American Bankers Association
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Cecelia A. Calaby
Senor Vice President
P 202-663-5325
ccalaby@aba.com

May 13, 2019

Ann E. Misback
Secretary, Board of Governors of the Federal Reserve System
Eccles Board Building
20th and C Street, N.W.
Washington, D.C. 20219

Re: Regulation D: Reserve Requirements of Depository Institutions, Docket No. R-1652, RIN 7100-AF-40

Dear Ms. Misback,

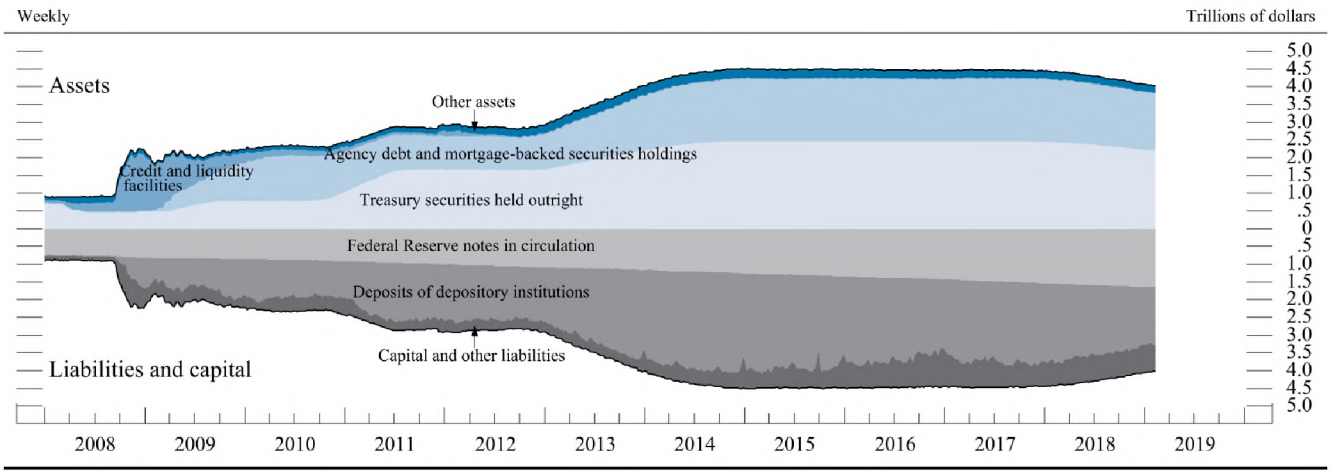
The American Bankers Association[1] (ABA) appreciates the opportunity to comment on the proposal[2] (Proposal) of the Board of Governors of the Federal Reserve System (Fed)[3] to amend Regulation D to provide for a lower rate of interest paid on excess reserve balances (IOER) maintained at Federal Reserve Banks by narrowly focused depository-only institutions, which the Fed refers to as Pass-Through Investment Entities (PTIEs). ABA supports the proposal to differentiate the IOER rate paid to PTIEs from the IOER rate paid to all other eligible institutions. We provide comments below on the importance of IOER for conducting monetary policy, our shared concerns about the potential detrimental impact of PTIEs on monetary policy, financial intermediation and financial stability, and we offer some suggestions for distinguishing PTIEs from other eligible institutions.

IOER is an important tool for the conduct of monetary policy

The Fed changed the size and nature of its balance sheet starting in 2008 to promote economic recovery by making significant purchases of assets – primarily longer-term Treasury and agency-guaranteed mortgage backed securities. Those asset purchases were funded by an increase in reserves held by banks at the Fed. As a result, the Fed's balance sheet grew from $807 billion in August of 2007 to a high of $4.5 trillion in January 2015.[4] The following chart from the Fed's February 22, 2019 Monetary Policy Report shows the growth and the relationship between the securities purchased by the Fed and reserve balances maintained by banks at the Fed.

