Testimony of

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Committee on Financial Services
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Hearing on the Repeal of Regulation Q

Ending Government Price Fixing in Deposits At Long Last

Madam Chairman, Ranking Member Maloney, and members of the Subcommittee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI in 2004 to work on financial issues, I was the President and CEO of the Federal Home Loan Bank of Chicago for 13 years, and spent in all 35 years working in financial services. In addition, I have extensively studied the history of banking and financial markets.

Last year's repeal of the final remaining vestige of Regulation Q, the prohibition of payment of interest on business demand deposits, at long last completed a pro-competitive process which began with the Monetary Control Act of 1980. The repeal was and is a good idea. We can easily see this by asking and answering half a dozen simple questions, to make the matter clear. These are:

1. Should Congress engage in price fixing to benefit banks?

   Obviously not.

2. Should Congress prevent depositors from getting interest income that banks would be willing to pay?

   Obviously not.

3. Is it the business of Congress to try to prop up banking profits?

   Obviously not.

4. Should Congress force depositors to subsidize borrowers?

   Obviously not.

5. Does Congress know the right price for a business checking account?

   Obviously not.

6. Should Congress promote competition to benefit the customers of banks?

    Obviously, yes.

I am tempted to say "Q.E.D." at this point and stop. But perhaps we do need to consider how Regulation Q, a rule so obviously opposed to competitive economic principles, managed to get enacted and survive, albeit subject to frequent fiddling, for nearly eighty years. The history of Regulation Q displays the folly of such schemes.

What did the Congress of 1933 think it was doing when it created interest rate ceilings on deposits, including a prohibition on paying interest on demand deposits, which became the rules of Regulation Q?

Well, they were trying to reduce competition and thus increase banking profits, goals now rightly out of fashion. As stated by Alton Gilbert, a scholar at the Federal Reserve Bank of St. Louis, one objective was "to increase bank profits by limiting the competition for deposits." In this respect, in other words, they wanted to make bank deposits a government-sponsored cartel, with the Federal Reserve as the cartel manager. So they put the government into the role of price fixing and preventing depositors from getting the interest income they might otherwise have earned.

In the findings of the Monetary Control Act, the Congress of 1980 accurately observed the results of this program, which had by then been clear for a long time: "The Congress hereby finds that limitations on interest rates which are payable on deposits and accounts discourage persons from saving money, create inequities for depositors, impede the ability of depository institutions to compete for funds…."

Another original reason for the ceilings, according to Gilbert, was to address "bank protests about the cost of federal deposit insurance premiums." Federal deposit insurance was also being established in the Banking Act of 1933. "Some members of Congress believed that the savings in interest expense resulting from interest rate ceilings on deposits would exceed the deposit insurance premiums"—an interesting political trade at the time.

Later, in the 1960s, Regulation Q rules tried to direct savings into financing housing, rather than industry and commerce, by giving savings and loans a slightly higher interest rate ceiling than commercial banks had. This was the then well-known and now forgotten "quarter point differential." In spite of this intention, the far bigger effect of the ceiling was to cause housing credit crunches. These happened when market interest rates went over the ceilings and deposits were withdrawn from thrifts, thus cutting off funds from mortgage lending, of which they at the time were the principal providers. This was a severe problem in the credit crunches of 1966 and 1969 and on into the 1970s—a problem caused by Regulation Q.

One regulatory response to this problem was to favor large depositors at the expense of small ones. In 1970, deposits of over $100,000 were made exempt from Regulation Q, while the ceilings remained for the smaller deposits. Thus huge amounts of money were effectively transferred from small depositors to bank profits—a result following logically from the goals of 1933, but clearly a perverse result, and equally perverse, this included transfers from small businesses with checking accounts to bank profits.

Also in 1970, in the Emergency Home Finance Act, Congress chartered Freddie Mac, to provide funding to mortgages unhindered by deposit rate ceilings. There is no need to go into the unhappy history of Freddie Mac and Fannie Mae, but note that Freddie Mac was the son of Regulation Q: one government intervention set up to address the effects of a previous government intervention.

