Testimony of James E. Smith
On Behalf of the American Bankers Association
Before the
Subcommittee on Financial Institutions and Consumer Credit
of the
Financial Services Committee
United States House of Representatives

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Mr. Chairman, I am James E. Smith, Chairman and CEO of Citizens Union State Bank and Trust, in Clinton, Missouri, and President-Elect of the American Bankers Association (ABA). I am pleased to be here today on behalf of the ABA. ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks – makes ABA the largest banking trade association in the country.

Mr. Chairman, I would also like to thank you for holding this hearing to discuss the prohibition of payment of interest on corporate demand deposits and on payment of interest on banks' reserve deposits held at Federal Reserve Banks. ABA applauds the initiative of Representative Sue Kelly for her leadership on these issues, including sponsoring legislation to provide for 24-transaction sweep accounts, Federal Reserve flexibility on setting reserve requirements, and payment of interest on sterile reserves. We appreciate the work of many members of this Committee who helped move this type of legislation through the House last year, and we support the legislative initiative underway this Congress.

In my testimony today, I would like to make several points:

- The ABA strongly supports the approach of authorizing a new non-reservable 24-transactions money market deposit-type account. We believe this account will be a useful and flexible instrument with which to meet the needs of many of banks' corporate customers, especially small businesses. It would also allow banks to better compete with non-bank firms such as investment companies, securities companies and credit unions that offer interest-bearing small business and corporate transaction accounts.

- ABA strongly supports proposals to allow the Federal Reserve to pay interest on bank reserve balances. Without this authority, these balances will eventually disappear. Paying interest on these reserves would enable the Federal Reserve to better control the federal funds rate and will increase bank transactions deposit services.

I will discuss each of these in detail below.

Interest on Transaction Accounts

The banking industry has wrestled with the issue of paying interest on corporate demand deposits for more than a decade. The debate within the industry continues, and no firm consensus on repeal or retention of the prohibition has yet been reached. However, ABA strongly supports the approach of authorizing a new non-reservable 24-transactions money market (MMDA) deposit-type account. This alternative would authorize a new Money Market Deposit-type account that would permit up to 24 transfers per month – that is, one transfer for every business day. Current restrictions on similar accounts allow only 6 transfers per month, thus limiting the value of this option for banks' corporate customers.

We believe the expanded transaction capability of this new MMDA-type account will be a useful and flexible instrument with which to meet the needs of many of banks' corporate customers, especially small businesses. It would also allow banks to better compete with non-bank firms such as investment companies, securities companies and credit unions that offer interest-bearing small business and corporate transaction accounts.

Because banks may not currently pay ***explicit*** interest on corporate transaction accounts, they have developed over the years various systems for paying ***implicit*** interest. Implicit pricing involves bundling together products and services and providing them at lower-than-market prices as compensation for what cannot be provided explicitly. The classic example of implicit interest is the toaster giveaways used to attract new customers during the days of Regulation Q (which imposed interest rate ceilings on consumer time and savings deposits).

The same theory applies today to corporate demand deposits. Implicit interest takes the form of transactions services, lending and line of credit arrangements, and other ancillary services that are bundled and priced to compensate for the inability to pay explicit interest. Banks have devoted considerable resources to develop systems for calculating the value of compensating services. Often the details of the implicit pricing arrangements between banks and their corporate customers are set in contracts.

More recently, some banks have developed "sweep" arrangements for their corporate customers. These arrangements sweep corporate demand deposit balances ***out*** of the bank each evening and put them into interest earning, non-deposit vehicles (such as money market instruments or mutual funds); the next day, the balances are swept back into the customer's deposit account to meet the daily transactions requirements. While this process helps banks compete for corporate customers, a very important point is that it takes money out of the local community since the deposits are moved out of the bank each night and are thus unavailable for funding loans. For many banks, funding is the critical issue today. Banks' deposit growth is very low, due to competition from non-deposit products. In many communities, it is increasingly difficult to meet loan demand because of the difficulty in obtaining deposits. That, of course, undermines local economic growth.

These market factors set the stage for the current debate within the banking industry. On one hand, some bankers have voiced concern that the existing prohibition against paying explicit interest on demand deposits makes it difficult to compete for corporate funds against money market funds and investment firms that offer interest-bearing transaction accounts. Even credit unions offer interest-bearing checking accounts to small businesses, and the potential for growth in this area is enormous. Moreover, many small banks find sweep arrangements and systems for calculating compensating balances too expensive and cumbersome and believe that explicit pricing would enhance their competitiveness.

On the other hand, many banks have invested considerable resources in setting up systems that calculate the appropriate compensation for other services rendered and in implementing sweep systems. Moving to the payment of explicit interest on transaction accounts means that many existing contractual arrangements between banks and their corporate customers would have to be unwound at considerable cost to both parties.

And it is not just demand deposit pricing that would be affected. All the services that have been bundled together to make up implicit pricing arrangements would also have to be unwound, and these services would also have to be explicitly priced or have their terms reset. In many instances, pricing on loans may be affected. Some banks believe that they would have to adjust their overall asset and liability mix to account for changes in the expected maturity of the deposits.

For these reasons, an industry consensus has not been achieved in support of immediate repeal of the prohibition of paying interest on demand deposits. However, we have found broad consensus for an account that would allow up to 24 transactions per month to another account. The 24-transfer feature would enable a bank to transfer balances ***within the bank*** between a non-interest-bearing checking account and an interest-bearing money market account each business day during the month. The 24-transfer account represents a middle ground – it would provide an important option for banks to meet the needs of their business customers, causing fewer market disruptions (such as renegotiating contracts for transaction and banking services). Furthermore, for those banks that currently offer sweep accounts, this approach would give them an alternative that would maintain deposit funds within the bank to meet loan demand at reasonable interest rates. It would keep the money in the local community. The majority of bankers believe that such a system would help them to be more competitive.

