ICBA
INDEPENDENT COMMUNITY BANKERS of AMERICA®

March 1, 2012

Keeping Small Business and Municipal Deposits in the Community

On behalf of its nearly 5,000 community bank members, ICBA is pleased to submit this statement for the record for the House Financial Services Subcommittee on Financial Institutions and Consumer Credit's March 1 hearing titled: "Understanding the Effects of Repeal of Regulation Q on Financial Institutions and Small Businesses." We appreciate the opportunity to share our perspective on Regulation Q and on a related topic, full FDIC coverage of non-interest bearing transaction accounts.

Regulation Q

Since 1933, Federal Reserve Regulation Q has prohibited the payment of interest on business checking accounts. Designed to reduce volatility in bank funding costs, Regulation Q has served our communities well for 70 years. Regulation Q was repealed as part of the Dodd-Frank Act, with little discussion or debate, effective July 21, 2011. We anticipate the following effects of Regulation Q repeal:

- As community banks are forced to pay interest on business checking accounts to stay competitive with larger banks, and as interest rates inevitably rise from their historic lows, a stable, fixed-rate source of funding will be replaced with more expensive, volatile funding, potentially putting the safety and soundness of thousands of community banks at risk and reducing their franchise value.
- Repeal of Regulation Q will increase the cost of borrowing for most small business customers as community banks are forced to pass along the increased cost of funding business deposits. In those areas where loan demand is not strong, community bank margins will be further squeezed since the banks will have to absorb the costs.
- Fixed-rate funding, made possible by Regulation Q, allows community banks to invest in fixed-rate municipal debt without incurring interest rate risk. Regulation Q repeal will deprive many struggling municipalities of an important source of funding and force them to pay more for their borrowing.
- Ultimately, repeal of Regulation Q could cause community banks to lose market share to larger banks who can afford to pay more interest on deposits and lead to further consolidation of the financial industry, creating greater systemic risk.

Regulation Q was put into place for a reason. Stable, reliable funding strengthens banks and helps them to serve local economies. If Regulation Q were to be reinstated, there is an alternative solution that would allow business depositors to earn interest without violating the prohibitions of Regulation Q: Amend Federal Reserve Regulation D to exempt from the definition of "demand deposit" a money market deposit account (or MMDA) that allows up to 24 transactions a month for entities not eligible for NOW accounts. This would allow community banks to sweep daily between a business checking account and the new MMDA without having to establish expensive sweep programs or using overnight repos. An expanded MMDA would

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not be as volatile as an interest-bearing demand deposit and would not pose as much risk to the banking system. A solution that pairs reinstatement of Regulation Q with reform of Regulation D would address concerns that led to Regulation Q repeal, without the significant and adverse impact on community banks.

Transaction Account Insurance

ICBA supports a short-term, five-year extension of full FDIC coverage of non-interest bearing transaction accounts. With $1.4 trillion (or 20% of all domestic deposits) insured under this coverage, Congress should not ignore the danger of the sudden withdrawal of insurance if the program expires as scheduled at year-end 2012. In the absence of Regulation Q, those deposits are eligible to earn interest. Once-stable deposits will become “hot money” that could flee an institution at the click of a mouse in pursuit of a higher interest rate or the implicit government guarantee of a too-big-to-fail institution. The abrupt shift in funds could destabilize the recovering banking system, curtail credit, and threaten the fragile economic recovery.

Transaction accounts, which have no restrictions on withdrawals, are typically used by businesses of all sizes as well as municipalities, hospitals and other nonprofit organizations to meet payroll and operating expenses. Prior to the financial crisis, deposit insurance coverage of transaction accounts was limited to $100,000, the same limit that applied to other types of deposit accounts. In October 2008, following the onset of the credit market crisis, the FDIC temporarily established full insurance coverage of transaction accounts, provided the accounts paid no more than a limited amount of interest. This action was needed to prevent the sudden withdrawal of deposits which may have destabilized the banking system and exacerbated the crisis. The program, which was extended for two years by Congress and modified to prohibit any payment of interest, has been successful in minimizing disruption in the banking system. If the current program is allowed to expire December 31, 2012, coverage for transaction accounts will revert to the current limit for all deposit accounts, $250,000.

Transaction account coverage is fully paid for by FDIC-insured banks through their deposit insurance premiums, at no cost to taxpayers. The FDIC takes into account the cost of the additional coverage in determining the assessment rate schedule. In absence of this program, the largest banks, because of their systemic importance, will continue to enjoy an implicit *and cost-free* government guarantee. The cost of deposit insurance should reflect the true risk – including explicit or implicit guarantees – borne by taxpayers. The FDIC program shifts the cost of insurance from taxpayers to the banks. It promotes transparency and reduces taxpayer risk.

The FDIC program has been successful in promoting confidence among small business and municipal depositors, allowing community banks to retain these deposits so that they can be reinvested in the community. The U.S. economy is only beginning to emerge from an historic recession. The global banking system remains fragile and depositors remain risk adverse as demonstrated by the $1.4 trillion placed into non-interest bearing transactions accounts that carry FDIC insurance. The financial crisis in Europe and the geopolitical crisis in the Middle East are but two factors that could shock the financial system and reverse the economic recovery. Full

FDIC coverage of transactions accounts continues to play a significant role in preserving financial stability. ICBA urges Congress to continue the program for an additional five years.

Thank you for convening this hearing and for the opportunity to submit this statement for the record.