Monday, May 16, 2011

By electronic delivery to:

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Ms. Johnson;

The American Bankers Association (ABA)[1] and The Clearing House (TCH)[2] appreciate the opportunity to comment on the issues raised by the Board of Governors of the Federal Reserve System's (Federal Reserve) Notice of Proposed Rulemaking (NPR)[3] implementing the repeal of the prohibition against payment of interest on Demand Deposits (Regulation Q) as mandated under §627 of Title VI[4] of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).[5]

Specifically, the Dodd-Frank Act repeals §19(i) of the Federal Reserve Act,[6] §18(g) of the Federal Deposit Insurance Act,[7] and part of §5(b)(1)(B) of the Home Owners' Loan Act.[8] The NPR is limited to repealing the Federal Reserve's published interpretation of Regulation Q and references to the regulation in Federal Reserve interpretations, commentary, and regulation,

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[1] 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. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities.

[2] Established in 1853, The Clearing House is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which employ 1.4 million people in the U.S. and hold more than half of all U.S. deposits. The Clearing House is a nonpartisan advocacy organization representing through regulatory comment letters, amicus briefs and white papers the interests of its owner banks on a variety of systemically important banking issues. The Clearing House Payments Company provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated clearinghouse, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

[3] 76 Fed. Reg. 20892 (April 14, 2011).

[4] Public Law 111-203, §627 *noted at* 12 U.S.C. 371(a), *Interest-Bearing Transaction Accounts Authorized.*

[5] Public Law 111-203. Codified at 12 U.S.C. 5301.

[6] 12 U.S.C. 371a.

[7] 12 U.S.C. 1828(g).

[8] 12 U.S.C. 1464(b)(1)(B).

including Regulations D and DD. The rulemaking proposes to remove the regulatory exclusion for premiums on deposits[9] and the Regulation Q definition of interest[10] as well as removing the interest exception from Regulation D's treatment of pass-through balances paid by correspondents to respondents.[11]

Although Regulation Q prohibits the payment of interest on all demand deposits, in practice, the prohibition was limited to forbidding the payment of interest on business checking accounts. In response to Regulation Q's limitations, Negotiable Order of Withdrawal (NOW) and sweep accounts were created to extend interest to individuals and some businesses.[12] Upon the repeal of Regulation Q, banks *may* offer interest-bearing demand deposits, including checking accounts, to businesses and individuals.

By statute, the repeal of Regulation Q is effective automatically July 21, 2011.[13] Due to the operation of a statutory termination, the Federal Reserve does not have the authority to delay or to implement a transitional phase-out of Regulation Q.

<u>Part I: Issues and Recommendations</u>

This comment letter consists of two-parts. Part I responds to the proposal generally and discusses outstanding issues and recommended solutions; Part II responds to the specific questions posed in the NPR.

In addition to the issues discussed in this comment letter, there are additional complementary issues related to the repeal of Regulation Q discussed in an attached companion letter (*Exhibit A*) directed to the Federal Deposit Insurance Corporation (FDIC) in response to their concurrent Regulation Q proposal.[14]

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[9] 12 C.F.R. 217.101.

[10] 12 C.F.R. 217.2(d). "*Interest* means any payment to or for the account of any depositor as compensation for the use of funds constituting a deposit. A member bank's absorption of expenses incident to providing a normal banking function or its forbearance from charging a fee in connection with such a service is not considered a payment of interest." The second sentence in the definition creates the exclusion for earnings credits from the definition of interest.

[11] 12 C.F.R. 204.10(c). *Pass-through balances.*

[12] NOW accounts are available to individuals, sole proprietorships, governmental units, and non-profit organizations. 12 U.S.C.1832(a). Sweep accounts move funds overnight from non-interest bearing into interest bearing accounts, such as a money market or mutual fund.

[13] 12 U.S.C. 371(b). The statutory repeal of Regulation Q is mandated by the Dodd-Frank Act to occur "1 year after the date of enactment of this Act." The enactment date of the Dodd-Frank Act was July 21, 2010.

