FEDERAL RESERVE BANK OF NEW YORK

[Circular No. **10571**
August 31, 1992]

AMENDMENTS TO REGULATION D — RESERVE REQUIREMENTS

— To Counteract Reserve-Avoidance Practices

— To Change the Computation and Maintenance of Required Reserves

(Including Increased Carryover Allowance Effective September 3, 1992)

To All Depository Institutions, and Others Concerned, in the Second Federal Reserve District:

The Board of Governors of the Federal Reserve System has announced amendments to its Regulation D, "Reserve Requirements of Depository Institutions," (a) to close loopholes some banking institutions have used to avoid proper maintenance of reserves, and (b) to change the way depository institutions compute and maintain required reserves. Following are the texts of statements issued by the Board relating to these actions:

Loopholes

The Federal Reserve Board has announced adoption of amendments to Regulation D (Reserve Requirements of Depository Institutions) to close loopholes some banking institutions have used to avoid proper maintenance of reserve requirements.

The amendments are designed to prevent erosion of the reserve base for transaction accounts and will:

1. Treat certain so-called "sweep accounts" involving commingled time deposits as reservable.
2. Reclassify as reservable multiple savings accounts where the depository institution suggests, or otherwise promotes, multiple accounts to permit transfers in excess of the limits applicable to individual savings accounts.
3. Prohibit the use of "due from" deductions where a large bank has moved funds to a smaller bank to take advantage of the lower reserve requirements imposed on small banks and has received the funds back in a reserve-free transaction.
4. Treat previously nonreservable teller's checks the same as reservable cashier's checks.
5. Include bonds and coupons as "cash items in the process of collection" only if the bonds and coupons have matured or been called.
6. Prohibit the netting of trust balances in a commingled transaction account held by the trust department of a banking institution for various trusts.

Amendments 1, 2, and 3 are effective September 29, 1992.
Amendments 4, 5, and 6 are effective December 22, 1992.

Computation and maintenance

The Federal Reserve Board has announced adoption of amendments to Regulation D (Reserve Requirements of Depository Institutions) to change the way depository institutions compute and maintain their required reserves.

(OVER)

The amendments will:

- Shorten by two weeks the lag in counting vault cash toward required reserves in order to reduce the decline in required reserve balances early in the year.
- Double the carryover allowance for reserve balances to the larger of $50,000 or 4 percent of required reserves plus required clearing balances. This will provide institutions with more flexibility in managing reserves from one maintenance period to another.

The reduction in the lag in application of vault cash will be effective for the maintenance period beginning November 12, 1992, for weekly reporting institutions. Quarterly reporting institutions will be unaffected by the change.

The carryover allowance will be effective in the maintenance period beginning September 3, 1992, for both weekly and quarterly reporting institutions.

Enclosed is the text of the amendments, as published in the *Federal Register* of August 25. Additional, single copies of the enclosure may be obtained at this Bank (33 Liberty Street) from the Issues Division on the first floor, or from our Circulars Division (Tel. No. 212-720-5215 or 5216). Please take note of the different effective dates for the various amendments; in particular, note that the change in the carryover allowance for reserve balances will be effective in the maintenance period beginning September 3, 1992, with reserve surpluses or deficiencies from this maintenance period carried over into the maintenance period beginning September 17, 1992.

Questions regarding *maintenance requirements* under Regulation D may be directed to our Accounting Department (212-720-5250 or 5803); questions on *reporting requirements* under the regulation, to our Statistics Function (212-720-8590); and other questions on the *interpretation of Regulation D*, to our Legal Function (212-720-8118 or 5041) or our Compliance Examinations Department (212-720-5914).

E. GERALD CORRIGAN,
President.

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AMENDMENTS TO REGULATION D

(Various effective dates from September 3, 1992 to December 22, 1992)

1. Docket No. R-0750:
   Vault Cash; Carryover Allowance
2. Docket No. R-0729:
   Provisions regarding Transaction Accounts

[Enc. Cir. No. 10571]

FEDERAL RESERVE SYSTEM

12 CFR Part 204

[Regulation D; Docket No. R-0750]

Reserve Requirements of Depository Institutions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board has adopted two amendments to its Regulation D to facilitate the computation and maintenance of reserves. The Board is reducing the lag in the application of vault cash to reserve requirements in order to damp the seasonal variations in required reserve balances. Reducing the lag in application should decrease the probability that reserve balances will drop seasonally to levels that would cause depository institutions difficulty in managing their reserve balances. The Board is also increasing from the greater of 2 percent or $25,000 to the greater of 4 percent or $50,000 the amount of excesses or deficiencies in reserve balances that may be carried over from one reserve maintenance period to the next to give depositories greater flexibility in managing reserve balances.

DATES: The amendment to § 204.3(c)(3) is effective November 12, 1992. The reduced lag in application of vault cash for weekly reporters will apply for the maintenance period beginning November 12, 1992. The amendments to § 204.3(h) are effective September 3, 1992. The increase in carryover of reserve deficiences or surpluses will apply for the maintenance period beginning September 3, 1992.

FOR FURTHER INFORMATION CONTACT: Patrick J. McDivitt, Attorney (202/452-3818), or Lawranne Stewart, Attorney (202/452-3513), Legal Division; or Joshua Feinman, Economist (202/452-2841), Division of Monetary Affairs, Board of Governors of the Federal Reserve System. For the hearing impaired *only*, Telecommunications Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC.

SUPPLEMENTARY INFORMATION: On March 6, 1992, the Board published for comment revisions to its Regulation D, Reserve Requirements of Depository Institutions, 12 CFR part 204, concerning the computation and maintenance of reserves.[1] The proposed changes, which concerned vault cash and carryover of reserve deficiencies and excesses, were intended to improve the ability of depository institutions to manage their reserve balances. Comments were due by April 6, 1992. The Board has reviewed the comments received on the proposals and is now adopting final amendments to Regulation D.

Summary of Comments

The Board received comments on the proposed rule changes from the following 39 commenters:

Type	Number
Commercial Banks	20
Bank holding companies	8
Federal Reserve Banks	5
Trade associations	2
Credit unions	2
Clearing house	1
Savings and loans	1

Vault Cash

Currently, reserve requirements for depository institutions that report weekly are assessed against transaction accounts on a roughly contemporaneous basis,[2] but offsetting vault cash is applied to the required reserves with a lag of two reserve maintenance periods. The Board proposed to amend Regulation D to reduce the lag in the application of vault cash to reserve requirements from two periods to one in order better to synchronize movements in required reserves and applied vault cash. The Board requested comment on whether a reduction in the lag in the application of vault cash would improve the ability of depository institutions to manage their required reserve balances and whether the proposal would have any adverse effects on their ability to predict required reserve balances. The Board also requested comment concerning the costs of implementing a shift in vault cash application, and whether these costs would be considered significant in relation to the benefits of the proposed amendment to the depository institution.

Thirty-five commenters supported the proposal generally, with twenty-four of these commenters indicating that the proposed amendment would improve their ability to manage their reserve positions. Of the fourteen commenters that addressed the question of costs, all indicated that the costs to depository institutions associated with the shift would be minimal.

Four of the commenters, while supporting the proposed shift in the application of vault cash, recommended that vault cash be applied to reserve requirements on a contemporaneous basis, that is, with no lag in application. The Board has not adopted this recommendation, as the lagged application of vault cash provides information needed to estimate the demand for reserves in the current maintenance period. Such estimates are essential to the conduct of open market operations. Two other commenters pointed out that the proposed amendment would not reduce the lag in the computation period for deposits other than transaction accounts, and indicated that if reserve requirements for nonpersonal time deposits and Eurocurrency liabilities were to be reimposed, depository institutions would have to maintain reserves based on three computation periods. At the time that the reserve ratios relating to nonpersonal time deposits and Eurocurrency liabilities were reduced to zero, however, the provisions of Regulation D providing for lagged maintenance of reserves against such deposits also were removed.[3] Should these ratios be raised above zero in the future, the Board would determine the appropriate period for reserve maintenance on such deposits at that time. Another commenter suggested that depository institutions be divided into two groups, with the reserve maintenance period for each group ending on alternating Wednesdays. The Board previously considered alternating maintenance periods, but concluded that such a system was not operationally feasible.

Although none of the commenters specifically opposed the proposed amendment, two commenters urged that reserve requirements be eliminated altogether. The Board does not have the authority to eliminate reserve requirements completely, as section 19(b) of the Federal Reserve Act establishes minimum reserve ratios for

[1] 57 FR 8096, March 6, 1992.

[2] Weekly reporters generally are depository institutions with total deposits of $44.8 million or more. Required reserves for weekly reporters are assessed based on daily average balances for a period beginning on a Tuesday and ending on the second Monday thereafter. This period is known as the "computation period." Reserves against the daily average balances for the computation period must be maintained throughout the "maintenance period," which begins on the Thursday following the beginning of the computation period and ends on the second Wednesday thereafter. *See* 12 CFR 204.3(c).

[3] 55 FR 50540, Dec. 7, 1990.

reserves on transaction account balances. Two other commenters expressed support for legislative proposals to permit interest to be paid on reserve balances.

In view of the comments received, the Board has adopted the amendment to reduce the lag in the application of vault cash to meet reserve requirements from two periods to one period as a final rule. The amendment will be effective for the reserve maintenance period beginning on November 12, 1992.[4] The delayed effective date has been provided in order to permit the necessary modifications to the reserve computation systems of depository institutions and the Federal Reserve Banks.

Carryover of Excesses or Deficiencies

The Board proposed an increase in the amount of reserve deficiencies or surpluses that a depository institution would be permitted to carry forward into the next maintenance period to the greater of 4 percent of required reserves and clearing balances[5] or $50,000. Currently, carryover of reserve surpluses or deficiencies into the next maintenance period is permitted up to the greater of 2 percent of the sum of required reserves and required clearing balances or $25,000. In either case, the carryover is reduced by the amount of an institution's required clearing balance penalty-free band, if applicable.[6] In proposing the amendment, the Board noted that reductions in reserve requirements have resulted in a decline in the maximum dollar value of the carryover, reducing the ability of a depository institution to cushion a given dollar shock to its reserve position late in maintenance period. The proposed amendment was intended to provide depository institutions with more flexibility in managing their reserve positions. The Board also proposed to amend the language of the carryover provision to clarify and more accurately reflect the method used to calculate the maximum carryover permitted.

Thirty-seven commenters stated that they supported the Board's proposed amendment. Of these thirty-seven, twenty-eight commenters indicated that the increase in permitted carryover would improve their ability to manage their reserve positions. No commenters opposed the amendment.

