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TESTIMONY OF
TREASURY ACTING UNDER SECRETARY DONALD V. HAMMOND
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, Ms. Waters, and Members of the Subcommittee, I appreciate this opportunity to present the Treasury Department's views on repealing prohibitions on the payment of interest on business checking accounts, and on permitting the payment of interest on reserve balances that depository institutions maintain at the Federal Reserve. The Treasury Department supports permitting banks and thrifts to pay interest on business deposits. While sympathetic to many of the arguments in favor of permitting the Federal Reserve to pay interest on reserve account balances, we are not prepared to endorse this 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. Such provisions have in the past been included in broader regulatory burden relief legislation or proposed on a stand-alone basis, such as H.R. 4067, which passed the full House of Representatives last year. Repeal of this prohibition would eliminate a needless government control on the price that banks may pay for business deposits, consistent with the earlier elimination of Regulation Q rate ceilings on other deposits. The result should be more efficient resource allocation. By earning a positive return on their transaction balances, small businesses especially should benefit from the repeal of the prohibition. Larger firms have been better able to offset the lack of interest on checking account funds by using sweep accounts to earn interest or by obtaining price concessions on other bank products.

Most proposals that would have allowed banks and thrifts to pay interest on demand deposits would have delayed repeal of the current prohibition for a number of years, and provided for transitional mechanisms. The Treasury Department continues to prefer a relatively quick repeal of the prohibition on paying interest on demand deposits, obviating the need for special transitional arrangements.

Permitting the Federal Reserve to Pay Interest on Reserve Balances

Background

The Federal Reserve Act requires depository institutions to maintain reserves against certain of their deposit liabilities. The first $5.5 million of an institution's transaction accounts are currently exempt from reserve requirements. Transaction balances between that level and $42.8 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 clearing balances. These 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. Clearing balances earn implicit interest through the offset of fees for Federal Reserve services.

As of January 2001, depository institution reserve requirements totaled $38.5 billion. Depository institutions met these requirements with $32.6 billion in vault cash and $5.9 billion in required reserve balances at Federal Reserve Banks. They also held $1.25 billion in excess reserves.

Since the beginning of the 1990s, required reserve balances at the Federal Reserve Banks have declined by 83 percent ($5.9 billion currently compared to $34.4 billion at year-end 1989). Three factors may be primarily responsible for the 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 to meet reserve requirements, as increased ATM usage has increased the need for such cash. The proportion of reserve requirements met by vault cash rose from 44 percent in December 1989 to 85 percent in January 2001.

The three principal grounds for paying interest on reserve balances are to: (1) promote economic efficiency, (2) facilitate monetary policy, and (3) lower costs to the banking industry.

Economic Efficiency

Large banks have long offered "sweep" accounts to their commercial customers – arrangements whereby balances in corporate demand deposits are routinely swept into repurchase agreements, Eurodollar deposits, and money market funds until they are drawn down by the account holders. Although intended to put otherwise "idle" corporate funds to work (since these accounts are prohibited by law from earning interest), as a byproduct these

[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).

arrangements also reduce the reserve requirements of banks. More recently, the declining cost of technology has allowed banks to establish new types of sweep arrangements for retail customer accounts (both interest-earning NOW accounts and retail demand deposits) with the express purpose of minimizing reserve requirements. This sweeping is often invisible to the customer as a practical matter.

Permitting the payment of interest on reserve balances might lead to greater economic efficiency. Banks have expended resources to avoid holding non-interest bearing required reserve balances. 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. But the extent of efficiency gains for banks, their customers, and the economy is highly uncertain. Advances in technology have lowered the cost of sweep programs. How many sweeps would unwind would also depend on: (1) whether banks would also be permitted to pay interest on business demand deposits; (2) what customers would earn on their transaction accounts compared to sweep instruments; and (3) what banks would earn on reserve balances compared to alternative investments.

Monetary Policy

As you will hear from the Federal Reserve, the decline in required reserve balances could potentially lead to greater short-term interest rate volatility, although such volatility is not a serious problem at present. For various reasons, the demand for balances to meet reserve requirements is more stable than the demand for balances to clear transactions through the Federal Reserve (Fedwire). Thus the smaller the required reserve balances, the greater the role that less predictable daily clearing needs of banks would have in determining the demand for reserves. This may make it more difficult for the Federal Reserve to supply the amount of reserves consistent with its federal funds rate target – the short-term, operational target of monetary policy. As a result, the daily volatility in the federal funds rate could increase. The Federal Reserve believes that such volatility would impair its ability to use federal funds rate targeting as a means of implementing monetary policy. Payment of interest on reserve balances would give banks greater incentives to hold balances at the Federal Reserve. This in turn may make the demand for reserve balances more stable and lessen the potential volatility of the federal funds rate.

Banking Industry Costs and Competitiveness

Banks have long contended that the costs of reserve requirements (i.e., forgone earnings) put them at a competitive disadvantage relative to non-bank competitors that are not subject to reserve requirements. Securities firms and other competitors offer transaction services through money market mutual funds and similar arrangements. Yet the forgone earnings that depository institutions currently incur through reserve requirements must be viewed in the context of their overall relationship to the federal government, including benefits derived from federal deposit insurance and access to the Federal Reserve payments system and discount window.

Budget and Taxpayer Issues

The Office of Management and Budget and Congressional Budget Office have in the past estimated that paying interest on required reserve balances (together with permitting banks to pay interest on business demand deposits) would cost approximately $600 million to $700 million over 5 years. Both the OMB and CBO estimates take into account the effect on tax revenues from depository institutions that receive interest. In addition, both project that the proposal would result in higher required reserve balances, which they estimate would generate some new earnings for the Federal Reserve and thus new Treasury receipts. Neither of these effects is enough to completely offset the revenue loss from the payment of interest.

Some proposals have provided for an "offset" to the budget cost by transferring a part of the Federal Reserve's surplus to the Treasury. It is true that in some previous years budget accounting rules have 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. Therefore budgetary receipts in the near term would increase only at the expense of longer-term receipts. Thus using the Federal Reserve surplus as a "pay-for" would not reduce the taxpayer cost associated with the proposal to pay interest on depository institution reserve balances maintained at the Federal Reserve.

Conclusion

Congress should act to repeal prohibitions on paying interest on business checking accounts at banks and thrifts. This would eliminate unnecessary restrictions on these institutions' ability to serve their commercial customers and 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.

Proponents of paying interest on reserve balances maintained at the Federal Reserve have put forth a number of reasons in its favor. The ability to pay interest on these balances may improve the effectiveness of the tools that the Federal Reserve has to implement monetary policy. Financial system efficiency might improve as fewer resources would likely be devoted to minimizing reserve balances. As a general matter, we are sympathetic to many of the arguments put forth by proponents of paying interest on reserve balances, particularly with respect to monetary policy.

At the same time, however, we are also mindful of the budgetary costs associated with this proposal, which would be significant. The President's Budget does not include the use of taxpayer resources for this purpose. At this time, then, the Administration is not prepared to endorse this proposal.

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