[14] 76 Fed. Reg. 21265. *Interest on Deposits; Deposit Insurance Coverage.*

Retain the Federal Reserve Library of Regulation Q Interpretive Letters and Staff Opinions

In order to provide greater regulatory certainty, the Federal Reserve's collection of legal opinions under Regulation Q, which have provided valuable guidance to the industry for a number of years, must survive the repeal of Regulation Q. The concurrent proposal by the FDIC to retain and move Regulation Q definitions to 12 CFR 330.1 *Deposit Insurance Coverage*[15] may need the support of the legal interpretive letters, staff opinions, published rulings, and other Federal Reserve materials. The continuing existence of the Regulation Q documentation is necessary to bring clarity for future product development as well as provide supporting documentation for examination and compliance purposes.

ABA and TCH recommend a transitional period for the retention and management of the library of Federal Reserve Regulation Q materials. As of July 21, 2011, the Federal Reserve interpretive letters, staff opinions, published rulings, and all Federal Reserve materials under Regulation Q should be retained for a period of 18-months or more. During the initial 18-month retention period, the library should be available electronically and fully searchable. For examination purposes, the FDIC should incorporate the Federal Reserve principles in these rulings into a Financial Institution Letter (FIL). After 18 months and the creation of the FIL, the library should be maintained in some format for historical and research purposes.

Existing earnings credit programs developed according the Federal Reserve standard set forth in interpretive letters and staff opinion should be grandfathered. The basis and validity of grandfathered programs should not be subject to examiner scrutiny following the repeal of Regulation Q.

Federal Reserve and FDIC Should Host Industry Roundtables Before July 21, 2011

As this comment letter will demonstrate, the immediate need of the banking industry is for post-Regulation Q regulatory clarity. A series of joint Federal Reserve and FDIC roundtables to discuss the Regulation Q repeal might be the most efficient way to address the need for immediate communication and regulatory certainty. In order to reach a larger banking audience, the roundtables could be accompanied by a Frequently Asked Questions (FAQ) document downloadable from the agency websites to offer further guidance. The majority of the roundtable discussions should occur prior to the July 21, 2011 repeal date to provide a timely response to industry comments, questions, and concerns.

[15] 76 Fed. Reg. 21265.

Confirm the Continuing Availability NOW Accounts

Although not governed by Regulation Q, the industry would appreciate confirmation through an FAQ or other informal communication that Negotiable Order of Withdrawal (NOW) accounts, which were developed in response to Regulation Q restrictions, will survive the repeal and continue as a permitted bank product. In a post-Regulation Q market, the rationale for NOW accounts may decrease, but banks should not be prohibited from offering these accounts. NOW accounts remain important to financial institutions, such as industrial loan companies, that have restricted product offerings, and should remain available to all banks to provide in response to customer preferences for NOW accounts.

Joint Cooperation Among the Regulators Needed

Due to the pending effective date, time is of the essence in gaining clarity and certainty on the issues addressed in this comment letter. To ease the post-Regulation Q transition, it would be helpful if the Federal Reserve and FDIC would work jointly to clarify issues generally, prior to the July 21, 2011 effective date, and modify reporting forms prior to the September 2011 Call Report and Thrift Financial Report (TFR) deadline.

Banks Need Adequate Time to Prepare for Regulatory Changes

ABA and TCH appreciate the implementation burden placed on the Federal Reserve by the prescribed Dodd-Frank deadlines. The implementation schedule is strict, and it will continue to stress the resources of both banking agencies and financial institutions. Although the one-year repeal of Regulation Q was well known, the implementing Federal Reserve NPR was released only 97 days before the Dodd-Frank Act mandated effective date. Looking forward to the next set of statutory deadlines, ABA and TCH respectfully request that the Federal Reserve consider providing financial institutions more time to prepare for new operational and compliance demands.

Due to the repeal of Regulation Q, banks choosing to offer interest-bearing demand deposits will have an operational burden to develop new deposit products, update contracts and disclosures, educate customers, and, depending on the applicable FDIC insurance levels, move a substantial volume of customer funds into new deposit products. From a compliance perspective, banks need clarity on the treatment of new interest-bearing demand deposit accounts, including hybrid interest products, and, very importantly, guidance on how to record interest-bearing demand deposits on quarterly bank reports.