Two commenters suggested that the Board consider further increases in permitted carryover. While the Board would consider a further increase if it appeared necessary to permit depository institutions to manage their reserve positions adequately, the Board believes that carryover generally must be limited in order to permit accurate estimates of required reserves. Another commenter suggested that the penalty-free band for clearing balances also be increased in order to provide similar benefits to depository institutions that maintain required clearing balances but are not bound by reserve requirements. Since these institutions hold no reserve balances, their ability to manage their reserve accounts has not been adversely affected by the recent cuts in reserve requirements. The Board believes that the current penalty-free band provides these institutions with adequate leeway in managing their clearing balance accounts.

Based on the comments received, the Board has adopted the amendment as a final rule. For both weekly and quarterly reporting institutions, the amendment will be effective for the maintenance period beginning September 3, 1992, with reserve surpluses or deficiencies from this maintenance period carried over into the maintenance period beginning September 17, 1992, based on the amended carryover provisions.

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 96-354, 5 U.S.C. 601 *et seq.*), the Board certifies that the amendments will not have a significant economic impact on a substantial number of small entities. The Board does not believe that the amendments would impose any additional reporting or recordkeeping requirements. To the extent changes in recordkeeping procedures may be required by the vault cash proposal, this will affect only weekly reporters, that is, depository institutions with total deposits of $44.8 million or more, and should enable these depository institutions to manage their required reserves more efficiently. Smaller institutions, which report only quarterly, will not be affected by the vault cash amendment.

Notice of Final Rule

A final rule generally is required to be published at least thirty days prior to its effective date. 5 U.S.C. 553(d). An exception is provided, however, for a substantive rule that grants or recognizes an exemption or relieves a restriction. 5 U.S.C. 553(d)(1). Although the amendment relating to carryover has an effective date less than thirty days after publication of this notice, the amendment permits a depository institution to carry over larger reserve balance deficiencies or surpluses than previously permitted. Because the amendment provides depository institutions with greater relief from reserve requirements, a thirty-day notice is not required for the amendment to become effective.

List of Subjects in 12 CFR Part 204

Banks, banking, Federal Reserve System, Reporting and recordkeeping requirements.

For the reasons set forth in the preamble, and pursuant to the Board's authority under section 19 of the Federal Reserve Act, 12 U.S.C. 461 *et seq.*, the Board is amending 12 CFR part 204 as follows:

PART 204—RESERVE REQUIREMENTS OF DEPOSITORY INSTITUTIONS

1. The authority citation for part 204 continues to read as follows:

Authority: Sections 11(a), 11(c), 19, 25, 25(a) of the Federal Reserve Act (12 U.S.C. 248(a), 248(c), 371a, 371b, 461, 601, 611); section 7 of the International Banking Act of 1978 (12 U.S.C. 3105); and section 411 of the Garn St-Germain Depository Institutions Act of 1982 (12 U.S.C. 461).

2. Section 204.3 is amended by revising paragraphs (c)(3) and (h) to read as follows:

§ 204.3 Computation and maintenance.

* * * * *

(c) * * *

(3) In determining the reserve balance that is required to be maintained with the Federal Reserve, the daily average vault cash held during the computation period that ended 3 days prior to the beginning of the maintenance period is deducted from the amount of the

[4] For the reserve maintenance period beginning Thursday, November 12th and ending Wednesday, November 25th, depository institutions will apply to their reserve requirements vault cash from the computation period beginning on Tuesday, October 27th, and ending on Monday, November 9th.

[5] Required clearing balances are set by agreement between a depository institution and its Federal Reserve Bank, based on clearing needs of the depository and its account overdraft record. Information on clearing balance requirements may be obtained from a depository institution's local Reserve Bank.

[6] The required clearing balance penalty-free band is currently equal to the greater of $25,000 or 2 percent of the depository institution's required clearing balance.

institution's required reserves.

* * * * *

(h) *Carryover of excesses or deficiencies.* Any excess or deficiency in a depository institution's account that is held directly or indirectly with a Federal Reserve Bank shall be carried over and applied to that account in the next maintenance period as specified in this paragraph. The amount of any such excess or deficiency that is carried over shall not exceed the greater of:

(1) The amount obtained by multiplying .04 times the sum of the depository institution's required reserves and the depository institution's required clearing balance, if any, and then subtracting from this product the depository institution's required clearing balance penalty-free band, if any; or

(2) $50,000, minus the depository institution's required clearing balance penalty-free band, if any. Any carryover not offset during the next period may not be carried over to subsequent periods.

* * * * *

By order of the Board of Governors of the Federal Reserve System, August 19, 1992.

Jennifer J. Johnson,

Associate Secretary of the Board.

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12 CFR Part 204

[Regulation D; Docket No. R-0729]

Reserve Requirements of Depository Institutions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board is adopting a number of amendments to its Regulation D relating to the definition of "transaction account" and concerning the calculation of reserves. The amendments include adding "teller's checks" to the definition of "transaction account" and clarifying the definition of "cash items in the process of collection." The Board is also adopting four interpretations concerning the definition of "transaction account" and arrangements used to avoid transaction account reserve requirements.

EFFECTIVE DATES: September 29, 1992, except for §§ 204.2(a)(1), (b)(1), and (u) (teller's checks), § 204.2(i) (cash items in the process of collection), and § 204.136 (netting of trust balances), which will be effective December 22, 1992.

FOR FURTHER INFORMATION CONTACT: Oliver Ireland, Associate General Counsel (202/452-3625), Patrick J. McDivitt, Attorney (202/452-3818), or Lawranne Stewart, Attorney (202/452-3513), Legal Division; or Thomas Brady, Chief, Banking and Money Market Statistics Section (202/452-2469), Division of Monetary Affairs, Board of Governors of the Federal Reserve System. For the hearing impaired *only*, Telecommunications Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington DC 20551

SUPPLEMENTARY INFORMATION: On April 12, 1991, and by notice published in the **Federal Register**, 56 FR 15,522, April 17, 1991, the Board proposed a number of revisions to its Regulation D, Reserve Requirements of Depository Institutions, 12 CFR part 204, and a number of interpretations of the Federal Reserve Act and Regulation D. These proposals primarily relate to the definition of "transaction account" and the calculation of required reserves on transaction accounts. Comments were due on the proposals by June 24, 1991. The Board has reviewed the comments received on the proposals and is now adopting final amendments to Regulation D and final interpretations to the Federal Reserve Act and Regulation D.

Under Regulation D, transaction accounts generally are subject to a 10 percent reserve requirement.[1] Currently, the reserve requirement applicable to all other deposit accounts is zero.[2] The Board has identified a number of practices that result in depository institutions: (1) issuing nonreservable payment instruments in place of functionally equivalent reservable instruments; (2) classifying accounts as time deposits when the accounts are used to provide funds directly or indirectly for the purpose of making payments or transfers to third persons or others and are therefore the functional equivalent of transaction accounts; (3) taking inappropriate "due from" or "cash item in the process of collection" deductions from their gross demand deposits in calculating required reserves; or (4) inappropriately netting negative trust account balances against positive balances in unaffiliated accounts in order to reduce reserve requirements on transaction accounts containing commingled trust funds.

The described practices avoid or reduce transaction account reserves, reducing the reserve base available for the conduct of monetary policy. Avoiding reserve requirements by exploiting the technical language of the regulation frustrates congressional intent that transaction accounts be subject to reserve requirements, results in inequitable treatment of similar transactions at other depository institutions, and favors depository institutions that have the legal and automation resources to develop reserve avoidance practices and are willing to implement such practices. Moreover, the increased use of such reserve avoidance practices could reduce required reserve balances at institutions using these practices to levels below those needed for clearing purposes, potentially resulting in much less predictable demands for Federal Reserve balances and more volatile funds rates.

The Board believes that reductions in reserve requirements on transaction accounts should be accomplished by the Board through changes in the ratio of transaction account reserves under section 19(b)(2)(B) of the Federal Reserve Act, such as the Board's action reducing this ratio from 12 percent to 10 percent, rather than through the growth of arrangements and accounts designed to avoid or reduce reserve requirements. Accordingly, the Board is adopting a number of amendments to Regulation D and interpretations to the Federal Reserve Act and Regulation D to treat certain transaction account substitutes as transaction accounts subject to reserve requirements and to clarify the deductions that may be made in computing required reserves.

Comments on the April Proposals

The Board received comments on the proposals from the following 67 commenters:

Type	Number
Commercial Banks	22
Bank Holding Companies	20
Trade Associations	8
Credit Unions	5
Financial Service Providers	4
Federal Reserve Banks	4
Savings and Loans	3
Individuals	1
Total	67

The comments are summarized below.[3]

General Comments

One trade association urged that the comment period be extended an additional 120 days so that credit unions could study the effect of the teller's check proposal. This comment was received on the last day of the comment period and did not elaborate on the reasons a longer comment period was needed other than to refer to other Board proposals that were outstanding. Because the request was received after most commenters had already submitted their comments and because it did not demonstrate a clear need for an extension, the Board did not extend the comment period.

One commenter suggested that the Board should pay interest on reserves. The Board does not, however, have express statutory authority to pay interest on reserves. Another commenter suggested that Regulation D be clarified generally. One commenter urged the Board to provide transitional relief (such as a ninety-day period) if it adopts the proposals to permit depository institutions to institute operational changes. The Board is deferring for 120 days the effective date of the

[1] A reduction in reserve requirements on transaction accounts from 12 percent to 10 percent became effective April 6, 1992. 57 FR 8059, March 6, 1992.

[2] In December 1990 the Board reduced reserve requirements on nonpersonal time deposits with a maturity of less than 18 months and net Eurocurrency liabilities from three percent to zero percent. 55 FR 50540, Dec. 7, 1990.

[3] The Board specifically requested comments from the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration, but did not receive written comments from any of these agencies.

amendments defining teller's checks and incorporating teller's checks in the definition of transaction account, the amendments modifying the definition of cash items in the process of collection, and the proposed interpretation on trust netting. The other proposals will be effective thirty days after the date of publication in the Federal Register.

A number of commenters questioned the economic validity of the reserve function or suggested that the proposals would increase the regulatory burden imposed on depository institutions. Nineteen commenters generally expressed concern that more stringent applications of reserve requirements would increase the competitive disadvantage that depository institutions have, particularly in competing with money market funds and other financial institutions. For example, one commenter suggested that if reserves are a necessity, they should apply to all forms of deposits at every depository institution and any organization that provides payment services. Another commenter suggested that no change be made in Regulation D until an overall strategic direction is established for the Regulation. Five commenters claimed that the proposals would result in funds leaving the banking system for other financial institutions, and would therefore adversely affect the ability of the Board to control the reserve base for monetary policy purposes.

