

Testimony
of
America's Community Bankers
on
Interest on Business Checking Accounts
before the
Subcommittee on Financial Institutions & Consumer Credit
Committee on Financial Services
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Mr. Chairman and members of the Subcommittee, my name is David Bochnowski. I am Chairman and Chief Executive Officer of Peoples Bank in Munster, Indiana. I am testifying today in my capacity of Chairman of America's Community Bankers. On behalf of ACB, thank you for this opportunity to testify today on this issue of critical importance to community banks and small- and medium-sized businesses across America.

ACB strongly supports allowing banks the option of paying interest on business checking accounts, as reflected in the legislation being introduced by Representatives Pat Toomey (R-PA) and Paul Kanjorski (D-PA). We also strongly support authorizing the Federal Reserve to pay interest on sterile reserves. In fact, these issues were first brought to the attention of Congress by ACB in 1994, and we have continued to make the passage of legislation a top priority since that time.

The ban on interest-bearing business checking accounts is the last statutory vestige of Regulation Q, an archaic law that dates back to 1933. The original intent of this law was to prevent potential bank insolvencies that might be caused by bidding wars vis a vis interest rates on demand accounts.

Clearly, this is no longer the case. In its 1996 joint report, *Streamlining of Regulatory Regulations*, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision stated that the statutory prohibition against paying interest on demand accounts "no longer serves a public purpose." This statement lends additional authority to twenty-five years of studies authorized by both the executive and legislative branches of the federal government consistently recommending that prohibitions against paying interest on demand deposits be removed.

This prohibition has resulted in an anti-competitive business environment that has allowed a limited number of financial conglomerates to corner the market for cash management services. It continues to block off an entire area of potential deposits for community banks like mine to lend to our neighbors and communities. And it prevents many small businesses from earning interest on their checking accounts.

The obvious solution to these problems is for Congress to pass legislation allowing banks the option of paying interest on business checking accounts. And in fact, just last year, the House passed such legislation – not once, but twice. H.R. 4067 was passed by voice vote in the House on April 11, 2000. In addition, on October 26, 2000, the House passed the conference report for H.R. 2614 (small business

and tax relief legislation) which also repealed the ban on interest-bearing business checking accounts. Both bills were passed with the support of ACB, the National Federation of Independent Business, the U.S. Chamber of Commerce, the American Farm Bureau, and the Association for Financial Professionals (formerly the Treasury Management Association). We believe that in both cases, the House spoke loud and clear in favor of lifting this archaic statutory prohibition.

In addition, during a speech before ACB in December, Federal Reserve Board Chairman Alan Greenspan singled out the detrimental effects of this prohibition, saying “This is of particular concern to community bankers, of course, given that larger banks are offering interest to their customers through sweep accounts. Pending legislation modernizing the law would potentially help bolster deposit growth and open opportunities for other profitable customer relationships without the unproductive and costly circumventions of the existing statute.” We are pleased that Governor Meyer today reiterated the Fed’s support for repealing this archaic law.

Given this broad coalition of support for repealing the ban, you may ask why this prohibition still stands. To answer this question, it is worthwhile to take a closer look at the opponents of the interest on business checking option.

Historically, much of the opposition has been generated by a few of the large financial firms and big banks. Unlike most community banks, these institutions conduct sweep arrangements efficiently because they have the financial resources to do so. To better understand why this gives these institutions an unfair competitive advantage, it is worth examining what sweep arrangements involve.

There are essentially three sweep options that banks may offer, none of which, practically speaking, are viable for most community banks or the businesses they hope to serve:

Demand/Sweep Arrangements

This arrangement involves sweeping funds from a savings account into a demand account. Because the law limits the number of possible transfers per month, this approach is generally undesirable for most businesses.

Third-Party Arrangements

Larger banks (those with \$750 million or more in assets) with ample commercial accounts and sweep transactions may use a third party, such as a mutual fund, for transfers. Because the third party is paying the interest, there is no technical

violation of the law. However, small- or medium-sized banks rarely have sufficient account volume or sweep activity to attract a “name” fund into which the swept dollars could be invested.

Repurchase Agreements

Repurchase agreements, which generally involve the use of U.S. government securities, are generally labor-intensive and involve costly paperwork expenses. For many small- and medium-sized community banks, the benefits of repurchase agreements are simply not worth the costs and burden.