Part II: Responses to Proposed Questions

Question #1. Does the repeal of Regulation Q have significant implications for the balance sheets and income of depository institutions? What are the anticipated effects on bank profits, on the allocation of deposit liabilities among product offerings, and on the rates offered and fees assessed on demand deposits, sweep accounts, and compensating balance arrangements?

Due to anti-trust concerns, ABA and TCH will not comment on rates, fees, or specific product development.

The anticipated effect on bank profits, allocation of deposit liabilities, and rates offered is closely tied to a bank's local market and the interest rate environment. To analyze the effect of the repeal, this letter will consider three scenarios: a local market with low competition for deposits, a low interest rate environment in a competitive market, and a high interest rate environment in a competitive market.

> *Local market with low competition for deposits:*
> In some smaller markets with less competition for deposits, few banks are paying for commercial deposits in the form of NOW accounts, repos, or sweeps. If deposit competition continues to be low, banks in these markets may elect to pay no interest or offer no earnings credits after the repeal of Regulation Q.
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> *Low interest rate environment with high competition for deposits:*
> In a low interest rate environment in markets where there is competition for deposits, most banks already are paying for deposits in some manner as NOW accounts, earnings credits, repos, or sweeps. For these banks, the ability to pay interest may offer a less tedious, less cumbersome method of paying for a deposit. Many banks have expressed that the cost difference in a low interest rate environment between paying direct interest or offering an interest substitute would not be significant.
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> *High interest rate environment with high competition for deposits:*
> In a high interest rate environment, banks in competitive markets will be under increased pressure to offer interest, and coincidently the cost of funds will increase and NIMs may decrease. Post-Reg Q, the banking industry's best defense against interest rates spiraling to exceptionally high and unsustainable levels are more account options, including interest, earnings credits, premiums, bonuses, and hybrid accounts.

Effect on Correspondent Banking and Bankers Banks

Of note to correspondent banks and bankers banks is the proposed change to 12 CFR 240, the payment of interest on pass-through balances from correspondents to respondents. The proposal removes the §204 reference to Regulation Q and the exception from the definition of interest for pass-through interest.[16]

The effect of the NPR on correspondent banking should be negligible. Currently, earnings credits are paid on these deposits, which many respondent banks prefer. If interest were to be paid, a low rate, when compared to the respondent's portfolio, would lower the respondent's Net Interest Margin (NIM). In addition, earnings credits are not taxable income. Thus, the interest rate would need to be significantly higher than the earnings credit amount to result in the same net benefit to a respondent bank.

Question #4. Does the repeal of Regulation Q have any implications for competitive burden on smaller depository institutions?

Increased Competition for Deposits

Changes to the FDIC assessment rules incentivize banks to pursue deposits, rather than asset growth. The repeal of the Regulation Q interest prohibition will increase the competition for typically high-balance business accounts, and the cost of funds will increase as these deposits become more difficult to attract and more expensive to retain.

Increased Interest Costs and Reduced Net Interest Margin

Community banks are particularly concerned that troubled financial institutions needing liquidity, "deposit starved" banks, and banks with a high cost of funds will aggressively market exceptionally high interest rates. These practices may place community banks with conservative deposit pricing at a disadvantage.

Improved Parity with Credit Unions

Before the repeal of Regulation Q, FDIC insured financial institutions were at a disadvantage relative to credit unions, which pay interest on business checking and are moving aggressively into the small business-banking niche. When short-term interest rates increase, the inability to offer interest-bearing business checking accounts would become a competitive disadvantage for banks if Regulation Q were not repealed. In a high interest rate environment, commercial customers would seek out credit unions offering interest-bearing business checking, while banks would be barred from competing for the interest-bearing demand deposit accounts of business customers.

[16] 76 Fed. Reg at 20893. 12 C.F.R. 204.10(c) *Pass-through balances.*

Reintermediation of Funds Outside the Traditional Banking System
The ability to pay interest may assist banks of all sizes and charter types to attract funds previously placed outside of the traditional banking system. The reintermediation of corporate money will be more noticeable when interest rates increase.

ABA and TCH appreciate the opportunity to comment on this proposed rulemaking. Please contact the undersigned with questions. Thank you for considering our comments and recommendations.

Sincerely,

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