[1] The American Bankers Association is the voice of the nation's $18 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard nearly $14 trillion in deposits, and extend more than $10 trillion in loans.
[2] 84 Fed. Reg. 8829, March 12, 2019.
[3] In this letter, we refer to both the Board of Governors of the Federal Reserve System and the Federal Reserve Banks, at which reserve accounts are held, as the Fed.
[4] Interactive data on the Fed's balance sheet can be found at: https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm. Reserves held by banks grew from $20 million to $2.8 trillion over a similar period.

47. Federal Reserve assets and liabilities



NOTE: "Credit and liquidity facilities" consists of primary, secondary, and seasonal credit; term auction credit; central bank liquidity swaps; support for Maiden Lane, Bear Stearns, and AIG; and other credit facilities, including the Primary Dealer Credit Facility, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, and the Term Asset-Backed Securities Loan Facility. "Other assets" includes unamortized premiums and discounts on securities held outright. "Capital and other liabilities" includes reverse repurchase agreements, the U.S. Treasury General Account, and the U.S. Treasury Supplementary Financing Account. The data extend through February 13, 2019.
SOURCE: Federal Reserve Board, Statistical Release H.4.1, "Factors Affecting Reserve Balances."

While the Fed's current monetary policy is slowly reducing the size of its balance sheet (to a level of about $3.9 trillion by April 2019),[5] it has signaled its expectation that its balance sheet will remain substantially larger than pre-2008 levels.[6]

Due to its much larger balance sheet, the Fed can no longer effect changes in short term money market rates through open market operations to prompt changes in reserve balances,[7] but instead it does so administratively by changing the interest rate it pays on excess reserves (IOER).[8] By raising or lowering IOER, the Fed prompts banks to adjust the rate they pay each other to lend and borrow funds (known as the federal funds rate). The federal funds rate is a key short term money market rate that influences other rates across funding markets, like those for commercial paper and repurchase agreements. Changes in such short term interest rates then influence other financial asset prices and thus overall economic activity. Accordingly, IOER is the key current monetary policy instrument for the Fed.

[5] *Id.* Reserves held by banks are about $1.6 trillion in April 2019.
[6] Fed, Quarterly Balance Sheet Developments, March 2019, pg. 9. In its January 30, 2019 Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization the Federal Open Market Committee stated that it "intends to conduct monetary policy in a regime in which an ample supply of reserves ensures that control over the level of the federal funds rate and other short-term interest rates is exercised primarily through the setting of the Federal Reserve's administered rates, and in which active management of the supply of reserves is not required." The Fed also published in March 2019, "Balance Sheet Normalization and Plans" which can be found at: https://www.federalreserve.gov/newsevents/pressreleases/monetary20190320c.htm.
[7] Reserve balances at the Fed are now so large that small adjustments to the quantity of reserves are not sufficient to effect changes in money market rates, and large adjustments that might have such an effect would have to be accomplished by significant sales of assets which would be highly disruptive to financial markets.
[8] The Fed has also implemented an overnight reverse repurchase agreement (ONRRP) facility, where eligible counterparties (e.g. banks, money market mutual funds, government-sponsored entities) provide overnight loans to the Fed secured by collateral from the Fed's securities portfolio. This facility is another tool the Fed uses to effect changes in short term money market rates.

In late 2016, ABA funded a study by Federal Financial Analytics to provide to policymakers and the public an educational paper explaining the function and important purposes of IOER. Released in December 2016, the paper, organized in a Q&A format, also explains the dangerous consequences for the economy and public finance were IOER to be significantly curtailed or prohibited.[9]

PTIEs will challenge the Fed's conduct of monetary policy

The Fed notes in its proposal that the PTIE business model could make the conduct of monetary policy more difficult. We agree. In recent years, the Fed has effected monetary policy by changing the target range for the federal funds rate through either or both of adjusting the supply of reserves in the banking system, or adjusting rates paid on reserves and, recently, in its ONRRP facility. The introduction of PTIEs into the financial ecosystem would compromise the Fed's ability to use both of those mechanisms.

As we note above, the Fed is currently following a policy of gradually reducing the size of its balance sheet, significantly funded by bank reserves, which it then expects to maintain at a stable level. PTIEs would challenge the Fed's ability to adjust the supply of reserves in the banking system, as the amount of reserve balances PTIEs would place on deposit would be entirely outside of the control of the Fed.

