THE BACK ALLEYS OF BANKING - INTEREST RESERVES

by Steve Brown

In the lightly traveled alleyways of banking, there is an arcane area that is little talked about, but will now have a profound affect on our industry. With the approval of the Rescue Plan the Fed gained the ability to pay interest on account balances. Previously, these balances were required for cash management operations and sat at the Fed but did not earn interest. Now the Fed will pay interest on these balances.

To provide background, banks keep "Required Reserve Balances," "Clearing Balances" and "Excess Reserve Balances" at the Fed. Required Reserve balances are those funds a bank must hold to meet reserve requirements (up to 10% of transaction deposits above certain minimum levels). This is the "minimum" banks must hold. Meanwhile, Clearing balances are those funds above Required Reserve Balances held to clear checks or wire transfers without overdrafting the account. This is the "cushion" banks hold on top of Required Reserves. Finally, Excess Reserves are anything above these two amounts left at the Fed.

Recall that balance targets are usually set on a rolling 14-day time frame called the "Maintenance Period," so that the average balance left at the Fed must be greater than the minimum when measured during the period. Starting this Thursday (the beginning of the next Maintenance Period), the Fed will pay the average Target Fed Funds rate (currently 2.00%) of the period less 10bp (currently 1.90% unless rates drop) on Required Reserves and the lowest Target Fed Funds less 75bp (1.25%) on Excess Reserve Balances. There is no change to clearing balances except earnings credits (imputed interest) will be paid on 100% of balances (instead of 90%).

These changes effectively place a "corridor" around the Fed Funds Target Rate (75bp below and 25bp above), dampening daily swings in Fed Funds trading and creating an environment of lower volatility. For example, if Fed Funds on any given day dip below 1.25%, banks will opt to park cash in their account at the Fed, essentially creating a "floor" at 1.25%. In the alternative, should Fed Funds begin to trade above 2.25%, banks will elect to borrow at the Discount Window, essentially creating a "ceiling." This stabilizes daily Fed Funds trading and allows the Fed to better manage monetary policy. Specifically, this gives the Fed a new tool to flood the system with liquidity, while holding the Fed Funds rate close to the Target.

It is important to note that there are multiple variations on how Excess and Clearing Balances are calculated; depending on a bank's reserve requirement, vault cash maintained, clearing balance requirement and carryover of excess balances. Banks looking for specific calculation examples are directed to: www.reportingandreserves.org.

The good news for users of Pacific Coast Bankers' Bank's ("PCBB") "As Agent" Fed Funds Pool and Settlement Product is that banks get the best of all worlds. The Pool gives banks a competitive Fed Funds rate and a diversified investment, while PCBB handles the reserve calculations for you under the Settlement Product. In addition, banks that pass through reserves utilizing PCBB, will receive this interest as soon as it is paid. While the new rule gives correspondent banks the right to retain all or a portion of this interest, PCBB knows community bankers need the income right now. That is why we decided to pass through 100% of the earnings until further notice. This will make it easy for community banks and allow all parties to evaluate the impact in coming months.

To recap, banks using PCBB Settlement and Fed Funds Program gain the advantage of automatically having their reserve requirements calculated and their earnings maximized. Each day, funds will be optimized to either take advantage of the payment of reserve interest or swept into a higher paying, well-diversified Fed Funds pool where counterparty risk is professionally managed. For information on how to take advantage of this seamless process, contact us. For more info on reserve interest, go to: http://www.federalreserve.gov/newsevents/press/monetary/20081006a.htm.

BANK NEWS

New FRB Program

The Federal Reserve announced a new program called the Commercial Paper Funding Facility ("CPFF") that will give it the flexibility to purchase commercial paper in the open market. CPFF is designed to provide a liquidity backstop to U.S. issuers of CP through a special purpose vehicle (SPV) that will purchase 3 month unsecured and asset-backed CP directly from eligible issuers. Purchases will be funded by the Treasury. This is one of the best moves the Fed has made yet to help the credit crisis.

TAF Expanded

Effective yesterday, the FRB increased the 28 and 84-day TAF auctions to $150B, raising the liquidity it will put into the system to an estimated $900B by year-end.

BofA 3Q Losses

The Bank reported a 68% drop in 3Q profits, cut its dividend by 50% and will raise $10B in capital.

Overseas Support

The EU announced it will guarantee deposits for $50k Euro throughout its 27 countries, in an effort to stabilize the banking system. Meanwhile, it also announced it would eliminate mark to market accounting rules.