The Board believes that reserves continue to be an important tool for implementing monetary policy and therefore believes that it is important to continue to maintain the integrity of the reserve base. To the extent that reductions in reserve requirements on transaction accounts are appropriate, the Board believes that such reductions should be accomplished by the Board through changes in the ratio of transaction account reserves under section 19(b)(2)(B) of the Federal Reserve Act. As noted above, the Board has recently reduced from 12 percent to 10 percent the ratio applicable to transaction account balances of over $42.2 million. In addition, the Board from time to time may consider the level of reserve requirements to ensure that they are appropriate.

Transaction Account Definition

Amendments

Teller's Checks

Many depository institutions use checks ("teller's checks") drawn by the depository institution on accounts at other depository institutions, Federal Home Loan Banks, or Federal Reserve Banks, or payable through or at depository institutions, as a substitute for reservable cashier's checks. Teller's checks are effective substitutes for cashier's checks, which are drawn by a depository institution on itself, because teller's checks bear the important legal characteristics of cashier's checks (*See* § 3–413(2) and § 3–802(1)(a) of the Uniform Commercial Code, Pre–1990 Official Text (UCC)). Under § 3–413(2) of the UCC, a bank drawing a check is liable on the check, whether it be a cashier's check or a teller's check, if the check is dishonored by the drawee. Under Section 3–802(1)(a) of the UCC, payment by either cashier's check or teller's check results in *pro tanto* discharge of the underlying obligation. However, under Regulation D, teller's checks have not been subject to reserve requirements while cashier's checks have been.

Teller's checks are often more economical to issue than cashier's checks, in part because they have not been subject to reserve requirements. Because of the cost savings attributable to shifting from cashier's checks to teller's checks, the Board is concerned that competitive pressures will encourage depository institutions to use teller's checks to avoid the cost of holding reserves against cashier's checks, and that this shift could materially affect the reserve base. Further, the disparate treatment accorded these instruments has put depository institutions using cashier's checks rather than nonreservable teller's checks, as well as teller's checks service providers that are bank affiliates, at a competitive disadvantage.[4]

Accordingly, the Board proposed amendments to Regulation D to change the manner in which reserve requirements apply to teller's checks, including checks drawn on Federal Home Loan Banks and Federal Reserve Banks. Under the proposal, a teller's check would be a transaction account of the depository institution drawing the check until the check is paid by the drawee. To the extent that the check is covered by immediately withdrawable funds of the selling depository institution on deposit in an account of the selling institution at the depository institution on which the check is drawn (or at or through which the check is payable), the selling depository institution would be able to take a "due from" deduction under § 204.3(f) of Regulation D.[5]

The proposal would: (1) amend Regulation D to include a definition of teller's checks; (2) amend § 204.2(a)(1)(iii) of Regulation D to define "deposit" to include teller's checks; (3) amend § 204.2(b)(1)(ii) of Regulation D to define "demand deposit" to include teller's checks; and (4) delete § 204.2(b)(3)(iv) of Regulation D, which excludes teller's checks from the definition of demand deposit.

The Board received thirty-three comments on this proposal. Seven of these commenters generally supported the proposal, twenty objected to the proposal generally, and six supported or did not object to the proposal as long as clarifications to the language of the provision were made. The objecting commenters claimed that adoption of this proposal would impose burdens on depository institutions, and suggested that reserves on teller's checks were unnecessary or should also be imposed on all financial institutions, not just depository institutions. One commenter suggested that the Board has not included teller's checks in the reserve base for eleven years and has not demonstrated a compelling reason to impose reserves on these items now. Another commenter noted that depository institutions can obtain economies of scale by using teller's checks provided by non-depository

[4] The Board has conditioned approval of bank holding company applications to issue and sell large-denomination payment instruments, including teller's checks, on several commitments that the bank holding company file weekly reports of the level of this activity and comply with certain deposit reserve requirements. These conditions were designed to counter the potential reserve avoidance characteristics of such instruments and to ensure accurate reporting of related monetary statistics. *Midland Bank PLC*, 76 Federal Reserve Bulletin 860 (1990); *Midland Bank PLC*, 74 Federal Reserve Bulletin 252 (1988); *Hong Kong and Shanghai Banking Corporation*, 73 Federal Reserve Bulletin 808 (1987); *BankAmerica Corporation*, 73 Federal Reserve Bulletin 727 (1987); *FirstBank Holding Company of Colorado*, 72 Federal Reserve Bulletin 662 (1986); *Wells Fargo & Company*, 72 Federal Reserve Bulletin 148 (1986); *The Chase Manhattan Corporation*, 71 Federal Reserve Bulletin 905 (1985); *RepublicBank Corporation*, 71 Federal Reserve Bulletin 724 (1985); *Citicorp*, 71 Federal Reserve Bulletin 58 (1985); *BankAmerica Corporation*, 70 Federal Reserve Bulletin 364 (1984). In addition, a number of the Board orders referenced above include limits on the denominations of some payment instruments. The Board will entertain applications and requests for relief from conditions from bank holding companies subject to these limits or requirements.

[5] This deduction would not be available for accounts that do not meet the requirements for a due from deduction in § 204.3(f)(3) of Regulation D such as escrow accounts and balances held at a Federal Reserve Bank, or of pass-through reserves held at a Federal Home Loan Bank. 12 CFR 204.3(f)(3). In order for a depository institution to take a "due from" deduction for funds held at another depository institution, the funds generally must be held in an account in the name of the depositing institution and be subject to immediate withdrawal by the depositing institution.

service providers. Another commenter suggested that the proposal should be limited to instruments drawn on a Federal Reserve Bank or a Federal Home Loan Bank because other transactions were already properly reflected in the reserve requirements calculation.

Teller's checks drawn on or payable through or at depository institutions as well as teller's checks drawn on Federal Reserve Banks and Federal Home Loan Banks currently are treated differently from cashier's checks for reserve purposes. In the proposal, the Board noted that, because of the cost savings attributable to shifting from the use of cashier's checks to teller's checks where the teller's check service provider is not subject to reserve requirements, the increased use of teller's checks could materially affect the reserve base. The Board also noted that market pressures could increase this effect. After a review of the comments, the Board continues to believe that its conclusions are correct.

Three commenters expressed concern that the proposal would require the same liability to be reserved against twice—once on the teller's check, and once by the depository institution where the funds are placed. The Board believes that the proposal generally would not produce this effect. Outstanding teller's check balances generally are not held in reservable deposit accounts at the drawee or paying bank. The Board understands that outstanding balances are generally invested by the service provider in order to earn a return on the funds for the service provider and the selling institutions.

The commenters indicated that the issuance of a teller's check resulted in a reduction of the due from account for the bank on which the check was drawn. For Call Report purposes, to the extent that a selling institution has a balance due from the drawee or paying bank, this balance must be reduced by the amount of any teller's checks drawn. For purposes of calculating reserve requirements, however, a depository institution may continue to take a due from deduction for a qualifying account at another depository institution until the balance in that account is debited to pay the teller's checks.

Nine commenters were concerned that depository institutions should not be subject to reserves on checks on which they have no liability (such as where the institution serves solely as agent for the entity drawing the instrument). Another commenter asserted that the proposal should be amended to apply to these instruments specifically. The Board's proposal would not impose reserve requirements on sellers of checks sold in an agency capacity where that capacity is clearly stated on the face of the check, as the selling bank would not be the drawer of the check. (*See* Article 3–403 of the Uniform Commercial Code Pre 1990 Official Text and Article 3–403 of the 1990 Official Text.) The Board believes that it would not be appropriate to impose reserve requirements on the selling bank for instruments on which the selling bank has no liability, as such checks are not the equivalent of cashier's checks.[6]

Another commenter, a teller's check service provider, claimed that some banks offer these checks as agent for a non-depository institution (and therefore have no liability on the check), but that the depository institution still is the issuer of the obligation. For this reason, the commenter argued, the check is a "teller's check" for purposes of the Board's Regulation CC (12 CFR Part 229), and thus is entitled to next day availability under that regulation. The commenter further argued that, under state law (UCC section 3-102(1)(a)), the issuer and the drawer are not necessarily the same person. The Board believes that this comment reflects a misunderstanding of the provisions of Regulation CC. Under § 229.2(gg) of Regulation CC, the term "teller's check" is limited to checks drawn by banks (as that term is defined in Regulation CC.) Therefore, under Regulation CC, checks sold by a depository institution as agent, but on which a depository institution was not the drawer, would not be considered to be teller's checks even if the checks were "issued" by the depository institution.

One commenter suggested that, in states that have not adopted the new section 3–414 of the UCC, the Board would be assessing reserves on a bank beyond the Board's statutory authority if the proposal applied to banks issuing teller's checks without recourse. Under the Board's proposal, checks drawn without recourse against the drawer are not defined as teller's checks. Two commenters also were concerned that the proposal would subject depository institutions to reserves on traveler's checks, and one suggested the Board clarify that this is not the case. The Board's proposal does not apply to instruments sold as traveler's checks unless the checks are drawn by a depository institution. Two commenters suggested that the proposal should be revised to include an exception for teller's checks under $10,000. Another commenter suggested that teller's checks that were only used for certain classes of transactions, such as international payments, should be exempt from reserve requirements. The Board does not believe that a special purpose test for determining the applicability of teller's check reserve requirements is practical. Depository institutions can, however, provide their customers with checks on which the selling institution does not act as drawer. Such instruments would function as substitutes for money orders, rather than as substitutes for cashier's checks, and would not be reservable under the Board's proposal.

One trade association suggested that depository institutions with less than $100 million in assets should be exempt from reserves on their teller's checks. The Board does not believe that such an exemption is appropriate, as smaller institutions already have lower reserve requirements relative to their total reservable deposits under the zero and low reserve tranches, and report deposits considerably less frequently than larger banks. In addition, an exemption for depository institutions under $100 million in assets would allow the current erosion in the reserve base to continue as exempted institutions moved from cashier's to teller's checks. Another trade association suggested that, rather than adopt this proposal, the Board could impose additional reserves on depository institutions that habitually draw teller's checks in such a manner that they avoid reserves. The Board regards a "habitual abuser" test for determining the applicability of teller's check reserve requirements as impractical, as it would require the Board to determine the motivation for the use of teller's checks.

Two commenters suggested that the Board permit an arrangement whereby teller's check service providers would hold the reserves relating to teller's checks for their customer depository institution. While nonmember depository institutions may hold their reserves through another depository institution, a Federal Home Loan Bank, or the National Credit Union Central Liquidity Facility, the Federal Reserve Act does not permit banks that are members of the Federal Reserve System to maintain reserves through another depository institution.[7] Reporting of

[6] If the selling bank is acting as agent for another depository institution, however, that depository institution would be required to hold reserves against the checks drawn by it or by the selling bank as its agent, as these checks would be drawn by that depository institution.