As the head of a \$400 million community bank, I can tell you first-hand that for most of us, sweep arrangements are a costly and cumbersome product. Peoples Bank offers them because we do not have the option of paying interest on business checking accounts, which would be much more efficient and beneficial to our business customers. For smaller community banks, sweep arrangements are not even a realistic business option.

In addition, the minimum investment for these types of accounts is well beyond the reach of most small- and medium-sized businesses. A 1998 *Forbes* magazine article describing the sweep account monopoly enjoyed by institutions like First Union concluded: “First Union earned an estimated 1.34 percent in 1997 on total assets, 19 basis points higher than its peers. Wonder how much of that edge comes from shortchanging small-business people? Quite a lot, we suspect.”

Mr. Chairman, we understand that First Union and Wall Street financial firms have invested significant resources in offering sweep account services to their customers. We do not begrudge the benefits they have reaped from their efforts, nor do we oppose their continuing to conduct business in this manner. But is it asking too much for Congress to allow community banks, many of whom are strapped for new deposits, to compete in the marketplace for cash management services?

Let me give you an example. From September 30, 1999 to September 30, 2000, Merrill Lynch transferred \$33 billion into insured money market accounts through its two banking subsidiaries. Its deposit growth represented 30 percent of all money market growth in the entire banking industry during this period. If you add in the four billion dollars of deposit growth earned by E*Trade Bank and TD Waterhouse, that \$37 billion is nearly double all the money market deposits held by all five thousand commercial banks under \$100 million in assets. Surely, this little change in the law can be effected to help community banks attract deposits.

And what about the small business customers that the larger financial institutions don't serve? Doesn't it make sense for Congress to give them the option of earning a market rate of return on their deposits? We think the time has come to lift this artificial prohibition and keep more money on Main Street, rather than continue diverting it to Wall Street.

We are also aware that some of our community bank brethren do not see eye-to-eye with us on this issue. A group that calls itself the "Coalition of Community Bankers" has actively opposed the interest on business checking option. In fact, in a letter dated February 28, 2001 to community bankers, this group stated that it "is strongly opposed to lifting the ban either now or in the future."

As a fellow community banker, I cannot understand the opposition of this group to allowing for the option of offering a better product to potential business customers. Today's world of financial services is much different than that of the 1930s. The evolution of capital markets and the expanded availability of mutual funds give both consumers and businesses a number of low-risk alternatives to deposit accounts. As a result, community banks face stiff competition for the business of deposit-taking. Allowing us to offer an efficient demand deposit product like interest-bearing business checking accounts is a forward-looking approach to addressing this problem.

Let me say to my fellow community bankers that we do not support legislation that will require banks to pay interest on business checking accounts; we simply want the option of doing so. If a bank would choose not to offer such a product, that's fine. But please don't stand in the way of those of us who would.

Mr. Chairman, I would also like to express ACB's support for legislation authorizing the Federal Reserve Board to pay interest on sterile reserves held at the Federal Reserve Banks. This implicit tax creates incentives to adopt sweep arrangements on demand deposits that are not subject to reserve requirements. Paying interest on required reserve balances will increase the effectiveness of monetary policy and help make a bank's payment of interest on its business checking accounts more feasible. On behalf of ACB, I would like to commend Representative Sue Kelly, a member of the Subcommittee, for her ongoing efforts on this issue.

Finally, I would like to address the critical point of timing with respect to this issue. Because a delay would only postpone the benefits of this much-needed

change in law, it is our strong preference that legislation giving banks the option to pay interest on business checking accounts do so immediately upon enactment. We recognize that some institutions are seeking an extensive transition period. While we appreciate the efforts made by Representatives Toomey and Kanjorski to accommodate these concerns, we strongly believe that a phase-in period is unnecessary and undesirable. It's the twenty-first century. Hasn't the time come to repeal the final relics of the Great Depression? We think so.

ACB strongly endorses the Toomey-Kanjorski bill as an important step in allowing banks to offer interest-bearing business checking accounts. We commend House Financial Services Committee Chairman Mike Oxley for putting this issue on the fast track, and we commend you, Chairman Bachus, for holding today's hearing. Thank you again for the opportunity to testify before the Subcommittee, and I look forward to any questions you may have.