TESTIMONY
108th CONGRESS

TESTIMONY OF

R. MICHAEL STEWART MENZIES, SR.
PRESIDENT & CEO

OF
EASTON BANK AND TRUST COMPANY
EASTON, MARYLAND

ON BEHALF OF THE

INDEPENDENT COMMUNITY BANKERS OF AMERICA

BEFORE THE

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE
HOUSE FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

MARCH 5, 2003

Mr. Chairman, Ranking member Sanders, members of the Committee, my name is R. Michael Stewart Menzies, Sr., and I am President and CEO of Easton Bank and Trust Company, located in Easton, Maryland. I am also Vice Chairman of the Independent Community Bankers of America's (ICBA)[1] Federal Legislation Committee. I am pleased to appear here today on behalf of the 5,000 community banks across the nation that are members of the ICBA to share with you our views on the payment of interest on reserves maintained at Federal Reserve banks, and the repeal of the prohibition of payment of interest on business checking accounts.

Repeal of the Prohibition of the Payment of Interest on Business Checking Accounts

I will first address the issue of interest on business checking accounts. Mr. Chairman, as you know, this issue has been hotly debated among community bankers for several years. Bankers remain divided on whether or not the prohibition on paying interest should be repealed, and there are wide differences of opinion regarding the anticipated effects. Some community banks argue that lifting the prohibition could be very costly in a high interest rate environment and these costs, as all costs of banking, would eventually be passed along to the consumer.

Other bankers argue that remaining competitive is necessary to retain their best business customers. Therefore, lifting the prohibition is a way of increasing economic efficiency, and simplifying business practices. They believe that the current prohibition has been competitively damaging to the banking industry, especially community banking. Brokerage firms and other non-bank competitors will continue to aggressively compete directly with commercial banks to develop and expand small business relationships. They further argue that if the banking industry is not allowed to be competitive in offering interest-bearing commercial checking accounts, community banks may become more vulnerable to losing their most important business deposit and loan customers to non-bank and money center financial services providers that are not constrained by banking prohibitions.

Proposed Alterative

Mr. Chairman, ICBA has neither endorsed nor opposed lifting the prohibition on paying interest on business checking accounts. Rather, we have advocated an alternative that bankers on both sides of the issue tell us they can support. Under this alternative, which is along the lines of H.R. 974 introduced by Congresswoman Kelly, the number of allowable transactions from money market deposit accounts (MMDA) would be increased to 24 per month, from the current limit of 6 per month. This will enable banks to sweep funds between non-interest bearing commercial checking accounts and interest-bearing MMDA accounts on a daily basis. Thus, any bank that chooses to pay interest on a commercial checking account would be able to do so using the “sweep” mechanism at a cost significantly lower than the current alternative re-purchase agreement sweep program. This would create less of a financial burden, and allow community banks to be more competitive.

As you know, the MMDA is a type of savings account that pays interest, and is available to businesses as well as other account holders. However, the law currently allows a maximum of six pre-authorized third-party withdrawals per month. Sweeps are arrangements between depository institutions and business customers that allow the institutions to transfer the businesses’ checking account balances out of those accounts each evening, and put them into interest-bearing MMDA accounts. The next morning, the balances are transferred back into the business’ checking accounts. Sweeps therefore, give customers the advantage of accumulating interest on their balances when the balances are not in use.

The proposal to amend the law governing MMDA accounts to permit 24 transactions per month is beneficial to both the customer and the bank. It would enable commercial customers to yield a return on the funds they have deposited with the bank, and small businesses would be given access to a sweep product that is otherwise unaffordable. Community banks would remain competitive in providing cash management services to their commercial customers, would be able to pay higher interest rates on small business money market sweep accounts without being forced to pay interest on all commercial checking accounts.

ICBA supports the bill introduced by Congresswoman Kelly, and we urge the Committee to support the proposed compromise. However, should the prohibition on the payment of interest on business checking accounts be repealed, we urge the Committee to build in a transition period of no less than two years to allow financial institutions to unwind long term business arrangements with their commercial customers.

Payment of Interest on Reserves Maintained at Federal Reserve Banks

Let me now move to the proposal to require the Federal Reserve to pay interest on required and excess reserves depository institutions maintain as balances at Federal Reserve Banks, and discuss the impact of this proposal on community banks.