Moreover, the introduction of PTIEs would interrupt and dilute the transmission of IOER and ONRRP rates – the key rates that the Fed sets directly – to the federal funds rate and thus to other short term money market rates and ultimately to the prices of other financial assets. We expect this dilution would result from current federal funds lenders shifting their activity from the overnight market to overnight deposits in PTIEs, changing the relevance of and introducing greater volatility into the federal funds market. Similarly, if other lenders of short terms funds shift from participation in various overnight money markets to depositing overnight funds in PTIEs, the reference rates in those money markets would also become less relevant and more volatile.

Some argue that PTIEs would themselves enhance the transmission of the IOER rate to other short term rates. We see at least two reasons why that is not likely. First, as the Fed notes, transmission through existing eligible institutions has already proven to be successful. Second, the customers that PTIEs propose to target – institutional investors – are already, through bank deposits and participation in the ONRRP facility, part of the Fed's transmission of administered rates to other short term money market rates. We do not find the opportunity to profit from the Fed's IOER rate a sufficiently compelling reason for PTIEs to attain access to IOER.

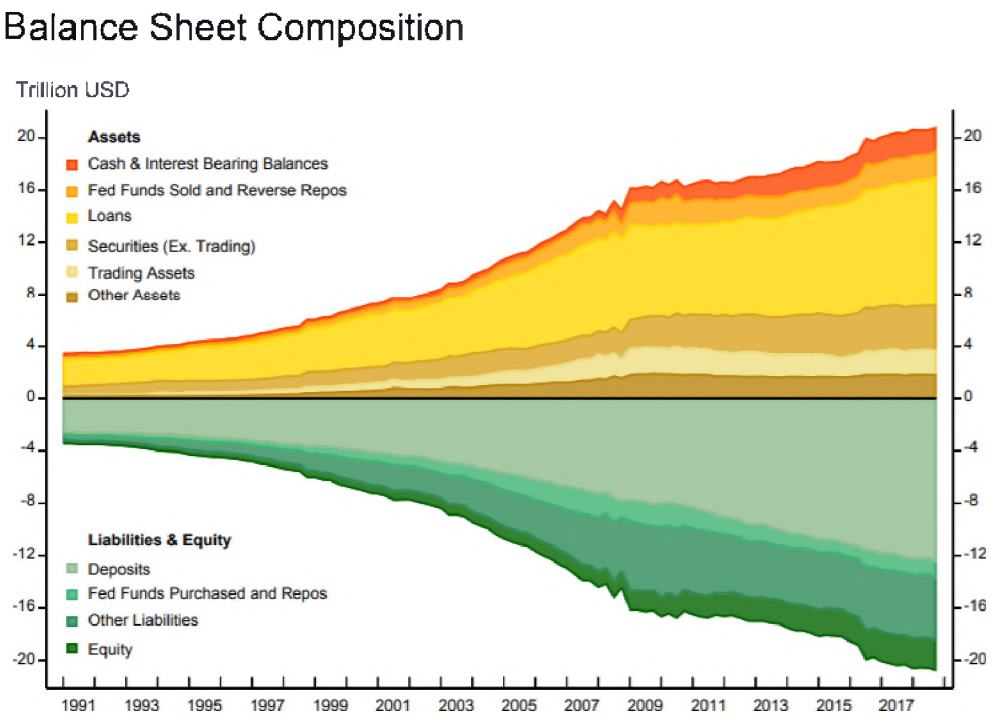
PTIEs will disrupt current financial intermediation to the detriment of economic activity

The Fed notes in the Proposal that PTIEs could have unpredictable effects on financial intermediation, noting the possibility of diminished funding availability for commercial banks leading to diminished lending and an increase in the cost of credit. We agree.

[9] The press release and paper, "Why the FRB Pays Interest to Banks on Excess Reserves and What Might Happen if it Didn't," can be found at: http://www.fedfin.com/images/stories/press_center/Press_Release_PR_12202016.pdf. ABA had no editorial authority over the paper's content, methodology, or findings.