[7] See section 19(c)(1) of the Federal Reserve Act (12 U.S.C. 461).

account balances, however, must be done by the account holding depository institution, in this case the selling institution.

One commenter argued that the proposal would require depository institutions drawing teller's checks to track and report outstanding teller's checks themselves and that this might cause depository institutions to return to the use of less efficient cashier's checks. This commenter further argued that, under certain existing teller's check programs, the drawee bank reserves against the teller's checks and that these arrangements should be permitted to continue in order to satisfy reserve requirements on teller's checks. Specifically, this commenter suggested that teller's checks be considered to be reservable deposits until paid by the drawee "or until the issuing depository institution has remitted immediately available funds to the drawee bank or payable through bank in satisfaction of the issuer's liability." This commenter further suggested that the Board require that the receipt of funds by the paying bank be a reservable deposit of the paying bank until the item had been paid or otherwise disbursed, and that the selling institution be permitted to take a "due from" deduction against funds remitted to the paying bank, regardless of the disposition of the funds after receipt by the paying bank. The commenter indicated that funds held by the paying bank are held in "omnibus accounts" for reasons of efficiency and to protect teller's check purchasers, and argued that separate accounts subject to withdrawal by the selling institutions should not be required in order for each selling institution to take a "due from" deduction against the accounts.

The Board has considered a number of alternatives for centralizing the holding of reserves against teller's checks, including the suggestion made by this commenter. Each alternative, however, suffers from significant practical or legal difficulties.

In order to create a liability subject to reserves that would be "centralized," a service provider would have to create a deposit subject to reserve requirements that could substitute for the liabilities of the individual depository institutions selling teller's checks. For example, the reserves could be maintained against the proceeds of outstanding teller's checks that are remitted to the service provider, instead of by the remitting depository institution, if the service provider placed the proceeds in a demand deposit account. This arrangement does not appear to be economically viable, as funds held in such a deposit account would not earn interest. The Board understands that teller's check service providers generally pay a return to sellers of teller's checks based on outstanding balances of funds remitted to the service provider to cover checks sold.[8] Sellers of teller's checks would no longer be able to earn such returns, as the service provider would receive no interest on its demand deposit and would not have earnings to pass on to selling institutions. Similarly, if the proceeds of the teller's checks were placed in an account under an agreement between the account holding depository institution and a depository institution selling the teller's checks to pay these checks, payment of interest on the account by the depository institution to the selling institution would constitute payment of interest on a demand account.

Finally, as noted above, while the holding of reserves against teller's checks could be centralized for many depository institutions by those institutions holding all their reserves through a single depository institution under a "pass through" arrangement under § 204.3(i) of Regulation D, section 19(c)(1) of the Federal Reserve Act precludes such arrangements for member banks.

Accordingly, the Board believes that the proposed structure of teller's check reserve requirements is appropriate. Staff will work with teller's check sellers and service providers to explore procedures to facilitate the holding of reserves against teller's checks.

Twelve commenters expressed concern that depository institutions would have to incur significant operating changes to treat teller's checks as reservable liabilities. One commenter asserted that a depository institution will not have the information it needs to report teller's checks for reserve purposes and, accordingly, should not be subject to reserves on these instruments. One commenter suggested that depository institutions be permitted to use the average outstanding balance of such instruments. Commenters indicated that drawers of teller's checks often do not track outstanding balances of teller's checks because this tracking is performed by the teller's check service providers, which may report activity to their customers only on a monthly basis. For a weekly reporter (generally a depository institution with deposits in excess of $44.8 million) to report teller's check data on a timely basis, confirmation of the daily outstanding balances of teller's checks would be required from the service provider with only a short lag.

The Board is concerned that it may not be appropriate to base teller's checks reporting requirements on average outstanding balances while other reporting requirements are based on actual balances. Special reporting arrangements would continue to favor the use of teller's checks over economically and legally similar cashier's checks. Further, daily deposit data permit verification of the data and ensure proper seasonal adjustments.

The Board recognizes, however, that implementation of the teller's check amendments will require operational changes for some drawers of teller's checks and for teller's check service providers, particularly for weekly reporters. These changes should be less significant for smaller institutions that report quarterly, as they are not required to track daily outstanding balances throughout the year. The Board is deferring the effective date of the teller's check amendment for 120 days. During that period, Board staff will work with teller's check sellers and service providers to ease potential reporting burdens.

Finally, one commenter suggested that the reference to teller's checks in proposed § 204.2(v)(iii) conflicted with the definition of teller's checks in proposed § 204.2(u). Section 204.2(a)(1)(iii) and § 204.2(b)(1)(ii) have been redrafted for clarity and § 204.2(u) has been revised to include checks payable through the drawing depository institution in the definition of teller's checks.

The Board is adopting the teller's check proposal subject to the drafting changes discussed above, with the effective date of this amendment deferred for 120 days to permit depository institutions to make appropriate arrangements to provide teller's check and other payment instrument services consistent with this amendment.

Incorporation of Reference to Interpretations

The definition of "transaction account" in Regulation D includes "[a]ll deposits other than time and savings deposits." 12 CFR 204.2(e)(6). The proposal would amend this subparagraph to refer also to accounts that may be nominally time or savings accounts, but that the Board has determined, by rule or order, to be transaction accounts. This amendment was intended to provide a reference to the Board's interpretations on

[8] Similarly, depository institutions earn a return on the proceeds of the sale of cashier's checks until the cashier's checks are presented for payment.

transaction accounts. The only comment received on this amendment supported the amendment. The amendment is being adopted as proposed.

Interpretations

The Board identified two practices involving the use of time deposits (including savings deposits) that it believed were designed to provide funds directly or indirectly for the purpose of making payments or transfers to third persons or others. The Board believes that these time deposits should be considered to be transaction accounts. Accordingly, the Board proposed for comment two interpretations identifying as transaction accounts certain deposits that would otherwise be considered to be time deposits. The Board is adopting these interpretations with certain modifications discussed below. If other practices become prevalent in which time deposits are used directly or indirectly for the purpose of making payments or transfers to third persons or others, the Board will consider appropriate action to ensure that such deposits are not used to avoid reserve requirements on transaction accounts.

Linked Savings Accounts (§ 204.133)

The Board proposed an interpretation, to be published at 12 CFR 204.133, that would require a depository institution to treat multiple savings deposits as transaction accounts in certain circumstances. The proposed interpretation would prohibit a depository institution from assisting a customer to establish multiple savings deposits with transfer abilities unless the customer has a legitimate purpose for the multiple accounts.

The Board received twenty-nine comments on this proposal, all but three of which opposed the proposal.

Three commenters contended that multiple accounts are not used to avoid transfer limits, but rather to meet customer needs. Three commenters claimed that the proposal would force institutions to use complicated arrangements to move funds out of the depository institution overnight to earn a return for their customers without violating the regulation. The proposal was intended to maintain the distinction between savings deposits and transaction accounts. The Board recognizes that maintaining this distinction imposes costs on depository institutions, but believes that it is necessary to maintain this distinction for monetary policy purposes. One commenter suggested that the final interpretation clearly state that it does not apply to sweep arrangements involving only a single savings account. While this interpretation applies only to arrangements involving multiple savings accounts, the Board believes that sweep arrangements involving only a single savings account could constitute evasions of reserve requirements in certain circumstances not addressed here.

Thirteen commenters asserted that depository institutions would have difficulties in determining whether there was a legitimate business purpose for the use of multiple savings deposits, and expressed uncertainty as to the efforts that a depository institution would have to make to comply with the proposal. For example, one commenter stated that because depository institutions could not judge the legitimacy of the classification, the burden should be on the Board to judge the legitimacy of a customer's purpose in opening an account. One commenter urged that the proposal be revised to eliminate any duty to determine whether there is a business purpose for the opening of multiple accounts. One commenter noted that customers wishing to circumvent the restrictions would simply present false reasons for opening up the accounts. Another commenter asked whether the "business purpose" test could be met by establishing a "personal business" purpose, and noted that if that were the case, customers could easily justify a purpose for multiple accounts. One commenter contended that, as long as the depository institution does not promote multiple accounts, the depository institution should be able to assume that there is a legitimate purpose for the multiple accounts. That commenter also argued that the proposal relies upon whether the accounts are "solely" for transfer purposes, and that a bank would have a nearly impossible time of monitoring compliance. Another commenter suggested that specific guidance be provided for the treatment of accounts of related persons, such as close family members. One commenter requested a clarification that credit unions could continue to use a sub-account arrangement if the purpose was not to evade Regulation D. Another commenter, also a credit union, claimed that under the proposal it would have to convert all its savings accounts to transaction accounts.

In order to address the comments as to the difficulty of identifying the legitimacy of customer purposes for establishing multiple savings deposits, the Board has revised the proposed interpretation. The final interpretation classifies as transactions accounts multiple savings deposits established by a single customer when the depository institution suggests or otherwise promotes the establishment or operation of multiple savings deposit arrangements to increase the customer's transfer capabilities and the multiple accounts do not have another legitimate purpose. The Board believes that, while some customers of depository institutions may be able to avoid the transfer limits on savings deposits on their own initiative, the revised interpretation will lessen the administrative burden on depository institutions and will prevent proliferation of linked savings accounts that are encouraged by depository institutions.

One commenter suggested redrafting the interpretation so that the language of the interpretation would be more consistent with the language of Regulation D, thereby avoiding confusion or reclassification of an account as a result of an occasional lapse by a customer or an oversight by the depository institution. The language that concerned the commenter has been revised to parallel the language in Regulation D more closely.

The Board has adopted proposed interpretation § 204.133 subject to the modifications discussed above.

Linked Time Deposits and Transaction Accounts (§ 204.134)

The Board proposed an interpretation, to be published at 12 CFR 204.134, that would require depository institutions to classify certain deposits as transaction accounts that at present are classified as time deposits. The reclassification would apply to time deposits where a number of participating depositors maintain transaction accounts linked to time deposits in an arrangement that permits each depositor to draw checks based on the aggregate amount held by that depositor in these accounts, including unmatured time deposits. The time deposits in such arrangements are held directly by the depositor or indirectly through a trust or other arrangement that generally contains the commingled funds of a number of depositors. The individual depositor's interest in time deposits may be identifiable, with an agreement by the participating depositors that balances held in the arrangement may be used to pay checks drawn by other depositors participating in the arrangement, or the depositors may have undivided interests in a series of time deposits. The time deposits have staggered maturities so that one time deposit matures each business day. At the end of each day, funds over a specified balance in the

depositors' transaction accounts are swept into one or more time deposits. New deposits made, as well as funds from any maturing time deposits, are available each day to pay checks or other charges to the transaction accounts of any of the depositors participating in the arrangement.

