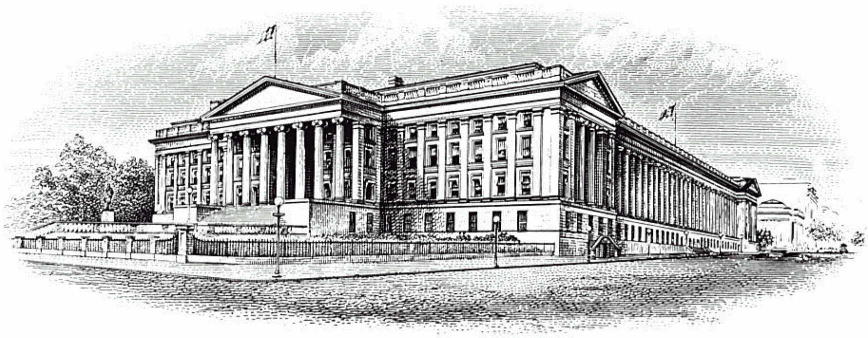

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

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INTEREST ON BUSINESS CHECKING ACCOUNTS AND RESERVE BALANCES

Testimony of Wayne A. Abernathy
Assistant Secretary for Financial Institutions
U.S. Department of the Treasury

Before the
Subcommittee on Financial Institutions and Consumer Credit
of the
Committee on Financial Services
U.S. House of Representatives

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Chairman Bachus, Representative Sanders, and Members of the Subcommittee, I appreciate this opportunity to present the Treasury Department's views on legislation repealing the prohibition on the payment of interest on business checking accounts, and permitting the payment of interest on reserve balances that depository institutions maintain at the Federal Reserve Banks. The Treasury Department supports permitting banks and thrifts to pay interest on business checking accounts. We are also sympathetic to the arguments in favor of permitting the Federal Reserve to pay interest on reserve balances and support the goals of the legislation; however, inasmuch as the potential budget impact of the provision is not included in the President's Budget, we are not prepared to endorse the proposal at this time.

Paying Interest on Demand Deposits

The Treasury Department has consistently supported provisions repealing the prohibition on paying interest on demand deposits. In each of the last two Congresses, the House of Representatives passed legislation that included this repeal. We hope that the House does so again and that the Senate moves forward soon with similar legislation.

The prohibition is a relic of the Great Depression. Many policymakers in the 1930s worried about the solvency of the nation's banks and the harmful effects of widespread bank failures on the overall economy. One manifestation of that worry was the belief that limiting competition among banks would reduce bank failures, even if that resulted in fewer options and higher costs for consumers of financial services. Therefore, among other competition-limiting measures, Congress prohibited the payment of interest on demand deposits and established ceilings on the interest rates that depository institutions could pay their customers on other types of deposits.

Experience has shown that limiting consumer choice is a sub-optimal strategy for bank regulation. The market has a way of asserting itself. In recent decades, competition to banks from money market mutual funds (not subject to rate caps) and the development of negotiable order of withdrawal (NOW) accounts by New England thrifts worked to undermine the "Regulation Q" deposit interest rate ceilings. At the beginning of the 1980s, Congress allowed banks to offer money market deposit accounts (MMDAs), free of interest rate controls, to compete with non-bank money market mutual funds. It also permitted interest to be paid on household checking deposits, approving NOW accounts nationwide.

Repeal of the prohibition on paying interest on demand deposits would eliminate a needless government control, consistent with the earlier elimination of Regulation Q rate ceilings on other deposits. The result will be greater economic efficiency. Banks could reduce the resources that they spend on procedures to get around these market restrictions, such as practices that provide implicit interest on compensating balance accounts or mechanisms that sweep demand deposits into money market investments. Community banks with fewer means to compensate for the lack of interest payments would be better able to compete with large banks and non-bank financial services providers in attracting business depositors. Repeal would benefit the nation's small businesses by allowing them to earn a positive return on their transaction balances. Larger businesses today have been able to offset the lack of interest on checking accounts by using sweep accounts to earn interest or by obtaining price concessions on other bank products.

We favor the direct repeal of the prohibition on paying interest on demand deposits, such as that contained in the bill authored by Representative Toomey (H.R. 859) that would be effective one year after enactment. Rather than directly repealing the prohibition, the bill introduced by Representative Kelly (H.R. 758) would authorize an increase from 6 to 24 in the allowable transactions per month between demand deposits and interest bearing money market deposit accounts, an indirect way for businesses to earn interest on their checking account funds. We think that this would be appropriate as a transitional arrangement until full repeal of the prohibition on demand deposit interest becomes effective. Combining these two proposals, as the House of Representatives did in the last Congress, would help ensure that banks are immediately able to offer the equivalent of interest bearing checking accounts to their business customers before the repeal of the prohibition becomes effective. In any event, the Treasury Department continues to prefer a relatively quick repeal of the prohibition on paying interest on demand deposits.

