

December 19, 2011

Ms. Jennifer J. Johnson  
Secretary,  
Board of Governors  
Of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington, DC 20551

RE: Docket No. R-1433  
RIN No. 7100 AD 83  
Regulation D, Requirements of Depository Institutions: Reserves Simplification and  
Private Sector Adjustment Factor

Dear Ms. Johnson:

The American Bankers Association<sup>1</sup> (ABA) is pleased to submit comments on the Federal Reserve Board's (Board) proposed changes to Regulation D to simplify the administration of reserve requirements. ABA commends the Board for its thoughtful effort to update the regulation and to ease the burden of banks that must comply with its requirements.

ABA supports the efforts of the Board to simplify the management of reserve requirements. The four part proposal will improve the administration of these funds if certain steps are taken to modify the changes associated with replacing as-of adjustments with direct compensation. It is important to note that most of these changes are being proposed as a result of a shift in Board policy regarding paying interest on bank balances, a recent occurrence. If Board policy changes and bank balances no longer earn interest then these policy changes would need to be revisited.

### **Summary of the Proposed Rule**

The Board of Governors requests comment on a four-part proposal to improve bank administration of reserve requirements. Banks are required to keep reserve requirements on certain deposits and other liabilities. Transaction account balances at banks are subject to reserve requirements of zero, three, or ten percent depending upon the level of those transaction accounts. The reserve balances may be met through using vault cash at the bank or through an account held by the bank at the Federal Reserve directly or through a correspondent bank. The balance amount that a bank must maintain that is not satisfied by vault cash is known as the reserve balance requirement.

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<sup>1</sup> The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$13 trillion banking industry and its two million employees. The majority of ABA's members are banks with less than \$165 in assets.

Changing as-of adjustments related to deposit revisions and replacing all other as-of adjustments with direct compensation necessitates providing banks with more information.

As-of adjustments are used to offset the effect of errors caused by the Federal Reserve and banks. When a bank reports revisions to past deposit reports because of errors, it can result in an increase in the reserve balance requirement. When this happens an as-of adjustment is used to make the change in a future maintenance period.

The Board believes these adjustments to be burdensome. The payment of interest on balances maintained to satisfy reserve requirements eliminates the need for these adjustments. Banks that hold too high of a balance are not penalized because they are being paid interest. Banks that hold too low of a balance, in theory, gain because they can lend out those funds and receive income. But, now, they will receive interest income when they increase their balance. The payment of interest on balances mitigates the need to use as-of adjustments.

The Board proposes to eliminate all other as-of adjustments such as those associated with the correction of transaction errors and, the recovery of float and replace them with direct compensation.

The Board proposes to use the Federal Funds rate to determine the amount of direct compensation.

The current form of this proposal makes it extremely difficult for banks that could receive notice of direct compensation to be able to reconcile their financial records. Simply put, banks need more information from the Board when these events occur so that they can investigate and validate the events that triggered the error. In addition, banks need information regarding the Board's calculations to confirm the correction's accuracy.

At a minimum, the Board must provide the following information regarding direct compensation notices:

- Entry date and entry amount of the adjustment posted to a bank's Fed account.
- The starting and ending dates covered by this notice of direct compensation and the number of days used in calculating the dollar amount of the correction.
- The value of each transaction including the original entry amount and any interest adjustment.
- The interest rate used in the direct compensation calculation.
- A description of the event triggering the erroneous entry amount.

Establish a penalty-free band around reserve balance requirements in place of carryover and routine penalty waivers.

Currently, if a bank does not carry enough of a balance to meet its obligations during a maintenance period, it can offset that shortfall by carrying additional funds in the next reporting

period, as long as the difference is small. If a bank carries an excess balance during one period it is allowed to hold a lower amount during the next period. This process is known as “carryover.”

The proposal would eliminate “carryover” and replace it with penalty-free bands around each bank's reserve balance requirement. The top of the penalty free band would be equal to the amount of the reserve balance requirement plus a dollar amount set by the Board. The lower part of penalty band would be the bank's reserve balance requirement, less a dollar amount set by the Board.

A bank that maintains balances that exceed requirements, but stayed within the top band, would be paid at the interest rate paid on balances maintained to satisfy the reserve requirement. Balances in excess of the top band would be remunerated at the interest rate paid on excess balances.

A bank that maintains deficient balances would only pay interest if the deficit was below the bottom band.

The Board proposes to set wide penalty-free bands. Currently, carryover is calculated as the greater of \$50,000 or 4% of a bank's total reserve requirements. The Board proposes to set the penalty-free bands at \$50,000 or 10% of a bank's reserve balance requirement.

In general, ABA believes that there is no urgent need to make this change and using carryover has been a useful funds management tool. Therefore, it is important that any amendments to this process be improvements to the current system.

This proposal is practical as long as the Board continues to pay interest on excess reserves and at an interest rate that is equal to or above the Federal Funds Target rate. In a low or zero percent interest rate environment the payment of interest on excess reserves is a benefit, but not often a critical factor for bank earnings. In a more normal, higher interest rate landscape, the payment of interest on excess reserves is critical for this proposal to work. If market interest rates move higher, then the interest rate used to calculate payments on excess balances must be similarly adjusted to ensure that a financial institution is not subject to an opportunity cost when it has excess funds on deposit and does not earn a competitive rate of return.

The proposal to establish a penalty-free band around reserve requirements should be adopted with the understanding that if the Board ceases the practice of paying interest on reserve balances this regulation would need to be revised as soon as possible.

