AMERICAN BANKERS ASSOCIATION

1120 Connecticut Avenue, NW
Washington, DC 20036

1-800-BANKERS
www.aba.com

World-Class Solutions, Leadership & Advocacy Since 1875

Keith Leggett
Senior Economist
Tel: 202-663-5506
Fax: 202-828-4547
Email: kleggett@aba.com

November 21, 2008

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

Re: Federal Reserve System; 12 CFR Part 204 Reserve Requirements of Depository Institutions; 73 Federal Register 59482, October 9, 2008

Dear Ms. Johnson

On October 6, the Board of Governors (Board) issued an interim final rule authorizing payment of interest on depository institutions' required and excess reserve balances. The interim final rule became effective on October 9, 2008. The American Bankers Association (ABA) has steadfastly supported giving the Federal Reserve authority to pay interest on reserve balances of depository institutions. The inability to pay interest on reserve balances was a tax on depository institutions.

ABA 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 $13.3 trillion in assets and employ over 2.2 million men and women.

Background

Section 128 of the Emergency Economic Stabilization Act of 2008 (the Act), enacted on October 3, 2008, accelerated the effective date granting the Federal Reserve Banks authority to pay interest on balances maintained at the Reserve Banks by or on behalf of depository institutions. The Act made this authority effective on October 1, 2008. This authority was originally enacted in Title II of the Financial Services Regulatory Relief Act of 2006 with an effective date of October 1, 2011.[1]

Section 201(a)(12)(A) of the Financial Services Regulatory Relief Act of 2006 (FSRRA) amended the Federal Reserve Act by adding that "balances maintained at a Federal Reserve bank by or on behalf of a depository institution may receive earnings to be paid by the Federal Reserve bank at least once each calendar quarter, at a rate or rates not to exceed the general level of short-term interest rates."

[1] Pub. L. 109-351, 120 Stat. 1966 (Oct. 13, 2006).

The Board made the determination to pay interest on average required reserve balances and average excess balances maintained over the reserve maintenance period. The Board concluded that paying interest on excess balances will permit the Federal Reserve to expand its balance sheet to provide sufficient liquidity to support financial stability. This would also enhance the ability of the Board to implement monetary policy so as to achieve their monetary policy objectives. For example, by paying interest on excess balances, this should help to establish a lower bound on the federal funds rate and, therefore, keep rates in the market close to the targeted rate.

Since announcing that it would pay interest on required and excess reserves, reserve balances held at the Federal Reserve Banks have grown dramatically. The average daily balance of reserves with the Federal Reserve Banks for the two-week period ending October 8 was almost $143.4 billion. For the two week period ending November 5, average daily reserve balances were nearly $377.3 billion. Much of the growth was in excess reserve balances. Excess reserves held with the Federal Reserve Banks went from $136.1 billion to $363.6 billion over the same time interval.

Initially, in implementing Section 201 of FSRRA, the Board established the initial rate of interest for required reserve balances to be the average targeted federal funds rate over the reserve maintenance period[2] less 10 basis points. Setting this rate below the targeted federal funds rate reflects the fact that deposits at the Federal Reserve Banks are considered to be risk-free. The choice of 10 basis points is approximately equal to the average spread between the overnight rate on repurchase agreements secured by general Treasury collateral and the overnight rate on federal funds in recent years but prior to the onset of the current financial turmoil. Additionally, the Board proposed establishing the rate of interest for excess balances to be the lowest targeted federal funds rate during the reserve maintenance period less 75 basis points. The Board believed the rate on excess balances should be set sufficiently low to provide an incentive for eligible institutions to trade funds in excess of required reserve balances and clearing balances in the federal funds market, but to provide a disincentive to trade funds at rates far below the targeted federal funds rate.

However, on October 22, 2008, the Federal Reserve amended the formula for calculating the interest rate, which became effective for the reserve maintenance period beginning on October 23, 2008. The new calculation set the interest rate on excess reserves equal to the lowest Federal Open Market Committee (FOMC) target rate in effect during the reserve maintenance period less 35 basis points. Narrowing the spread between the target funds rate and the rate on excess balances at this time would help foster trading in the funds market at rates closer to the target federal funds rate.

On November 5, the Board further amended the formula for calculating interest on reserves, because of concerns that the federal funds rate continued to trade well below the targeted rate. Therefore, the rate on required reserve balances was set equal to the average target federal funds rate over the reserve maintenance period. The rate on excess balances was set equal to the lowest FOMC target rate in effect during the reserve

[2] A reserve maintenance period is either one week or two weeks in length, generally depending on the size of the institution.

maintenance period. These changes became effective for the maintenance periods beginning Thursday, November 6.

The Federal Reserve's massive injection of liquidity into the financial system could explain why the effective federal funds rate continues to trade well below the targeted federal funds rate. The growth rate of M-1 and the monetary base have accelerated in recent months. For the 13 week period ending October 27, M-1 grew at annualized rate of 14.8 percent. In comparison, M-1 expanded at an annual rate 9.1 percent over the last 26 week period. This rapid growth in the money supply would seem to be inconsistent with the goal of achieving its targeted federal funds rate.

ABA's Comment

ABA strongly supports paying interest on reserves. The inability to pay interest on reserve balances was a tax on depository institutions. This created an incentive for banks to develop programs to minimize their required reserves – a non-earning asset.

However, the implementation of this interim final rule seems to be not optimally timed. The freezing up the credit markets caused the Federal Reserve to rush the implementation of this interim final rule. This has had unintended consequences, especially for bankers banks.

Bankers' banks, which provide valuable services to our nation's community banks, did not have adequate lead time to adapt their business model to the Federal Reserve paying interest on reserves. As pointed out earlier, the original effective date for paying interest on reserves was October 1, 2011. If the original date had remained October 1, 2011, bankers' banks would have had sufficient time to alter their business model. However, the Emergency Economic Stabilization Act of 2008 accelerated the date to October 1, 2008. The Federal Reserve issued its interim final rule on October 6 to start paying interest on October 9. There was little lead time for bankers' banks to prepare for the change. The ramifications for bankers' banks of the Board's action to pay interest on reserves could include a decline in daily liquidity, impairment in contingent funding sources and reduction in sources of revenue.

Moreover, bankers' banks are concerned that the Federal Reserve will become a competitor for federal funds. An unintended consequence of the Board's decision to pay interest on excess reserves may significantly impair the long-term viability of the Agent Fed Funds Programs offered by bankers' banks. The payment of interest on excess balances at a rate pegged to the federal funds target rate, especially at a rate higher than the market effective rate, creates a competitive disadvantage for bankers' banks' agency federal funds programs.

Therefore, ABA encourages the Federal Reserve to take every possible action to limit the impact of its actions to pay interest on reserves on bankers' banks. ABA believes one appropriate action is that the Board should not require pass-through correspondents to pass back interest on behalf of these respondents. Pass-through correspondents and respondents should be allowed to negotiate the structure of the contractual relationship, as a market solution is preferable to a federally imposed requirement.

In conclusion, ABA strongly supports the payment of interest on reserves. ABA does encourage the Federal Reserve to carefully evaluate the unintended consequences associated with the accelerated implementation of this policy.

Sincerely,

Keith Leggett