The depository institution's decision whether to pay checks drawn on an individual depositor's transaction account is based on the aggregate amount of funds that the depositor has invested in the arrangement, including any amount that may be invested in unmatured time deposits. Only if checks drawn by all depositors participating in the arrangement exceed the total balance of funds available that day is a time deposit withdrawn prior to maturity so as to incur an early withdrawal penalty. Because the aggregate of individual participants' deposits plus the time deposit maturing each day tends to exceed the aggregate of individual participants' withdrawals on any day, the total balance maintained in the arrangement is highly stable and an early withdrawal of time deposits is rarely, if ever, necessary. The arrangement may be marketed as an arrangement to provide the customers unlimited access to their funds with a high rate of interest.

The Board believes that (1) these arrangements substitute time deposit balances for transaction accounts balance with no meaningful reduction in the depositors' access to their funds in practice, and (2) the time deposits in such arrangements are used to provide funds indirectly for the purposes of making payments or transfers to third persons. Accordingly, the Board proposed an interpretation to be published at § 204.134 that would require that such time deposits be considered to be transaction accounts.

The Board received eighteen comments on this proposal. Three comments supported the proposal although one of these commenters urged the Board to permit depository institutions to compete against nondepository institutions for transaction balances. Ten commenters claimed that the purpose of this kind of program was not to avoid reserves, but to compete with nonbanking entities. One commenter contended that providing higher yield transaction accounts rather than reduction in reserves was the driving force behind such arrangements. The Board notes, however, that while the practice covered by the interpretation enables depositors to earn a higher rate of return than would be possible in the absence of these practices, it does so by allowing the depository institution to reclassify transaction accounts as time deposits, thereby avoiding the transaction account reserve requirement. Even though these funds remain in the banking system, reservable liabilities and the reserve base may be substantially reduced, impairing the ability of the Federal Reserve to conduct monetary policy. In addition, such arrangements allow depository institutions with the resources to establish such arrangements to reduce their reservable liabilities while other, often smaller, depository institutions lack the resources or sizeable deposit base necessary to establish similar programs.

One commenter suggested that the Board create a "super NOW" account upon which the first $5,000 would be reserved as a transaction account, and the balance as a savings deposit. The Board believes that such an exemption would provide an inequitable benefit by reducing reserve requirements on large deposits in transaction accounts while retaining reserve requirements on small deposits in transaction accounts.

Two commenters suggested that the arrangements covered by the proposal were preferable to other sweep arrangements where funds are transferred out of the bank to a securities dealer. These commenters believed that the Board should not encourage such arrangements because they are contrary to Board concerns about the systemic risks arising from a failure of the securities dealer, a computer system failure, or the failure of a bank in a large daylight overdraft position. The Board recognizes that funds transfers due to nightly sweep arrangements may involve operational and credit risks, but believes that permitting unlimited sweep arrangements within a depository institution could virtually eliminate transaction accounts and reduce reserve balances below the level necessary for the conduct of monetary policy.

One bank holding company contended that, under the proposed interpretation, large businesses and wealthy individuals have access to other sweep arrangements, but that others on the lower end of the economic spectrum would not. This commenter also argued that adoption of the proposal would not be fair because the commenter had developed its program after consultation with Board staff, and that, if the commenter's service had to be discontinued, it would lose a significant amount in research and development costs. At one time, Board staff had advised certain depository institutions that the program did not violate Regulation D, as it appeared that the time deposits met the requirements for time deposits under Regulation D. Experience with the arrangement, however, has demonstrated that the time deposits serve as an effective substitute for transaction accounts. Accordingly, the Board is exercising its authority under sections 19(a) and 19(b)(1)(F) of the Federal Reserve Act to treat such time deposits as transaction accounts.

Two commenters asked for clarification of the effect of this proposal on cash management sweep accounts generally. The proposal applies to the sweep arrangements described in the interpretation and does not necessarily apply to other sweep arrangements, although the Board might view other arrangements where funds are swept between transaction accounts and time deposits similarly.

Two commenters claimed that the Board's proposal would make transaction accounts out of certain commingled time deposits opened by trust departments for their fiduciary customers as allowed by state law and by regulations of the Comptroller of the Currency. The Board's interpretation is limited to the arrangements described in the interpretation and it does not necessarily apply to other arrangements. For example, where a bona fide trust or collective fund invests in certificates of deposit of the fiduciary bank, the proposed interpretation would not require the classification of these time deposits as a transaction account for Regulation D purposes in the absence of an arrangement under which these funds were used to fund a transaction account or to pay overdrafts incurred in a transaction account. Similarly, arrangements under the Comptroller's Interpretation section 9.3206 (*See*, Comptroller's Handbook for Fiduciary Activities, section 9.3206), in which funds are swept from demand deposits maintained by the trust department into a commingled interest bearing account maintained by the trust department and the trust department makes withdrawals from this account to carry out the terms of the trust agreement, would not necessarily be affected by the proposed interpretation. The Board notes, however, that an arrangement that is permissible under the Comptroller's rulings or is within a permissible trust activity may result in the reclassification of accounts under Regulation D if the arrangement is being used to avoid reserve requirements.

Two commenters expressed concern that the proposed interpretation, coupled with a recently issued staff interpretation on trust department use of non-interest bearing time deposit open accounts, would have the cumulative effect of prohibiting the long-standing practice of bank trust departments of segregating a portion of the trust department's commingled demand account into one or more time accounts. The practice of segregating a portion of the demand account into a non-interest bearing time account was the subject of a staff opinion letter dated May 17, 1991, which discussed the rescission in December 1987 of a 1959 interpretation of Regulation D (FRRS 2-491). The 1959 interpretation recognized the practice of classifying a portion of a demand deposit as a time deposit where the practice was consistent with principles of fiduciary law. The May 1991 staff letter expressed the opinion that, in view of recent technological advances, the practice of maintaining zero interest bearing time deposits is inconsistent with a trustee's responsibility to make productive use of trust funds (unless specific consent or authorization to the contrary is obtained). The proposed interpretation is directed at the use of time deposits to provide funds, indirectly, for the purpose of making payments or transfers to third persons. It is not directed at the segregation into time deposits of trust department balances that are not required for immediate disbursement.

The Board has adopted the interpretation § 204.134 as proposed.

Time Deposit Withdrawal Penalty

Section 204.2(c)(1)(i) of Regulation D defines "time deposit" generally to include a deposit from which the depositor does not have a right and is not permitted to make withdrawals within six days after the date of deposit, unless the withdrawal is subject to an early withdrawal penalty of at least seven days' simple interest. One type of time deposit, known as a "time deposit open account," does not have a stated maturity and may be payable any time after the expiration of a specified time not less than seven days after the date of deposit. *See* 12 CFR 204.2(c)(1)(i)(A). Unlike savings deposits, this type of time deposit may have no restrictions on the number of transfers from the account that can be made each statement period. If the early withdrawal penalty is not imposed on a time deposit, the account becomes either a savings deposit subject to limitations on withdrawals and transfers or a transaction account.

Depository institutions have asked whether the six-day period runs from the date of the last deposit or the date that an amount corresponding to the amount of the withdrawal was initially deposited. Under a first-in first-out, or "FIFO", accounting treatment, depositors could regularly withdraw funds from the account if a like amount had been on deposit for more than six days. Such withdrawals would not be subject to an early withdrawal penalty and would not be limited by the transfer limits on savings deposits.

The Board was concerned that a FIFO rule would facilitate the use of a time deposit open account to make transfers, in excess of those permissible for a savings deposit, from the time deposit to a transaction account for the purpose of making payments to third persons, thus avoiding transaction account reserves. Accordingly, for reserve purposes the Board proposed to adopt a last-in first-out or "LIFO" accounting treatment for time deposits. To this end, the Board proposed amending § 204.2(c)(1)(i) by adding the words the "last" before the word "deposit" at the end of the first sentence of that paragraph.

The Board received twelve comments on this proposal. Three commenters supported this proposal or indicated that it corresponded to their current practice. The remainder opposed the proposal. Four commenters contended that the proposal would freeze funds in the accounts and would be inconsistent with the expectation of customers that the customers can have access to their funds as long as an amount equal to the amount withdrawn had been on deposit for six days. Another commenter claimed that the proposal would preclude the use of time deposits for investing idle trust funds. One commenter argued that LIFO accounting for time deposits would permit as many withdrawals as FIFO accounting where only large periodic deposits are made.

Four commenters noted that the proposal would cause institutions to incur significant costs to implement and to monitor compliance with the proposal. One of these cited the costs associated with notifying customers of the change.

This amendment was proposed to prevent a time deposit from being used for the purpose of funding a transaction account through transfers from the time deposit in excess of the six transfers per month that can be made from a savings deposit to a transaction account. While the Board regards such an arrangement as a method of evading reserve requirements, the Board wishes to avoid imposing unnecessary costs on depository institutions that do not use time deposits for this purpose. Accordingly, the Board is not adopting the proposed amendment at this time. The Board may reconsider this proposal if the use of time deposits to fund transaction accounts proliferates.

Computation of Reserve Requirements

Amendments

Cash Items in the Process of Collection

Section 204.2(i)(1) of Regulation D defines the term "cash items in the process of collection" to include redeemed bonds and coupons. Section 204.3(f) provides that, in determining the reserve balance required by Regulation D, a depository institution may deduct the amount of cash items in the process of collection from its gross transaction accounts. The reference to redeemed bonds and coupons in § 204.2(i)(1)(iii)(B) has caused confusion, as bonds and coupons that have been redeemed by the paying agent have no further need for collection. The term "redeemed" could be interpreted, however, to refer to the receipt for redemption of bonds or coupons by a depository institution in order to send them for collection, regardless of when the bonds or coupons mature, if the depository institution has given credit for the bonds or coupons.

Such an interpretation could allow a depository institution to send bonds or coupons for redemption and extend credit on the security of the bonds or coupons while receiving a "cash item in the process of collection" deduction until the bonds or coupons were redeemed by the paying agent on maturity. This practice could materially reduce the amount of reserves held against transaction accounts in a way that the Board believes is inappropriate and inconsistent with the purpose of the "cash items in the process of collection" deduction.

