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Monday, February 1, 2010

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

Re: Docket No. R-1381; Regulation D; Reserve Requirements of Depository Institutions; Policy on Payment System Risk; 74 Federal Register 69301; December 31, 2009.

Dear Ms. Johnson:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the Federal Reserve Board of Governors' (the Board) proposal to establish term deposits, intended to assist in the management of aggregate reserve balances within the Federal Reserve's conduct of monetary policy. The proposal would permit "eligible institutions"[2] to hold term deposits at a rate not exceeding the general level of short-term interest rates.

ABA supports the Board's objective of exploring appropriate instruments of monetary policy while managing the unwinding of over $1 trillion of banks' excess reserves.[3] Under the program, funds invested in term deposits would no longer be reported as reserves. This reclassification may provide evidence that the Federal Reserve is running off reserves in a controlled manner. If the recategorization of bank reserves into term deposits has the benefit of enhancing transparency that would, for example, allow financial markets to recognize the change in the amount of excess reserves, then the term deposit program as proposed would in that regard have merit.

[1] The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.2 trillion in assets and employ over 2 million men and women.
[2] As defined in the proposal, an institution is eligible to place a term deposit with the Federal Reserve if it is eligible to receive earnings on its balances in accounts at Federal Reserve Banks. This definition includes foreign bank branches and agencies. 74 Fed. Reg. 69,302, n.1 (2009).
[3] Federal Reserve, *Aggregate Reserves of Depository Institutions and the Monetary Bank*, Chart H.3., Table 1, Column 4. Jan 21, 2010.

ABA offers the following additional comments on the proposal:

- In offering term deposits, the dual roles of the Board as conductor of monetary policy and as market participant need to be carefully balanced to avoid interference with natural market processes. That includes a careful consideration of potential competition with—or at least comparison with—Treasury securities.

- The Board should clarify the need for term deposits as a monetary policy tool and the advantages offered by term deposits absent from existing monetary policy tools.

- The term deposit program should be structured to assure adequate opportunity for participation by banks of all sizes, including small and mid-tier community banks and correspondent banks.

- The conditions of use and participation need to be clear and fixed so that participants are not exposed to regulatory or financial risks from changes in the program, such as new fees, taxes, premiums, supervisory restrictions on business operations, or other conditions.

- As a temporary monetary policy tool, the term deposit program should have a hard sunset provision to end the program when the need has passed.

- The tension between tightened credit and the focus on increased lending needs to be mediated through dialogue with the relevant private and public sector parties.

Background

In response to an expanding balance sheet and a large volume of reserves in the banking system, the Board has proposed the creation of a term deposit product for eligible financial institutions. As a monetary policy tool, term deposits would be intended to assist the Board in managing aggregate excess reserves. Similar to a certificate of deposit, term deposits could not be withdrawn prior to maturity. These deposits would be distinct from funds held in master reserve accounts or excess reserve accounts and would be eligible to collateralize discount window advances. However, the deposits would not satisfy required reserve balances or contractual clearing balances and would not be available to clear payments or overdrafts, daylight or overnight. Interest rates, to be set by auction, formula, or administratively, "would be no higher than the general level of short-term interest rates."[4] The duration of term deposits would be one month to one year.

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[4] Short term interest rates are defined in the proposal as "the primary credit rate and rates on obligations with maturities up to one year in which eligible institutions may invest, such as rates on term Federal funds, term repurchase agreements, commercial paper, term Eurodollar deposits, and other similar rates." 74 Fed. Reg. 69,302 (2009).

Concerns Arising from the Proposal

Federal Reserve as Market Participant

As proposed, term deposits of 30 days to one year are investment vehicles that will compete directly with other investment opportunities. In order to make the proposed term deposits attractive, the Federal Reserve will have to pay a competitive interest rate that likely will exceed the rate of comparable Treasuries.[5] If the Federal Reserve is forced to price term deposits higher than Treasuries, it will create a negative interest rate spread for the Federal Reserve, which generally invests in Treasuries. Commonly, a negative interest rate spread indicates interference in natural market processes. Whether that would raise confidence issues for the markets is unknown but merits consideration.