The Federal Reserve is in support of such a requirement and argues that this could induce banks to increase their reserve balances. The Fed has stated that it is concerned that a steady continued decline in reserve balances could impair its ability to execute monetary policy. The reserves at the Fed have dropped significantly in recent years as required reserves have decreased and depository institutions have become more adept at managing their reserve balances.

One of the reasons for this precipitous decline in the reserve balance is that some financial institutions have been able to reduce the amount in their transaction accounts, against which reserves must be maintained, by sweeping funds into non-reservable, interest-bearing instruments at the end of each day. This is a practice that takes place mostly with larger financial institutions, and not smaller financial institutions such as community banks.

Currently, no reserves are required for reservable liabilities under $5.7 million. When taking this into account, many community banks are not required to post substantial reserves, and many community banks can meet their required reserves with vault cash. If a smaller bank has no reserve requirements, or meets them directly through the use of vault cash (including cash at branches and ATM locations), or a combination of vault cash and reserve accounts, they do not stand to benefit directly from this proposal. They would not earn interest on reserves, because either they do not maintain a Fed reserve account or their balance is very small.

Another reason for the decline in reserve levels is the proliferation of deposit options available to bank customers. Customers are diversifying their funds by placing them in IRA's and 401(k)s and purchasing mutual funds, bonds or CDs. The availability of these options, coupled with ready access to these options through the Internet, has contributed to the steady decline in reservable deposits.

This deposit shift has been particularly harmful to community banks that rely on core deposits as their primary source of lendable funds. That is why the ICBA has advocated an increase in deposit insurance coverage levels as a means to keep more funds in local financial institutions for community lending purposes.

Little Benefit for Smaller Banks

So you can see, Mr. Chairman, the interest on reserves proposal would have little, if any, direct monetary benefit for most community banks. Indeed, it is the larger depository institutions that would benefit most from such a proposal. According to a Federal Reserve analysis, almost all of the banks that would receive interest on required reserve balances would be distributed evenly among banks in the top three-fifths, ranked by total deposits, but the dollar payments would be heavily skewed to those banks in the top fifth. These findings were conveyed to our association (then called the Independent Bankers Association of America) in a letter from Donald L. Kohn, director of the Federal Reserve's Division of Monetary Affairs, dated October 21, 1998.[2] We wrote to the Federal Reserve to inquire as to whether an analysis had been done to quantify the benefits to large banks versus community banks if legislation allowing the Fed to pay interest on reserves was enacted.

Role of Reserves in Monetary Control

Central to the required reserves issue is the role of reserves in monetary control. We appreciate Federal Reserve Chairman Greenspan's concern that if the decline in reserves continues, it could have an effect on the Federal Reserve's ability to implement monetary policy and may have the potential to increase the volatility of the federal funds interest rates. We defer to Chairman Greenspan on this important issue.

In conclusion, legislation to require the payment of interest on reserves maintained at Federal Reserve banks would not benefit community banks directly. However, we understand the importance of the Federal Reserve's concern about maintaining monetary control and the role that the Federal Reserve System provides to our nation's community bankers. Therefore, we do not oppose the proposal to require the Fed to pay interest on sterile reserves.

Conclusion

Thank you for the opportunity to testify on both issues regarding the payment of interest on sterile reserves held at Federal Reserve banks and the issue of the payment of interest on business checking accounts.

ICBA stands ready to work with you on these issues. I look forward to answering any questions you or other Subcommittee members may have.

[1] ICBA is the primary voice for the nation's community banks, representing nearly 5,000 institutions at nearly 17,000 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business, agricultural and consumer lending. ICBA's members hold more than $486 billion in insured deposits, $592 billion in assets and more than $355 billion in loans for consumers, small businesses and farms. They employ nearly 239,000 citizens in the communities they serve. For more information, visit www.icba.org.

[2] Letter to the Independent Community Bankers of America from Donald L. Kohn, director of the Federal Reserve's Division of Monetary Affairs, October 21, 1998.

[3] The reserve requirement is 3% of net transaction accounts up to $41.3 million, and $1,239,00 plus 10% of any amount over $41.3 million (12 CFR 204.9).

ONE THOMAS CIRCLE NW, SUITE 400
WASHINGTON, DC 20005 • 202.659.8111
Send mail to info@icba.org with questions or comments.