The Board proposed an amendment to the definition of the term "cash item in the process of collection" in § 204.2(i)(1)(iii)(B) of Regulation D to delete the term "redeemed" and replace it with the term "matured." Bonds that have not reached the original maturity date, but that have been called and are payable immediately upon presentation, would be considered matured for the purposes of this provision.

The Board received seven comments on this proposal. Three commenters supported the proposal. One commenter noted that this proposal would be cumbersome and time consuming as normal account reconciliation would not necessarily coincide with reporting dates. One commenter suggested that the Board's regulation clarify that bonds

that have been called can qualify for the deduction.

One commenter urged that bonds and coupons be eligible for the "cash item in the process of collection" deduction for two days prior to maturity. This commenter further maintained that the proposed treatment of bonds and coupons is inconsistent with some depository institutions' treatment of other items in the process of collection. The commenter indicated that some depository institutions take a cash item in the process of collection deduction for commercial paper and bankers' acceptances that have not yet matured, as well as for post-dated drafts.

The Board believes that the commenters have not demonstrated that the costs of reconciling bonds and coupons in the process of collection will outweigh the potential use of this deduction to avoid reserve requirements. With respect to commercial paper and bankers' acceptances that have not yet matured and post-dated drafts, which some depository institutions may be treating currently as cash items in the process of collection, the Board believes that these instruments do not fit within the current definition of "cash item in the process of collection," as these items are not "payable immediately upon presentation" when the deduction is taken, as required by § 204.2(i)(1)(iii) of Regulation D. Accordingly, the Board has adopted the amendment, with the clarification that called bonds may be considered to be cash items in the process of collection. The effective date of this amendment has been deferred for 120 days to permit depository institutions to make any necessary modifications to their systems.

Interpretations

Due from Deduction (§ 204.135)

A number of depository institutions have been engaging in practices designed to reduce their reserve requirements by increasing the use of the low reserve tranche among affiliated depository institutions. Under § 204.9(a)(2) of Regulation D, a depository institution is exempt from reserve requirements on its first $3.6 million in reservable liabilities and is subject to three percent reserves on its transaction account balances of up to $42.2 million. Under § 204.3(f)(1) of Regulation D, balances subject to immediate withdrawal from other depository institutions located in the United States may be deducted from gross transaction accounts in computing reserve requirements. Further, under § 204.2(a)(1)(vii)(A)(1) of Regulation D, federal funds transactions with other offices located in the United States of depository institutions and certain other entities generally are exempt from reserve requirements. In a number of cases, depository institutions have used the relationship between these provisions to reduce their reserve requirements through a series of transactions entered into for that purpose.

For example, when small depository institutions in an affiliated family of depository institutions do not take full advantage of the low reserve tranche in § 204.9(a)(1) of Regulation D (i.e. the 3 percent reserve ratio on transaction account balances up to $42.2 million), these small depository institutions may accept demand deposits from larger affiliates to increase the small institutions' total transaction accounts up to the $42.2 million limit. These deposits may be subject to immediate withdrawal by the larger depository institution and thereby generate a "due from" deduction for the larger depository institution. The transaction account balances at the small depository institutions are subject to a 3 percent reserve requirement rather than the full 10 percent requirement. The small depository institutions then return the funds to the larger depository institution, less an amount equal to the 3 percent reserve requirement that the small depository institutions must hold against the larger depository institution's deposit. The funds are returned by means of a federal funds transaction. The federal funds transaction is exempt from reserve requirements under § 204.2(a)(1)(vii)(A)(1) of Regulation D. The larger depository institution may then invest or lend the funds. The net effect of these transactions is to reduce the reserve requirements of the larger depository institution by 7 percentage points on the amount transferred to the smaller depository institutions at a cost of a few bookkeeping entries and funds transfers.

The Board believes these transactions are designed to avoid reserve requirements, and are inconsistent with the purpose for which Congress provided the low reserve tranche, and proposed an interpretation that would eliminate the due from deduction under these circumstances.

The Board received ten comments on this proposal. Three commenters supported the proposal. One of these commenters suggested that the proposal should also cover similar transactions that are designed to take advantage of the transition provisions of Regulation D, under which some institutions, including *de novo* or merged institutions, may be subject to lower reserve requirements during a phase-in period. The Board did not include such transactions in the final interpretation, but will monitor them to determine whether such transactions are being used to evade reserve requirements.

Seven commenters opposed the proposal. Generally, these commenters argued that the proposal would serve to penalize banks for legitimate transactions, such as deposits placed to compensate the smaller institution for services provided to the larger institution, or deposits to buttress the deposit base of the smaller institution or deposits for other prudent business purposes. Two commenters suggested that transactions between larger banks and smaller affiliates be permitted if the funds either do not flow back to the larger bank or, if they do, interest is charged at the going fed funds rate.

The Board recognizes that there may be legitimate reasons for large banks to place deposits subject to immediate withdrawal, and that are therefore eligible for the due from deduction, in small affiliated banks. However, in the case of deposits subject to immediate withdrawal by large banks in small affiliated banks or other small banks, the Board believes that there are few, if any, legitimate reasons for the small banks to then sell federal funds to the larger bank in lieu of the large bank withdrawing its deposit. This is particularly true in cases in which such sales are made at a low or zero rate of interest.

One commenter argued that this problem could be eliminated by elimination of the low reserve tranche. The low reserve tranche is established by section 19(b)(2) of the Federal Reserve Act, and therefore the Board does not believe that it has the authority to eliminate the low reserve tranche.

The Board has adopted the proposed interpretation with revisions to clarify that it applies to all situations in which funds are returned to the larger institution by a transaction that is exempt from reserve requirements, such as a sale of federal funds.

Commingled Trust Deposit Netting (§ 204.136)

Depository institutions' trust departments often commingle the idle balances of the individual trusts and place the funds in a single transaction account in the depository institution. This account is subject to reserve requirements as a transaction account. In some cases, the trust department nets

negative balances in some trust accounts against positive balances in other trust accounts in order to arrive at a net amount that it credits to the commingled transaction account. This practice generally understates the balances in the transaction account. Individual trust instruments generally do not authorize the trustee to use the funds in one trust to lend to another trust. Consequently, any overdraft in a trust is covered, in effect, by a loan from the bank where the bank makes a payment on behalf of the trust. A negative balance in a trust account should be reflected as a zero balance and should not be netted against positive balances in other trusts in computing the amount in the commingled transaction account each day.

Accordingly, the Board proposed an interpretation to be published at 12 CFR 204.136 that, in certain circumstances, would prohibit the netting of negative balances in individual trust accounts against positive balances in other trust accounts. The effect of this proposal would be to increase aggregate trust department transaction account balances for reserve requirement purposes in certain depository institutions. The prohibition would not apply, however, if the applicable trust law specifically permitted the netting, or if a written trust agreement, valid under applicable trust law, permitted a trust to lend money to another trust account.

The Board received seventeen comments on this proposal, one of which supported the proposal. Seven commenters contended that adoption of the proposal would result in a competitive advantage for trust companies that deposit their institution's uninvested trust balances at another bank. They argued that those trust companies would not be subject to the prohibition on netting of trust balances because such netting would take place outside of the institution determining the reserves, while at the same time, trust demand deposit accounts of the reserving bank's own trust department would be subject to reserves on a gross basis even though the accounts at both institutions serve the same purpose. Additionally, these commenters claimed that prohibiting netting would inflate trust cash balances.

The Board believes that the prohibition against netting for reserve purposes is consistent with accurate accounting of a bank's cash deposit liability to its trust customers. Trust principles apply to non-depository as well as depository institutions engaged in the administration of fiduciary accounts. These principles do not permit a trustee to lend funds from one trust to another trust unless specifically authorized by the governing trust agreement or State law. Consequently, unless such loans are expressly authorized, the negative balances in individual trust accounts, in effect, represent loans from the trustee institution. Both non-deposit trust companies and bank trust departments must conduct their activities in accordance with these trust principles. Additionally, the adoption of the interpretation should reduce, rather than promote, competitive inequalities that may now exist among trust institutions by reminding all such institutions that they are subject to the same fiduciary principles in the determination of cash balances for deposit.

Two commenters were concerned that national banks would be required to post additional collateral for trust deposits if netting were prohibited. National banks are required to post collateral only where the cash balance of an *individual* trust account is in excess of Federal insurance. As collateral requirements are not determined on the aggregate balance in a commingled trust department account, the Board does not believe that additional collateral will be required as a result of the interpretation.

Two commenters maintained that the proposed changes would place reserves on transactions that are accomplished on the trust side of the bank when Regulation D specifically excludes these transactions from reserve requirements. One commenter claimed that the proposal could be interpreted as a limit on the authority of the bank to pay overdrafts in a trust.

Fiduciary funds are not subject to reserve requirements under Regulation D unless they are placed in a deposit account in a depository institution. Most trust departments deposit uninvested trust funds in their depository institution. Where the institution has netted uninvested trust fund balances, it avoids reserve requirements by reporting a lower balance than that for which the fiduciary is responsible.

Other commenters requested the establishment of a safe harbor for overdrafts of less than $200,000 per day, requested an exemption from separate reporting for institutions with less than $100 million in trust assets, and requested guidance on the calculation of overdrafts and the meaning of netting. One commenter argued that the costs of complying with the proposal would be greater than the costs of holding the additional reserves that would be required.

The Board believes that it is unnecessary and in appropriate to provide safe harbors or exemptions from reserves for deposits by a depository institution's trust department. Further, the Board believes that it is inappropriate to specify detailed trust accounting procedures in Regulation D.

Nine commenters argued that the interpretation would prohibit overdrafts that are "technical overdrafts," i.e. overdrafts for bookkeeping purposes only, or that result from longstanding practices that trust departments are permitted to employ. Some of these commenters cited as examples of technical overdrafts negative balances in suspense accounts used for the prepayment of interest or dividends, and negative balances in clearing house fund accounts used for the processing of securities transactions.

The proposed interpretation was intended to prohibit netting of *true* overdrafts and was not intended to prohibit netting where overdrafts are merely technical and where funds are still available within the trust department to offset the overdraft. The Board agrees that technical overdrafts may be netted provided there is a corresponding positive balance for the trust incurring the overdraft that is available for the offset. For example, a negative balance in a trust account could be offset by a corresponding credit in a securities settlement suspense account until settlement date, and a negative balance in a pre-credit suspense account could be offset by a corresponding positive balance in a trust account until the dividend or interest payment corresponding to these entries is received. Paragraph (d) of the interpretation has been revised to reflect the permissibility of netting in these circumstances.