The Federal Reserve will be in competition not only with Treasury securities but also with the private market. The private market includes issuers of certificates of deposit and commercial paper as well as correspondent banks and bankers banks acting as intermediaries for bank funds. As a market participant of substantial size, the Board must be careful that its products and services are correctly valued as to create the required run off of reserves without underpricing the products of the private market. Otherwise, the Federal Reserve could displace competitors and cause long-term harm to the private sector offering similar investment products.

Need for Increased Transparency and the Use of Existing Monetary Policy Tools

Industry support of term deposits would be strengthened if the need, intent, and details of the program were explicit. It is not entirely clear what additional benefit term deposits bring as a monetary policy tool. If the purpose of a short-term deposit tool is to control the release of bank reserves, there are other existing monetary policy tools that may have the same effect.

As an alternative to the creation of a new Federal Reserve program, the Board could offer higher interest rates on reserves and reverse repurchase agreements. While managing the flow of reserves may be more complex with these tools, neither requires a new program nor requires the Federal Reserve to compete against the private market or the Treasury for investments.

Participation of Small and Mid-Tier Community Banks and Correspondent Banks

Many community banks lack the manpower and expertise to monitor the markets, develop an auction strategy, and manage their participation in a Federal Reserve program. If term deposits are to be a widely utilized monetary policy tool, then the program infrastructure needs to have low barriers of entry that encourage the participation of community banks, either individually or through correspondent agency funds management programs.

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[5] Unlike the proposed term deposits, Treasuries can be traded freely, while a market for term deposits has yet to develop. In order to make term deposits attractive, despite their limitations, the interest rate likely would be higher than the comparable Treasury.

To encourage broad participation, portions of every auction should be preserved for noncompetitive bids priced at the accepted rate. This strategy is similar to the process used for auctions of Treasury securities, which have proven successful at attracting investments from smaller market participants. Concurrent with the non-competitive bid option, the Federal Reserve may place quantitative limits on the bidding process so that no one bank captures all or even most of the available placements for funds.

Other Terms and Contingencies
The term deposit proposal must be considered through the contextual lens of the Troubled Asset Relief Program (TARP) and its progeny. Following the public fallout from perceived "bailouts" and restrictions on executive compensation, the banking industry is reticent to participate in new federal programs, especially if they may be susceptible to change or the imposition of new conditions. Banks of all sizes and charter types need further assurances that the rules of the game and terms of the program will not change adversely. Further, banks are not confident that participation will not give rise to prejudicial repercussions involving special fees, taxes, operational restrictions, or FDIC insurance premiums.

Program Sunset
If term deposits are a true temporary monetary policy tool, then they should not outlive the need to reduce liquidity in the market. The program as proposed should include a hard sunset for term deposits that allows for the proper management and wind down of the program within a reasonable timeline. With other tools performing a similar function, ABA does not support term deposits as a tool remaining in use once the temporary purpose is over.

If the Board becomes concerned that term deposits may be needed on a non-temporary basis, the program should be reexamined for its effectiveness in long-term reserve targeting. In order to allay industry concern, ABA recommends the Board initiate a substantial review of the program's utility, market impact, accessibility, and effect on competitors offering similar products. The findings of the report should be public and a detailed proposal formally submitted for industry comment.

Tension between Tightened Credit and the Focus on Increased Lending
In order for banks to function effectively, the tension between economic tools and public policy needs to be mediated. The Board, in collaboration with the bank regulators and Treasury, is best positioned to dialogue with relevant public and private sector parties regarding a balanced view of lending and liquidity while working to suppress the latent risk of inflation.

Thank you for the opportunity to comment on this proposal. Should you have any questions, please contact the undersigned at 202-663-5333 or ddepierr@aba.com.

Sincerely,

Denyette DePierro