During the 1970s, when I criticized theory and effects of Regulation Q, a banking lobbyist memorably told me, "You have to understand that Regulation Q is so imbedded in the American banking system that it is permanent." A poor prediction, as it turned out, although it took until 2011 for it to be completely falsified.

Because banks were prevented by the government from paying interest on business demand deposits for so long, cumbersome methods were developed to compensate for this regulatory rigidity. The banks would provide "free" payments and operating services because the business customers were providing "free" funding to the bank. This meant each bank had to set a theoretical (and debatable) "earnings credit" for the funds, instead of the interest it might have paid, and the theoretical fees for operating services (or "penny prices") were measured to see how much of the earnings credit they consumed.

In other words, the Regulation Q effect on business demand deposits was to encourage complex implicit pricing arrangements, instead of clear explicit pricing, and large companies employed treasury personnel to track, measure and negotiate these arrangements. This was more difficult for small companies without internal bureaucracies, of course.

Regulation Q also resulted in complicated devices to get around its prohibition. A small business witness testified to the Senate Banking Committee in 2005 that when "I started my first business, I can vividly recall my astonishment at being told that a business could not earn interest on a checking account." Later, "as the business prospered, my banker suggested a 'sweep account.' Boy, was it complicated…a paperwork nightmare." He rightly asked why the government should force this complication on small businesses? Why indeed?

In general, I believe that explicit pricing, or at least the possibility of explicit pricing, i.e. interest rates for funds and cash fees for services, is superior to forcing implicit pricing by regulation. Likewise, allowing straightforward deposit arrangements is better than forcing complicated work-arounds.

Also in general, customers are better served by encouraging competition than by suppressing it. This is especially true for smaller customers who lack negotiating power and are price takers.

To address the specific questions asked by the Subcommittee:

1. Has competition for business checking accounts increased since the repeal of the last vestige of Regulation Q last year? Because the Federal Reserve has manipulated short term interest rates to approximately zero, I would not expect to see major competitive results from the repeal at this point. When interest rates rise, as they inevitably will in time, I believe we will see such increased competition, to the advantage of business customers. Since we are in a time of essentially zero interest rates, this is in fact a good time for the repeal and the transition, so banks can more easily get ready for the post-Regulation Q world.

2. Are you concerned with any unintended consequences? No. There will certainly be consequences not foreseen, because market competition always creates new possibilities and

product variations. Having improvements which are invented by markets, although we could not previously imagine them, is what we want to happen.

3. Will small businesses benefit? I believe they will benefit from more competitive markets. It is a possible argument that Regulation Q caused borrowers to get subsidies from depositors--if it did, these subsidies will be replaced by market prices. Regulation Q certainly caused regulatory subsidies from small business depositors to bank profits, which will be removed. This is a good thing.

4. What are your thoughts about the Federal Reserve's statement that the repeal will provide greater clarity? As discussed above, I believe explicit pricing is indeed clearer than implicit pricing.

It used to be thought that providing checking accounts was the dominant function in funding a commercial bank. But demand deposits had in the past a far greater role in bank funding than they do now. Sixty years ago, banks were heavily funded by these non-interest bearing deposits. Checkable deposits represented about 65% of total commercial bank assets in 1952. At the time of the Monetary Control Act in 1980, this was down to 24%--still big enough to perhaps have persuaded the Congress of that day to leave the price control on business demand deposits in place, while dismantling all the rest of Regulation Q. By 2011, this proportion was further down to only 8.5%.

So for the banking system as a whole, the adjustment to the post-Regulation Q world is much easier than it would have been in past times.

An op-ed writer opined in 2010 that "the nation's bankers, particularly community bankers, now have a golden opportunity. It is the repeal of Regulation Q…that would allow banks to offer their best business customers fairer value for their checking deposits on a fully transparent and more accountable basis than before." This suggests the right kind of attitude for banks to take.

In my opinion, the Dodd-Frank Act had a few good points in it, and the repeal of the last vestige of Regulation Q is definitely one of them.

Thank you again for the opportunity to share these views.

United States House of Representatives
Committee on Financial Services

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1. Name:	2. Organization or organizations you are representing:
ALEX J. POLLOCK	SELF

3. Business Address and telephone number:

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4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
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6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

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A J Pollock

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