The business model of PTIEs can be simply described as creating an institution eligible to be paid IOER[10] to make it possible for non-eligible institutions to earn IOER. PTIEs, by passing institutional investors' funds through to a reserve account at the Fed, have the potential to attract significant deposits, including deposits that would otherwise be placed in banks for meeting borrower needs and otherwise funding other productive financial activity. Detrimental effects can be expected: less credit would become available, and its allocation in the economy would be distorted. Each of these detrimental effects would reduce overall economic activity and efficient allocation of funds.

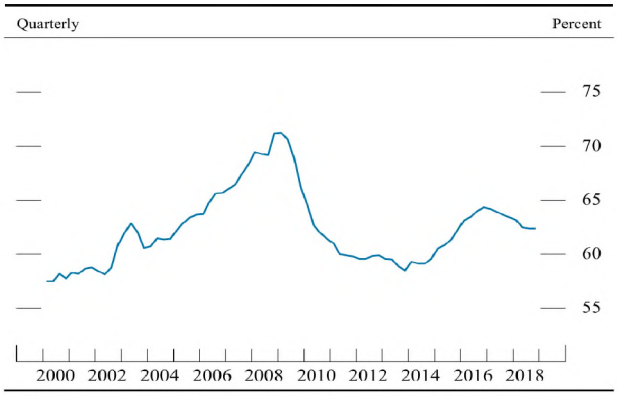
Banks, as lending institutions, rely predominantly on deposit funding to make loans to businesses, farms, and families. The following chart shows the aggregate balance sheets of U.S. banks over nearly a 30-year period, demonstrating this reliance.[11]



While it is difficult to predict the quantity of deposits PTIEs may attract away from banks, or the consequent decline in bank lending, banks' reliance on deposits to fund loans is so apparent that we can credibly expect any significant shift of deposits to PTIEs to affect bank lending to a substantial degree. Bank lending is a major source of funding for commercial and industrial enterprises as well as consumers.

[10] We understand the Fed has not yet determined whether any or all PTIEs are 'eligible institutions' under Regulation D, i.e. eligible to earn IOER.
[11] Federal Reserve Bank of New York, Quarterly Trends for Consolidated U.S. Banking Organizations, Fourth Quarter 2018.

36. Ratio of total commercial bank credit to nominal gross domestic product



NOTE: Data for 2018:Q4 are estimated.
SOURCE: Federal Reserve Board, Statistical Release H.8, "Assets and Liabilities of Commercial Banks in the United States"; Bureau of Economic Analysis via Haver Analytics.

The chart to the left shows the importance of bank credit to overall economic activity in the United States.[12]

Furthermore, the allocation of credit in the economy would be distorted. If significant deposits migrated from banks to PTIEs for deposit at the Fed, instead of banks deploying those funds to borrowers of all kinds and sizes, the Fed would deploy those funds into the only investments it is statutorily permitted to make: U.S. Treasury securities, government-backed agency securities, certain State and municipal securities, bank commercial paper, and certain foreign sovereign securities.

PTIEs will contribute to financial instability

The Fed notes in its proposal that we can expect in a period of crisis that deposits at PTIEs, providing the safety and liquidity of what is essentially a deposit at the Fed, would attract funds away from many other productive uses, sharply limiting liquidity and exacerbating financial stress at a critical time. We agree.

One of the major lessons we have learned since 2008 is the importance of ensuring the maintenance of ample liquidity in the banking system, supported by robust internal processes and controls, and in the case of our largest depositories, various quantitative measures of liquidity such as the liquidity coverage ratio rule. We believe that the ability of PTIEs to attract large amounts of institutional deposits would frustrate these important policy measures by depriving the financial system of funding at precisely the time when it may be most needed.

We are also concerned that financial instability could be magnified by greater participation of less or non-regulated entities in lending markets. If the banking system were deprived of sufficient funding, it would impair the ability of banks to serve as financial intermediaries and encourage non-bank participants, such as private equity funds and mutual funds, to increase their lending activity. However, such non-bank lenders do not have deposit insurance or access to the Fed's discount window, important mechanisms which make banks less vulnerable to liquidity runs. If non-bank lenders faced a sudden withdrawal of their funding in a period of stress, it would prompt asset sales. Such asset sales could quickly become the type of disruptive fire sales that precipitate or deepen a crisis, regardless of underlying asset quality.