One commenter also urged that there be no prohibition on netting overdrafts in a common trust fund (using accrual accounting methods) since such overdrafts represent amounts, such as interest or dividends, that have been distributed to participating individual trust accounts. The commenter noted that OCC precedents require the use of accrual accounting and that OCC Regulations (12 CFR 9.18(b)(8)(i)) recognize the inevitability of net cash overdrafts in common trust funds. The only OCC precedent related to the permissibility of netting overdrafts in common trust funds appears to be OCC Opinion 9.6900. This Opinion permits offsetting within a single common trust fund of overdrafts of income cash with principal cash, where the income cash overdraft is the result of a required income distribution and the distribution

does not exceed total principal and income cash then on hand. The Board's interpretation is not intended to prohibit netting in circumstances described in OCC Opinion 9.6900 where the fund has a legally permissible right of offset between principal cash and income cash. The Board notes, however, that the cited Opinion does not authorize net cash overdrafts, and that netting such balances against other trust accounts is prohibited by the interpretation.

One commenter requested the Board to clarify that the interpretation is not intended to limit a bank's payment of overdrafts in a trust account by means of extensions of credit by the bank. The proposal was not intended to limit this practice. Two commenters requested a delay in the implementation of the changes to allow institutions to make system changes in order to comply with the regulation.

The Board has adopted proposed interpretation § 204.136 with revisions to clarify its application to suspense accounts and other issues raised by the commenters. The Board is deferring the effective date of this interpretation for 120 days to permit depository institutions to adapt their internal systems to the interpretation.

Technical Amendments

In April 1991, the Board made several technical amendments to Regulation D concerning reserve deficiency charges. 56 FR 15493, April 17, 1991. Two conforming amendments are included in this rule to substitute the term "reserve deficiency charges" for "penalties" in § 204.3.

Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 96–354, 5 U.S.C. 601 *et seq.*), the Board certifies that these amendments and interpretations will not have a significant economic impact on a substantial number of small entities. With the exception of the amendment requiring sellers of teller's checks to maintain reserves against the outstanding balances of such checks, the Board does not believe that the amendments or interpretations would impose any additional reporting or recordkeeping requirements.

As a result of the teller's check amendments, depository institutions that sell teller's checks will be required to obtain outstanding teller's check balances from teller's check service providers and to include these balances in their reports of deposits. Currently, seller's of tellers checks generally obtain this information from teller's checks service providers on a monthly basis. After adoption of the amendment, weekly reporters, that is, depository institutions with assets of over $44.8 million, will need to obtain the information from providers on a more timely basis in order to include teller's check balances in their reports. Smaller institutions, which are required to report only on a quarterly basis, should already be receiving sufficient information from service providers to include outstanding teller's check balances in their reports of deposit. The issues and alternatives considered by the Board in adopting this amendment are detailed in the Supplementary Information.

Although these amendments and interpretations may increase required reserves for some depository institutions, they should not have a disproportionally adverse impact on small institutions, as Regulation D provides an exemption from reserve requirements for the first $3.6 million of transaction account balances and a low reserve tranche for transaction account balances above this limit up to $42.2 million, on which a lower rate of three percent rather than the full 10 percent is required. Although one of the interpretations (§ 204.135) would reduce the use of the low reserve tranche in some circumstances, this interpretation relates to the use of the low reserve tranche by larger depository institutions affiliated with a small depository institution, and does not affect the ability of the small institution to use the low reserve tranche for their own deposits. The Board does not expect that the amendments and interpretations will have a significant negative impact on the ability of small institutions to attract deposits. Further, the Board believes that the amendments and interpretations will improve the ability of small institutions to compete in some areas, as many small institutions do not have the resources available to develop and maintain reserve avoidance practices of the kinds the proposals address. Negating the effect of these practices will therefore improve the ability of small institutions to compete with larger institutions that would otherwise be able to use these reserve avoidance techniques.

Notice and Public Participation

With the exception of the technical amendments to § 204.3, all amendments and interpretations included in this notice have been published for notice and comment. Notice and comment have not been provided for the amendments to § 204.3, as these are technical, conforming amendments that do not make any substantive change to the regulation.

List of Subjects in 12 CFR Part 204

Banks, banking, Federal Reserve System, Reporting and recordkeeping requirements.

Pursuant to the Board's authority under section 19 of the Federal Reserve Act, 12 USC 461 *et seq.*, the Board is amending 12 CFR Part 204 as follows:

PART 204—RESERVE REQUIREMENTS OF DEPOSITORY INSTITUTIONS

1. The authority citation for Part 204 continues to read as follows:

Authority: Sections 11(a), 11(c), 19, 25, 25(a) of the Federal Reserve Act (12 U.S.C. 248(a), 248(c), 371a, 371b, 461, 601, 611); section 7 of the International Banking Act of 1978 (12 U.S.C. 3105); and section 411 of the Garn St-Germain Depository Institutions Act of 1982 (12 U.S.C. 461).

2. Section 204.2 is amended by revising paragraphs (a)(1)(iii), (b)(1)(ii), (e)(6), and (i)(1)(iii)(B), by adding the word "or" after the semicolon at the end of paragraph (b)(3)(iii), by removing paragraph (b)(3)(iv), by redesignating paragraph (b)(3)(v) as (b)(3)(iv), and by adding paragraph (u), to read as follows:

§ 204.2 Definitions.

* * *

(a)(1) * * *

(iii) an outstanding teller's check, or an outstanding draft, certified check, cashier's check, money order, or officer's check drawn on the depository institution, issued in the usual course of business for any purpose, including payment for services, dividends or purchases;

* * * * *

(b)(1) * * *

(ii) certified, cashier's, teller's, and officer's checks (including such checks issued in payment of dividends);

* * * * *

(e) * * *

(6) All deposits other than time and savings accounts, including those accounts that are time and savings deposits in form but that the Board has determined, by rule or order, to be transaction accounts.

* * * * *

(i)(1) * * *

(iii) * * *

(B) matured bonds and coupons (including bonds and coupons that have been called and are payable on presentation);

* * * * *

(u) *Teller's check* means a check drawn by a depository institution on another depository institution, a Federal

Reserve Bank, or a Federal Home Loan Bank, or payable at or through a depository institution, a Federal Reserve Bank, or a Federal Home Loan Bank, and which the drawing depository institution engages or is obliged to pay upon dishonor.

3. Section 204.3 is amended by revising the second sentence in paragraphs (a) introductory text and (g) to read as follows:

§ 204.3 Computation and maintenance.

(a) * * * Reserve deficiency charges shall be assessed for deficiencies in required reserves in accordance with the provisions of § 204.7. * * * * *

* * * * *

(g) * * * If a depository institution draws against items before that time, the charge will be made to its reserve account if the balance is sufficient to pay it; any resulting impairment of reserve balances will be subject to the penalties provided by law and to the reserve deficiency charges provided by this part. * * *

* * * * *

4. Section 204.133 is added to read as follows:

§ 204.133 Multiple savings deposits treated as a transaction account.

(a) *Authority.* Under section 19(a) of the Federal Reserve Act, the Board is authorized to define the terms used in section 19, and to prescribe regulations to implement and prevent evasions of the requirements of that section. Section 19(b) establishes general reserve requirements on transaction accounts and nonpersonal time deposits. Under section 19(b)(1)(F), the Board also is authorized to determine, by regulation or order, that an account or deposit is a transaction account if such account is used directly or indirectly for the purpose of making payments to third persons or others. This interpretation is adopted under these authorities.

(b) *Background.* Under Regulation D, 12 CFR 204.2(d)(2), the term "savings deposit" includes a deposit or an account that meets the requirements of § 204.2(d)(1) and from which, under the terms of the deposit contract or by practice of the depository institution, the depositor is permitted or authorized to make up to six transfers or withdrawals per month or statement cycle of at least four weeks. The depository institution may authorize up to three of these six transfers to be made by check, draft, debit card, or similar order drawn by the depositor and payable to third parties. If more than six transfers (or more than three third party transfers by check, etc.) are permitted or authorized per month or statement cycle, the depository institution may not classify the account as a savings deposit. If the depositor, during the period, makes more than six transfers or withdrawals (or more than three third party transfers by check, etc.), the depository institution may, depending upon the facts and circumstances, be required by Regulation D (Footnote 5 at § 204.2(d)(2)) to reclassify or close the account.

(c) *Use of multiple savings deposits.* Depository institutions have asked for guidance as to when a depositor may maintain more than one savings deposit and be permitted to make all the transfers or withdrawals authorized for savings deposits under Regulation D from each savings deposit. The Board has determined that, if a depository institution suggests or otherwise promotes the establishment of or operation of multiple savings accounts with transfer capabilities in order to permit transfers and withdrawals in excess of those permitted by Regulation D for an individual savings account, the accounts generally should be considered to be transaction accounts. This determination applies regardless of whether the deposits have entirely separate account numbers or are subsidiary accounts of a master deposit account. Multiple savings accounts, however, should not be considered to be transaction accounts if there is a legitimate purpose, other than increasing the number of transfers or withdrawals, for opening more than one savings deposit.

(d) *Examples.* The distinction between appropriate and inappropriate uses of multiple accounts is illustrated by the following examples:

Example 1. (i) X wishes to open an account that maximizes his interest earnings but also permits X to draw up to ten checks a month against the account. X's Bank suggests an arrangement under which X establishes four savings deposits at Bank. Under the arrangement, X deposits funds in the first account and then draws three checks against that account. X then instructs Bank to transfer all funds in excess of the amount of the three checks to the second account and draws an additional three checks. Funds are continually shifted between accounts when additional checks are drawn so that no more than three checks are drawn against each account each month.

(ii) Suggesting the use of four savings accounts in the name of X in this example is designed solely to permit the customer to exceed the transfer limitations on savings accounts. Accordingly, the savings accounts should be classified as transaction accounts.

Example 2. (i) X is trustee of separate trusts for each of his four children. X's Bank suggests that X, as trustee, open a savings deposit in a depository institution for each of his four children in order to ensure an independent accounting of the funds held by each trust.

(ii) X's Bank's suggestion to use four savings deposits in the name of X in this example is appropriate, and the third party transfers from one account should not be considered in determining whether the transfer and withdrawal limit was exceeded on any other account. X established a legitimate purpose, the segregation of the trust assets, for each account separate from the need to make third party transfers. Furthermore, there is no indication, such as by the direct or indirect transfer of funds from one account to another, that the accounts are being used for any purpose other than to make transfers to the appropriate trust.

Example 3. (i) X opens four savings accounts with Bank. X regularly draws up to three checks against each account and transfers funds between the accounts in order to ensure that the checks on the separate accounts are covered. X's Bank did not suggest or otherwise promote the arrangement.