Eliminate the contractual clearing balance program review the methodology used to determine the Private Sector Adjustment Factor that is used to set prices for Federal Reserve Bank Services.

Currently, banks and a Reserve Bank may agree that the bank shall hold a clearing balance in excess of its balance requirement. Instead of earning interest, the bank earns credits banks use to pay for Reserve Bank services. These arrangements came about when the Reserve Banks were not allowed to pay explicit interest on balances. Banks earned earnings credits at the rate of 80% of the 13 week moving average of the yield of the three month Treasury bill.

Now that explicit interest can be paid by Reserve Banks, the clearing balance totals have dropped from \$6.5 billion to \$2.7 billion in the past three years. This is because the Reserve Banks now pay explicit interest on excess balances at a rate that is higher than the rate of implicit interest currently paid on clearing balances. Naturally, funds migrate to where they earn the higher return.

The Board proposes to eliminate contractual clearing balance programs and Reserve Banks would no longer issue earning credits. However, the level of clearing balances is a significant factor in how the Reserve bank sets fees and recognizes that Private Sector Adjustment Factor (PSAF) currently used will be affected.

The proposal to eliminate the contractual clearing balance program as proposed is acceptable as long as the Reserve Banks pay interest on balances. If this practice stops the use of contractual clearing balances would need to be revisited or perhaps some other method of compensating banks for keeping excess funds on deposit would need to be devised.

### Two-Week Maintenance Periods

The proposal would create a common two-week maintenance period for all depository institutions.

Currently, Regulation D allows for two types of maintenance periods, one-week and two-week. Maintenance periods provide banks flexibility in meeting reserve requirements because they can be over or under on any one day as long as they meet the target on average over the period.

Generally, banks that have reserve requirements above the exemption amount are required to submit deposit data on a weekly or quarterly basis. Banks with larger sums of transaction accounts, savings deposits and small time deposits report weekly and are subject to a two-week maintenance period and those that don't meet the threshold submit reports quarterly and are subject to a one-week maintenance period.

This proposal to set a common two-week maintenance period for all depository institutions should be adopted.

### Effective Dates

Effective dates that are too aggressive place a burden on the banks expected to comply with the changed rules. It is preferred that deadlines be set up to allow for an efficient and effective change process at banks. Requiring quick changes, rather than allowing them to be integrated into an already set calendar of changes, is wasteful and expensive. This is especially true with regard to the proposed changes to Regulation D that are warranted, but not urgent.

*Postpone the elimination of contractual clearing balances and the use of as-of adjustments to no earlier than Q1 2013.*

The Q1 2012 deadline is not reasonable because the proposal regarding as-of adjustments is not practical at this time. Banks need to have additional information provided to them in order to process the adjustments. That information is outlined previously in this letter. Without that information being provided, reasonable effective dates are hard to project.

ABA recommends that if the Board provides that described information related to the as-of adjustments in a final rule in Q1 2012 then a Q1 2013 implementation would be reasonable.

The Q1 2012 deadline is not reasonable to eliminate the contractual clearing balances. Setting an effective date within three months of the closing period for comments on the proposal does not allow enough time for banks to adjust their balance allocations with care.

ABA recommends that banks should be allowed the opportunity to begin moving these funds in the first quarter following the final rule with elimination of contractual clearing balances occurring no earlier than Q1 2013.

*Postpone the implementation of a common reserves maintenance period and the penalty-free bands to no earlier than Q1 2013.*

No, these are not reasonable effective dates. These changes will require new policies and procedures be implemented at banks across the industry. System and software changes are planned and budgeted at least 12 months in advance in most cases. These changes are not currently in banks' systems planning calendars for 2012. Implementing changes within six months would require banks alter their existing system upgrade planning process resulting in higher costs without a justifying benefit.

ABA recommends that the effective date for these changes be no earlier than Q1 2013.

#### Private Sector Adjustment Factor (PSAF)

The Board uses the PSAF to determine the prices for services provided to banks by the Federal Reserve Bank. The Monetary Control Act of 1980 requires that these fees recover all direct and indirect costs as well as imputed costs such as financing costs, taxes and other expenses including a return on equity. This is known as the correspondent bank model. The intent of this requirement is to ensure that the Federal Reserve Banks do not have an advantage over private sector providers of these services.

Changing the contractual clearing balance program will have an effect on the PSAF calculation and the Board issued a proposal in 2009 to shift to a "publicly traded firm model" (PTF) that would use publicly available statistical information to set prices. However, the Board has continued to use the correspondent bank model through 2011.

The Board's proposal seeks comment on several different scenarios where the contractual clearing balances are shrinking contributing to changes in the imputed equity rates leading to lower prices for services. The Board also seeks comment on when the PTF model should replace the correspondent bank model.

It is difficult to provide comment without seeing how the proposed changes would affect the actual PSAF as calculated by the Board. It would be helpful if the Board provided sample calculations that would demonstrate how the PSAF would be affected by shrinking contractual clearing balances. It would also be informative if the Board provided a side-by-side comparison of the correspondent banking model with the PTF model. Displaying the numerical results of the financial models under different scenarios would provide granularity that will help to clarify the differences between the two methods.

ABA appreciates the opportunity comment on the Board's proposal regarding Reserve Requirements of Depository Institutions: Reserves Simplification and Private Sector Adjustment Factor. If you have any questions about these comments, please contact the undersigned at (202)663-5147 or via email at [skenneally@aba.com](mailto:skenneally@aba.com).

Sincerely,

A handwritten signature in cursive script that reads "Stephen K. Kenneally".

Stephen K. Kenneally  
Vice President  
Center for Regulatory Compliance