Permitting the Federal Reserve to Pay Interest on Reserve Balances

H.R. 758 also would allow the Federal Reserve Banks to pay interest on the reserve balances that they hold of depository institutions. The Federal Reserve Act requires depository institutions to maintain reserves against certain of their deposit liabilities. The first $6 million of an institution's transaction accounts are currently exempt from reserve requirements. Transaction balances between that level and $42.1 million are subject to a 3 percent reserve requirement. The Federal Reserve prescribes a 10 percent requirement on balances above that amount, within a statutorily prescribed range of 8 to 14 percent.[1] Institutions typically meet these reserve requirements through vault cash and a portion of their reserve balances at a Federal Reserve Bank, known as required reserve balances. Depository institutions may voluntarily hold reserve balances above the amount necessary to meet reserve requirements, which are called excess reserves. They may also enter into agreements with the Federal Reserve to hold certain balances that would cover transactions cleared through their accounts, called contractual clearing balances. Contractual clearing balances do not count toward meeting reserve requirements.

Required reserve balances and excess reserves held at the Federal Reserve do not earn interest. They are therefore sometimes referred to as sterile reserves. Contractual clearing balances earn implicit interest through the offset of fees for Federal Reserve services. In January 2003, depository institution reserve requirements averaged $41 billion. Depository institutions met these requirements with $32.7 billion in vault cash and $8.3 billion in required reserve balances at Federal Reserve Banks. They also held $1.7 billion in excess reserves and $10.5 billion in contractual clearing balances.

Although they have risen in the last couple of years due largely to declining interest rates, required reserve balances at Federal Reserve Banks have declined by more than three-fourths since the end of the 1980s (from $34.4 billion in December 1989 to $8.3 billion in January 2003). Three factors may be primarily responsible for the long-term decline: (1) regulatory actions taken by the Federal Reserve in the early 1990s reducing reserve requirements, (2) banks' growing use of new products and technology, such as retail sweep accounts, to minimize required reserves, and (3) growth in the use of vault cash through the first half of the 1990s to meet reserve requirements, as increased ATM usage continued to increase the need for such cash. The proportion of reserve requirements met by vault cash rose from 44 percent in December 1989 to 80 percent in January 2003.

Governor Kohn has presented the concerns that current limitations may affect the ability to conduct monetary policy. While these problems are not imminent, we share the concerns about the implications of these restrictions over time.

In addition to potential benefits for the operation of monetary policy, permitting the payment of interest on reserve balances at the Federal Reserve Banks would promote economic efficiency. Uncompensated reserves act as a tax upon banks, while serving no public policy interest. To avoid this tax, banks have engaged in otherwise uneconomic activity to avoid

[1] The Federal Reserve may also set reserve requirements on nonpersonal time and savings deposits within a statutorily set range of zero to 9 percent (currently set at zero), and may prescribe requirements for Eurocurrency liabilities (currently zero).

holding these non-interest bearing required reserve balances. In recent years, the declining cost of technology has allowed banks to establish new types of sweep arrangements for retail customer accounts with the express purpose of minimizing reserve requirements. This sweeping is often invisible to the customer as a practical matter, but it does impose an unrecompensed business cost on banks. These costs harm the competitiveness of banks – not only with foreign institutions but with other financial services providers. If banks earned interest on these reserve balances, they would be less likely to expand the use of sweeps and might unwind some existing sweep programs.

The Office of Management and Budget (OMB) and Congressional Budget Office (CBO) have in the past estimated that paying interest on required reserve balances would have a budget cost, since it would reduce Federal Reserve System earnings transferred to the Treasury. Neither the OMB nor CBO have recently updated their estimates of the cost of this proposal.

H.R. 758 provides an "offset" to the budget cost by transferring a part of the Federal Reserve's surplus to the Treasury. It is true that in the past, budget accounting rules have at times permitted the transfer of Federal Reserve surplus funds to the Treasury to count as receipts that would offset the cost of other programs. Yet, over time, transfers of the surplus do not result in budget savings. In transferring a portion of its surplus to the Treasury, the Federal Reserve would reduce its portfolio of interest-earning assets. This would in turn decrease the Federal Reserve's future earnings and remittances to the Treasury. Budgetary receipts in the near term would increase only at the expense of foregone longer-term receipts.

Conclusion

We welcome action by Congress to repeal prohibitions on paying interest on business checking accounts at depository institutions. Repeal would eliminate unnecessary restrictions on these institutions' ability to serve their commercial customers, and it would level the playing field between them and other financial services providers that can compensate businesses for deposits without similar legal restrictions. Repeal would especially benefit the nation's small businesses.

The ability to pay interest on reserve balances maintained at the Federal Reserve Banks may improve the effectiveness of the tools that the Federal Reserve has to implement monetary policy. Financial system efficiency would likely improve as fewer resources would be devoted to minimizing reserve balances. As a general matter, we are sympathetic to these arguments and support the goals of the legislation. However, inasmuch as the potential budgetary costs associated with this proposal are not provided for in the President's Budget, the Administration is not prepared to endorse the proposal at this time.

Thank you for the opportunity to appear before the Subcommittee. I am happy to respond to any questions.