Interest on Required Reserve Balances and Excess Balances FAQs

1. Under what authority do the Federal Reserve Banks pay interest on balances maintained at Reserve Banks?

The Financial Services Regulatory Relief Act of 2006 authorized the Federal Reserve Banks to pay interest on balances held by or on behalf of depository institutions at Reserve Banks, subject to regulations of the Board of Governors, effective October 1, 2011. The effective date of this authority was advanced to October 1, 2008 by the Emergency Economic Stabilization Act of 2008. The text of both Acts is available on the Library of Congress' THOMAS Legislative Information website at http://thomas.loc.gov.

2. What kinds of balances do depository institutions hold at Reserve Banks?

Institutions hold required reserve balances, clearing balances, and excess balances. Required reserve balances are balances that an institution holds in an account directly at a Federal Reserve Bank or indirectly through a pass-through correspondent to satisfy its reserve requirement. Clearing balances are balances that an institution agrees to hold, in addition to a required reserve balance, in its account at a Federal Reserve Bank under a clearing balance agreement. Excess balances are balances that an institution holds in its account that exceed the sum of the institution's required reserve balance and clearing balance.

3. What kinds of balances will receive interest?

The Federal Reserve Banks will pay interest on required reserve balances and on excess balances. Clearing balances already earn implicit interest in the form of earnings credits.

4. Why does the Federal Reserve want to pay interest on required reserve balances?

The inability to pay interest on balances held to satisfy reserve requirements essentially imposes a tax on depository institutions equal to the interest that might otherwise have been earned by investing those balances in an interest-bearing asset. Paying interest on required reserve balances effectively eliminates this tax.

5. Why does the Federal Reserve want to pay interest on excess balances?

Paying interest on excess balances should help to establish a lower bound on the federal funds rate by lessening the incentive for institutions to trade balances in the market at rates much below the rate paid on excess balances. Paying interest on excess balances will permit the Federal Reserve to provide sufficient liquidity to support financial stability while implementing the monetary policy that is appropriate in light of the System's macroeconomic objectives of maximum employment and price stability. For more information about the implementation of monetary policy with the payment of interest on required reserve balances and excess balances, please see the Federal Reserve Bank of New York's website at www.newyorkfed.org.

6. What is the interest rate for required reserve balances?

The interest rate for required reserve balances is 10 basis points below the average target federal funds rate for a reserve maintenance period. A reserve maintenance period is either one week or two weeks in length, generally depending on the size of the institution.

7. What is the interest rate for excess balances?

The interest rate for excess balances will be set initially at the lowest target federal funds rate for a reserve maintenance period less 75 basis points. A reserve maintenance period is either one week or two weeks in length, generally depending on the size of the institution. The Board of Governors may adjust the formula for the interest rate on excess balances in light of experience and evolving market conditions.

8. When will the Federal Reserve begin to pay interest on required reserve balances and excess balances?

Interest will be paid on balances maintained at Federal Reserve Banks for the reserve maintenance periods beginning on Thursday, October 9, 2008.

9. When will interest payments be credited to an institution's account?

Interest will be credited to an institution's Federal Reserve account fifteen days after the close of a reserve maintenance period to allow for the application of reserve carryover.

10. What are the implications for the clearing balances program?

Clearing balances will continue to receive earnings credits. With the reserve maintenance period beginning October 9, 2008, earnings credits will be paid on 100 percent of eligible clearing balances. There will not be any change in the way that earnings credits are used to offset Federal Reserve service charges.

11. Will the Federal Reserve pay interest on vault cash?

No. The Federal Reserve is not authorized to pay interest on vault cash.

12. Which institutions are eligible to receive interest on their balances?

Depository institutions, U.S. branches and agencies of foreign banks, Edge Act and agreement corporations, and trust companies are eligible to receive interest (eligible institutions). Pass-through correspondents that are not themselves eligible institutions are eligible to receive interest on balances held on behalf of their respondents.

13. Are pass-through correspondents required to pass the interest they receive back to their respondents?

Pass-through correspondents may pass the interest they receive on balances that represent their respondents' required reserve balances and excess balances, but they are not required to do so. Passing back such interest to a respondent will not be considered a payment of interest on a demand deposit in violation of Regulation Q ("Prohibition Against Payment of Interest on Demand Deposits," 12 CFR Part 217).

14. What effect will the clearing balance allowance and carry-over have on the calculation of interest?

Balances up to the top of the clearing balance band are included in clearing balances and therefore are excluded from excess balances.

The carry-over provision will affect the allocation of an institution's average balance maintained among its required reserve balance, clearing balance, and excess balance for the purposes of interest calculations. Contact the reserve administration staff at your Reserve Bank if you have any questions.

15. How will revisions to amounts reported on the Report of Transaction Accounts, Other Deposits, and Vault Cash (FR2900) affect previously paid interest?

Revisions to amounts reported on an institution's FR 2900 report that change an institution's reservable liabilities can change an institution's required reserve balance. In this case, the reallocation of the average balance maintained in a reserve maintenance period among the institution's required reserve balance, clearing balance, and excess balance may result in a recalculation of previously paid interest. The difference between the original and revised interest payments will be credited to or debited from, depending on the revision, an institution's account.

16. How will as-of adjustments affect the calculation of interest?

As-of adjustments affect the level of average balances maintained by an institution and are included in the calculation of interest payments and earnings credits.

17. How will interest be calculated for a Federal Reserve account that closes in the middle of a reserve maintenance period due to a merger?

The survivor of a merger will receive any interest payments earned by the nonsurvivor.

18. Will the Federal Reserve use the authority provided in the Financial Services Regulatory Relief Act of 2006 to reduce required reserve ratios below their previously permitted ranges or to eliminate reserve requirements?

The Board of Governors has not made any determination about changing required reserve ratios or eliminating reserve requirements.

19. Will the Board of Governors seek comment on the rules governing the payment of interest?

Yes. The Board of Governors is seeking comment on the rules governing the payment of interest. The Board of Governors is seeking comment particularly on the treatment of interest paid on required reserve balances and excess balances held by pass-through correspondents. Comments are due November 21, 2008, following the procedures in the Board's notice in the *Federal Register*.

20. Does the legislation permit depository institutions to pay interest on customers' demand deposits?

No. Depository institutions are still prohibited from paying interest on demand deposits.

21. Why did the Board of Governors eliminate transitional adjustments for reserve requirements following a merger or consolidation?

These adjustments were originally intended to phase-in the burden of higher reserve requirements associated with a merger or consolidation. The reserve requirement for the surviving institution is higher because the merged institution receives only one low reserve tranche and one exemption amount, while, prior to the merger, each institution had a low reserve tranche and an exemption amount. Paying interest on required reserve balances is a much more effective method for addressing the higher reserve tax associated with mergers or consolidations because the interest earned essentially eliminates the tax.

22. How does the Board's ruling affect depository institutions that currently have transitional adjustments due to a prior merger or consolidation?

Adjustments associated with mergers completed prior to October 9, 2008 will be left in place. No new adjustments will be issued on or after that date.

23. Whom do I contact if I have further questions?

Contact the reserve administration staff at your Reserve Bank. For a list of contacts please visit the Federal Reserve System Reporting and Reserves website (http://www.reportingandreserves.org/).