(ii) X's Bank may treat the multiple accounts as savings deposits for Regulation D purposes, even if it discovers that X is using the accounts to increase the transfer limits applicable to savings accounts because X's Bank did not suggest or otherwise promote the establishment of or operation of the arrangement.

5. Section 204.134 is added to read as follows:

§ 204.134 Linked time deposits and transaction accounts.

(a) *Authority.* Under section 19(a) of the Federal Reserve Act (12 U.S.C. 461(a)), the Board is authorized to define the terms used in section 19, and to prescribe regulations to implement and prevent evasions of the requirements of that section. Section 19(b)(2) establishes general reserve requirements on transaction accounts and nonpersonal time deposits. Under section 19(b)(1)(F), the Board also is authorized to determine, by regulation or order, that an account or deposit is a transaction account if such account is used directly or indirectly for the purpose of making payments to third persons or others. This interpretation is adopted under these authorities.

(b) *Linked time deposits and transaction accounts.* Some depository institutions are offering or proposing to offer account arrangements under which a group of participating depositors maintain transaction accounts and time deposits with a depository institution in an arrangement under which each depositor may draw checks up to the aggregate amount held by that depositor in these accounts. Under this account arrangement, at the end of the day funds over a specified balance in each

depositor's transaction account are swept from the transaction account into a commingled time deposit. A separate time deposit is opened on each business day with the balance of deposits received that day, as well as the proceeds of any time deposit that has matured that day that are not used to pay checks or withdrawals from the transaction accounts. The time deposits, which generally have maturities of seven days, are staggered so that one or more time deposits mature each business day. Funds are apportioned among the various time deposits in a manner calculated to minimize the possibility that the funds available on any given day would be insufficient to pay all items presented.

(1) The time deposits involved in such an arrangement may be held directly by the depositor or indirectly through a trust or other arrangement. The individual depositor's interest in time deposits may be identifiable, with an agreement by the depositors that balances held in the arrangement may be used to pay checks drawn by other depositors participating in the arrangement, or the depositor may have an undivided interest in a series of time deposits.

(2) Each day funds from the maturing time deposits are available to pay checks or other charges to the depositor's transaction account. The depository institution's decision concerning whether to pay checks drawn on an individual depositor's transaction account is based on the aggregate amount of funds that the depositor has invested in the arrangement, including any amount that may be invested in unmatured time deposits. Only if checks drawn by all participants in the arrangement exceed the total balance of funds available that day (i.e. funds from the time deposit that has matured that day as well as any deposits made to participating accounts during the day) is a time deposit withdrawn prior to maturity so as to incur an early withdrawal penalty. The arrangement may be marketed as providing the customer unlimited access to its funds with a high rate of interest.

(c) *Determination.* In these arrangements, the aggregate deposit balances of all participants generally vary by a comparatively small amount, allowing the time deposits maturing on any day safely to cover any charges to the depositors' transaction accounts and avoiding any early withdrawal penalties. Thus, this arrangement substitutes time deposit balances for transaction accounts balances with no practical restrictions on the depositors' access to their funds, and serves no business purpose other than to allow the payment of higher interest through the avoidance of reserve requirements. As the time deposits may be used to provide funds indirectly for the purposes of making payments or transfers to third persons, the Board has determined that the time deposits should be considered to be transaction accounts for the purposes of Regulation D.

6. Section 204.135 is added to read as follows:

§ 204.135 Shifting funds between depository institutions to make use of the low reserve tranche.

(a) *Authority.* Under section 19(a) of the Federal Reserve Act (12 U.S.C. 461(a)) the Board is authorized to define terms used in section 19, and to prescribe regulations to implement and to prevent evasions of the requirements of that section. Section 19(b)(2) establishes general reserve requirements on transaction accounts and nonpersonal time deposits. In addition to its authority to define terms under section 19(a), section 19(g) of the Federal Reserve Act also give the Board the specific authority to define terms relating to deductions allowed in reserve computation, including "balances due from other banks." This interpretation is adopted under these authorities.

(b) *Background.* (1) Currently, the Board requires reserves of zero, three, or ten percent on transaction accounts, depending upon the amount of transaction deposits in the depository institution, and of zero percent on nonpersonal time deposits. In determining its reserve balance under Regulation D, a depository institution may deduct the balances it maintains in another depository institution located in the United States if those balances are subject to immediate withdrawal by the depositing depository institution (§ 204.3(f)). This deduction is commonly known as the "due from" deduction. In addition, Regulation D at § 204.2(a)(1)(vii)(A) exempts from the definition of "deposit" any liability of a depository institution on a promissory note or similar obligation that is issued or undertaken and held for the account of an office located in the United States of another depository institution. Transactions falling within this exemption from the definition of "deposit" include federal funds or "fed funds" transactions.

(2) Under section 19(b)(2) of the Federal Reserve Act (12 U.S.C. 461(b)(2)), the Board is required to impose reserves of three percent on total transaction deposits at or below an amount determined under a formula. Transaction deposits falling within this amount are in the "low reserve tranche." Currently the low reserve tranche runs up to $42.2 million. Under section 19(b)(11) of the Federal Reserve Act (12 U.S.C. 461(b)(11)) the Board is also required to impose reserves of zero percent on reservable liabilities at or below an amount determined under a formula. Currently that amount is $3.6 million.

(c) *Shifting funds between depository institutions.* The Board is aware that certain depository institutions with transaction account balances in an amount greater than the low reserve tranche have entered into transactions with affiliated depository institutions that have transaction account balances below the maximum low reserve tranche amount. These transactions are intended to lower the transaction reserves of the larger depository institution and leave the economic position of the smaller depository institutions unaffected, and have no apparent purpose other than to reduce required reserves of the larger institution. The larger depository institution places funds in a demand deposit at a small domestic depository institution. The larger depository institution considers those funds to be subject to the "due from" deduction, and accordingly reduces its transaction reserves in the amount of the demand deposit. The larger depository institution then reduces its transaction account reserves by 10 percent of the deposited amount. The small depository institution, because it is within the low reserve tranche, must maintain transaction account reserves of 3 percent on the funds deposited by the larger depository institution. The small depository institution then transfers all but 3 percent of the funds deposited by the larger depository institution back to the larger depository institution in a transaction that qualifies as a "fed funds" transaction. The 3 percent not transferred to the larger depository institution is the amount of the larger depository institution's deposit that the small depository institution must maintain as transaction account reserves. Because the larger depository institution books this second part of the transaction as a "fed funds" transaction, the larger depository institution does not maintain reserves on the funds that it receives back from the small depository institution. As a consequence, the larger depository institution has available for its use 97 percent of the amount transferred to the small depository institution. Had the larger depository institution not entered into the transaction, it would have maintained

transaction account reserves of 10 percent on that amount, and would have had only 90 percent of that amount for use in its business.

(d) *Determination.* The Board believes that the practice described above generally is a device to evade the reserves imposed by Regulation D. Consequently, the Board has determined that, in the circumstances described above, the larger depository institution depositing funds in the smaller institution may not take a "due from" deduction on account of the funds in the demand deposit account if, and to the extent that, funds flow back to the larger depository institution from the small depository institution by means of a transaction that is exempt from transaction account reserve requirements.

7. Section 204.136 is added to read as follows:

§ 204.136 Treatment of trust overdrafts for reserve requirement reporting purposes.

(a) *Authority.* Under section 19(a) of the Federal Reserve Act (12 U.S.C. 461(a)), the Board is authorized to define the terms used in section 19, and to prescribe regulations to implement and prevent evasions of the requirements of that section. Section 19(b) establishes general reserve requirements on transaction accounts and nonpersonal time deposits. Under section 19(b)(1)(F), the Board also is authorized to determine, by regulation or order, that an account or deposit is a transaction account if such account is used directly or indirectly for the purpose of making payments to third persons or others. This interpretation is adopted under these authorities.

(b) *Netting of trust account balances.* (1) Not all depository institutions have treated overdrafts in trust accounts administered by a trust department in the same manner when calculating the balance in a commingled transaction account in the depository institution for the account of the trust department of the institution. In some cases, depository institutions carry the aggregate of the positive balances in the individual trust accounts as the balance on which reserves are computed for the commingled account. In other cases depository institutions net positive balances in some trust accounts against negative balances in other trust accounts, thus reducing the balance in the commingled account and lowering the reserve requirements. Except in limited circumstances, negative balances in individual trust accounts should not be netted against positive balances in other trust accounts when determining the balance in a trust department's commingled transaction account maintained in a depository institution's commercial department. The netting of positive and negative balances has the effect of reducing the aggregate of a commingled transaction account reported by the depository institution to the Federal Reserve and reduces the reserves the institution must hold against transaction accounts under Regulation D. Unless the governing trust agreement or state law authorizes the depository institution, as trustee, to lend money in one trust to another trust, the negative balances in effect, for purposes of Regulation D, represent a loan from the depository institution. Consequently, negative balances in individual trust accounts should not be netted against positive balances in other individual trust accounts, and the balance in any transaction account containing commingled trust balances should reflect positive or zero balances for each individual trust.

(2) For example, where a trust department engages in securities lending activities for trust accounts, overdrafts might occur because of the trust department's attempt to "normalize" the effects of timing delays between the depository institution's receipt of the cash collateral from the broker and the trust department's posting of the transaction to the lending trust account. When securities are lent from a trust customer to a broker that pledges cash as collateral, the broker usually transfers the cash collateral to the depository institution on the day that the securities are made available. While the institution has the use of the funds from the time of the transfer, the trust department's normal posting procedures may not reflect receipt of the cash collateral by the individual account until the next day. On the day that the loan is terminated, the broker returns the securities to the lending trust account and the trust customer's account is debited for the amount of the cash collateral that is returned by the depository institution to the broker. The trust department, however, often does not liquidate the investment made with the cash collateral until the day after the loan terminates, a delay that normally causes a one day overdraft in the trust account. Regulation D requires that, on the day the loan is terminated, the depository institution regard the negative balance in the customer's account as zero for reserve requirement reporting purposes and not net the overdraft against positive balances in other accounts.

(c) *Procedures.* In order to meet the requirements of Regulation D, a depository institution must have procedures to determine the aggregate of trust department transaction account balances for Regulation D on a daily basis. The procedures must consider only the positive balances in individual trust accounts without netting negative balances except in those limited circumstances where loans are legally permitted from one trust to another, or where offsetting is permitted pursuant to trust law or written agreement, or where the amount that caused the overdraft is still available in a settlement, suspense or other trust account within the trust department and may be used to offset the overdraft.

By order of the Board of Governors of the Federal Reserve System, August 19, 1992.

Jennifer J. Johnson,

Associate Secretary of the Board.

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