It is important to distinguish PTIEs carefully from other eligible institutions

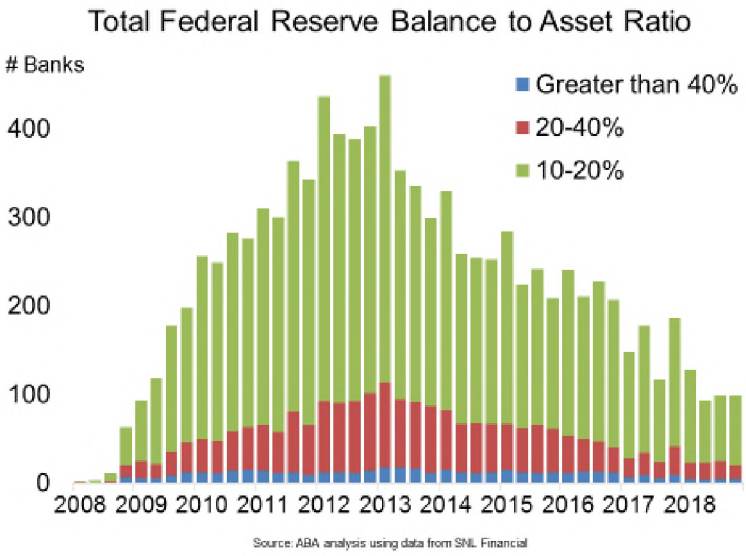
In light of the importance of IOER to the conduct of monetary policy, the Fed must carefully distinguish PTIEs from economically productive intermediaries eligible for IOER. We agree that PTIEs should be

[12] Fed, Monetary Policy Report, February 22, 2019, pg. 25.

defined so that existing eligible institutions would continue to be paid the current IOER rate on all of their excess balances. The Fed has suggested three alternatives for identifying PTIEs: (i) any eligible institution that holds a very large share of its assets in the form of balances at the Fed; (ii) any eligible institution that holds a very low level of capital relative to its assets; (iii) any eligible institution that both has a very high ratio of reserves/assets or low capital/assets ratio and is not subject to supervision by a federal banking agency. We believe the Fed should implement a multi-feature approach to identifying PTIEs, based on a combination of metrics including a high level of reserves/assets, a low level of capital/assets, *and* whether subject to supervision by a federal banking agency. We discuss each of those features below and also offer some considerations for the Fed in in distinguishing PTIEs from other eligible institutions.

Reserves/assets

We compiled reserves/assets data from bank Call Reports[13] for individual banks, and in the aggregate, at quarter ends over the period 1997-2018. We found a significant amount of variability both in the reserves/assets ratios across banks and in the banks that had high reserves/assets ratios at different quarter ends. Although most banks have reserve/assets ratios well below 20%, the fifty banks at any year end from 2014-2018 with the highest reserves/assets ratios had ratios that ranged from 14%-93%. At the two peak quarter ends when reserve balances at the Fed were highest, 2013Q1 and 2012Q1, the banks with the highest reserves/assets ratio had 99.53% and 99.39%, respectively.



To the left we present a chart that shows the number of banks holding reserves/assets ratios of 10-20%, 20-40%, and greater than 40% at quarter end from 2008 through 2018.

We can see from this chart that only a few banks have high reserves/assets ratios at any quarter end, and that this is consistent over time. From our review of individual banks' reserves/assets ratios, we note a significant degree of variability in which banks have high reserves/assets ratios at any particular quarter end.

