCR) treatment of federal funds and financial institution deposits.[8] The aggregate effect of EBA pricing and the early morning settlement deadline, as well as other factors, disincentivizes the efficient placement of deposits throughout the market. This undermines the safety and soundness of the banking system as sources of funding are restricted, and otherwise local deposits relocate to regional, often out-of-state Federal Reserve Banks. The result of which is a concentration of financial institution deposits, and potentially systemic risk, at the Federal Reserve. The net result, and perhaps the unintended consequence, which will be to tend to push excess funds to the Federal Reserve in an improving economy, which over the long term has the potential to eliminate federal funds-based credit and liquidity alternatives from the private market.

The combined effect of these policies could be particularly harmful in a troubled economy, where the Federal Reserve may be the chief source of available liquidity, not merely the lender of last resort. In a troubled economic scenario, correspondent banks,[9] which traditionally function as important alternative sources of liquidity and capital to financial institutions, may exit the federal funds business, and would be little able to offer collateralized facilities that expedite the extension of bank stock loans, letters of credit, or other forms of financial institution credit,[10] due to safety and soundness concerns and uncertainty about the interaction of various prudential regimes or the prospective requirements of regulators.

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[7] Federal Reserve Policy on Payment System Risk; Procedures for Measuring Daylight Overdrafts, 79 Fed. Reg. 72,112 (2014) (to be codified at 12 C.F.R. pt. 210).

[8] Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg 61,440 (2014) (to be codified at 12 C.F.R. pt. 249). The LCR has made funding on "federal funds purchased" impractical at some banks. Coupled with a 100% runoff for liquidity outflows, "federal funds purchased" require LCR compliant banks to hold equal amounts of cash, thus reducing, if not eliminating, the appetite for federal funds.

[9] The primary mission of correspondent banking is to provide products and services to other domestic financial institutions, primarily community banks, which often rely on a correspondent for liquidity management tools through the provision of federal fund lines of credit. This line of credit is used to facilitate payments in the form of checks, Depository Transfer Checks (DTCs), securities transactions, and government remittances. Liquidity can be bought or excess sold through a correspondent depending on the bank's liquidity needs. This service also provides an effective alternative to borrowing at the Federal Reserve Bank Discount Window.

[10] When community banks have a limited ability to raise capital and are without access to public capital debt markets, a correspondent could provide an important source of capital through bank holding company financing, and bank stock loans to shareholder.

The policy governing EBA interest rates is not merely a simple calculation, but it must also consider the interplay of other policies, regulations, and requirements. A tangible example of the failure to consider problems across regulations—and the potential for harm—is recent change to Part II of the Federal Reserve's Payment System Risk Policy,[11] which adjusts the posting times for Federal Reserve account for automated clearinghouse (ACH) debit transactions, and commercial check transactions. Although appearing to be a simple change from 11:00 A.M. Eastern to 8:30 A.M. Eastern for posting transactions, the burden on banks could be significant.[12] The change requires funds to be available in a Federal Reserve account by 8:30 A.M. Eastern to cover net debit positions or utilize a net debit cap. If the interest on EBAs is not well-managed relative to other deposits, or if the Federal Reserve pricing is less than banks are willing to pay on overnight federal fund investments, banks will face a significant operational challenge to return overnight sales of federal funds prior to 5:30 A.M. Pacific/8:30 A.M. Eastern. The likely result is the loss of flexibility to deploy overnight funds efficiently in the marketplace. Rather, artificially restricted by the early morning deadline, overnight funds will be parked unnecessarily at Federal Reserve Banks.

Similar to the EBA dialogue requested in this letter, the change to the ACH settlement deadline also offers an opportunity to improve engagement and collaboration with industry as the economy improves, and the Federal Reserve prepares for a rising interest rate environment. ABA encourages the Federal Reserve to articulate the settlement risk mitigated by the new timeline, and address the conformity challenge for banks, particularly those located in the Pacific Time Zone.

IV. Federal Reserve Should Assure a Level Playing Field in the Federal Funds Market.

When coupled with the concurrent proposal to revise Form FR 2420 data reporting,[13] the Federal Reserve may find itself in the enviable position of having access to proprietary pricing and demand information as a supervisory entity while at the same time competing against private industry for excess deposits. This creates an unlevel playing field to the disadvantage of private sector actors. The Federal Reserve should consider either removing itself as an active player in the market, or releasing pricing, demand, and deposit data to all market participants.

[11] Federal Reserve Policy on Payment System Risk; Procedures for Measuring Daylight Overdrafts, 79 Fed. Reg. at 72,119 (2014).
[12] Of note, is the effect on banks located in the Pacific Time Zone that may be at a particularly severe disadvantage.
[13] Proposed Agency Information Collection Activities, 80 Fed. Reg. 18,620 (2015). The proposed changes to Form FR 2420, a daily report of money market transactions, which includes federal funds purchased, certain time deposits and Euro dollar liabilities, will used by the Fed to calculate the federal funds rate. The proposal would lower the

V. **Implement a Two Year Public Review and Evaluation.**

Given the novelty of near real-time updates to interest rates, ABA respectfully recommends revisiting the program in two-years for public review and evaluation. Unintended consequences and aggregate impacts affecting federal funds, effectiveness in moving short-term rates, and the effect on bank behavior should be carefully considered. The Federal Reserve and the banking industry would benefit from the opportunity to evaluate, and potentially improve the program, while creating an opportunity to address unintended harm and market inefficiencies.

ABA appreciates the opportunity to comment on the Proposal. Thank you for considering our comments and recommendations. Please contact me at ddepierr@aba.com or 202-663-5333 with questions.

Sincerely,

Denyette DePierro
Vice President and Senior Counsel

asset threshold from $26 billion to $15 billion for reporting domestic financial institutions and also require institutions with assets of $5 billion or more that meet certain federal funds activity requirements to report.