We do not believe there is one explanation for this variation, but we note that there are several bank business models that *tend* to have consistently higher reserves/assets ratios. In this regard, bankers banks, trust banks, custody banks, correspondent banks, non-U.S.-based banks, and certain financial market utilities (FMUs) all tend to hold high amounts of reserves at the Fed as a result of their particular business model and function within the financial system. *De novo* banks may also, as they start

[13] Banks file quarterly financial information with the Federal Financial Institutions Council, which is available publicly on the FFIEC's website at: https://www.ffiec.gov/infosystem.htm. Banks with total assets of less than $300m (about 3,275 banks) do not have to report the relevant line item; we expect, however, a similar variance in reserve/assets ratios among those banks as among reporting banks.

operations, hold high reserves. One way to ensure that bankers banks and correspondent banks are not considered PTIEs is for the Fed to clarify that PTIEs do not include institutions that have tri-party agreements with the Fed and a respondent bank for purpose of maintaining pass-through reserves on behalf of the depositing (respondent) banks.

Because at any particular quarter end, currently eligible institutions could have a very high reserves/assets ratio, we believe that the Fed should consider an institution's reserves/assets ratio over no less than four quarters. It could distinguish PTIEs from economically productive intermediaries eligible for IOER by the variability of reserves/assets ratios over time. We can expect, based on the PTIE business model, that PTIEs would have a *consistently* high reserves/assets ratio. We do not see the same consistency among other banking entities, even among the bank business models we mention above that have reason to maintain high levels of reserves.

Capital/assets

While we expect that any PTIE chartered by a State will be subject to some minimum capital requirement by that State, we agree that a PTIE may be distinguishable from economically productive eligible institutions by a very low capital/assets ratio. We suggest that one useful measure of very low capital/assets could be any capital level that is below the minimum tier one leverage capital ratio requirement. The tier one leverage capital ratio is a key federal minimum capital requirement which acts both to ensure overall capital adequacy and to limit excessive leverage at banks.

Another feature the Fed could consider in differentiating PTIEs is whether the PTIE is subject to an operational risk capital charge or information technology (IT) examination or oversight. Larger banks are subject to a capital charge to reflect operational risk as part of their federal minimum capital requirements, and all banks are subject to IT examination and oversight. We may anticipate that a PTIE may grow quite large, and will present a variety of operational risks including cybersecurity risks, but will not be subject to a federal operational risk capital charge or federal IT examination or oversight. Accordingly, we believe another way to distinguish PTIEs is whether the PTIE is subject to an operational capital charge, and IT examination or oversight equivalent to that imposed by federal prudential requirements.

Prudential federal regulation

The Fed has suggested that a potential distinguishing feature of PTIEs from other eligible institutions is that PTIEs are not subject to prudential federal regulation. We agree.

Federal prudential regulation typically encompasses capital, liquidity, resolution, risk management, and counterparty exposure requirements, all important regulatory elements for economically productive intermediaries in the banking system. We note, though, that there are at least two kinds of currently eligible institutions – trust companies and certain FMUs – that may not be subject to prudential federal regulation but that nonetheless provide important and valuable intermediary functions for the banking system and economy, and so should not inadvertently be characterized as PTIEs.

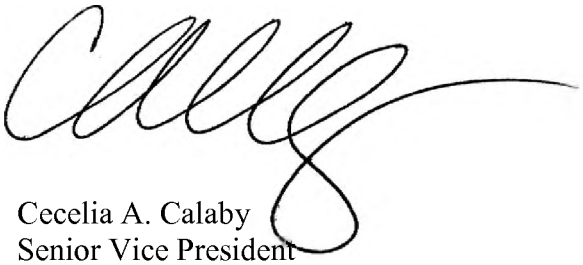
A particular element of prudential federal regulation that may be useful in distinguishing PTIEs from other eligible institutions is resolvability. All insured depository institutions are eligible for resolution under the FDIC's well-established receivership rules and processes. Similarly, uninsured special purpose national banks are resolvable under the OCC's receivership rules for national banks. The Fed

could consider as another feature for distinguishing PTIEs from other eligible institutions the presence of a resolution regime at least as robust as the standards under federal prudential regulation.

* * *

Thank you for considering our comments. If you have any questions or require additional information, please do not hesitate to contact me at (202) 663-5325, or ccalaby@aba.com.

Sincerely,



Cecelia A. Calaby
Senior Vice President
Office of Regulatory Policy