Some bills introduced over the last few years go beyond ABA's current position in that they would eliminate the prohibition on payment of interest on demand deposits after several years. As I have already mentioned, there is no current consensus within the banking industry for repealing the prohibition. However, we recognize some Members of Congress and some business groups believe that the prohibition should be repealed. If Congress does decide to take such action, we believe it is critical that ***an adequate transition period be provided.*** This would give banks and their customers time to unwind current contracts and other arrangements. In the interim, it is important to note that small businesses will have gained the opportunity to make their bank transaction balances productive through the 24-transfer provision.

Last year, the Housing Banking Committee reported out, and the full House passed, such a bill – combining the 24 transfers concept with a transition to a sunset of the prohibition on payment of interest. As you know, ABA supported that bill. If this Committee chooses a similar approach, we would be pleased to work with you to develop a bill we can support.

ABA has favored an account that is not subject to reserve requirements by the Federal Reserve. We understand that the Fed has some concerns about a non-reservable account. Reserve balances held at the Federal Reserve have declined significantly over the past few years, due to customers transferring funds out of banks to brokers, money market funds, and to bank sweep arrangements. The Federal Reserve is apparently worried that creating a non-reservable 24-transfer MMDA account would reduce reserves even further, and that this decline could affect its ability to conduct monetary policy.

We believe that the imposition of reserves will ***raise*** the cost to customers of the 24-transfer account, making it less competitive with non-bank products. If reserves are imposed, the account could be so expensive (absent other factors) to provide *vis-a-vis* non-bank competitors that banks would in many cases continue to sweep corporate balances outside the bank, ***thus defeating the purpose of creating the account in the first place. Ironically, the result would be a continued decline in reserve balances.***

We would support two other provisions that would somewhat alleviate the cost of imposing reserves on the 24-transfer account. The first is the proposal to widen the range of required reserves, giving the Fed authority to set reserves for transaction deposits between zero and 14. The current 10 percent reserve requirement represents a significant opportunity cost for banks, and reducing it would obviously lower that cost and lessen the incentive to provide sweeps to customers. ***Importantly, nothing in this provision would impede the Federal Reserve's ability to conduct monetary policy.***

The second provision would allow the Fed to pay interest on reserves maintained at the Fed. As will be discussed more fully below, this would also help offset the opportunity cost of placing required reserves on 24-transaction accounts.

Payment of Interest on Sterile Reserves

The ABA supports authorizing the payment of interest on reserves maintained at the Federal Reserve Banks. The opportunity costs of holding non-interest-bearing (sterile) reserves at the Federal Reserve have been significant over the years. Clearly, the introduction of sweep accounts was prompted in part as a response to the requirement to hold non-interest-bearing reserves.

We believe the most effective way for the Fed to maintain whatever level of reserves it feels is necessary to facilitate monetary policy is to pay market interest rates on reserves held at the Fed. It is important to note that paying interest on reserves mitigates the impact of imposing required reserves on any account – including 24-transaction MMDAs.

While ABA has long supported paying interest on sterile reserves, the value of such interest payments to the industry has declined steadily over the last decade. This is due to past reductions in required reserve ratios, the decline in the level of demand deposits, the ability of most banks to meet reserve requirements by holding vault cash in the bank (rather than at the Fed), and the use of sweep accounts. In fact, a study by the Federal Reserve Bank of St. Louis[1] indicates that very few banks are “economically” constrained by reserve requirements today.

There are four key points that deserve emphasis:

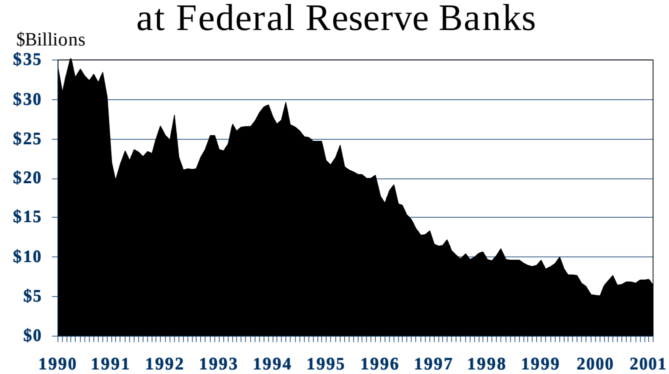
- Required reserves held at Federal Reserve Banks will continue to decline as long as banks do not receive market interest rates on these funds.
- The burden of sterile reserves places banks at a competitive disadvantage and inhibits the development of transactions deposit products.
- Paying interest on reserves could help the Federal Reserve conduct monetary policy and stabilize short-term interest rates.
- Interest on reserves at the Federal Reserve would not have a significant immediate impact on the Federal budget, and, we believe, would yield a net surplus over the longer run.

Required Reserves in Federal Reserve Banks Have Declined

As you know, Mr. Chairman, the basic business of every bank is to take deposits and use these funds to make loans. However, when someone deposits $100 in his or her checking account, the bank is only allowed to lend out $90 of this $100. The bank is required to keep ten percent as cash or as deposits at the district Federal Reserve Bank.[i] These balances are called “sterile reserves” because they do not earn interest.

Not being paid interest on sterile reserves imposes an expensive tax on bank deposits. The direct cost is the interest that banks would earn by lending reserved funds back into their local communities. A conservative estimate of the cost is nearly $400 million a year (the current federal funds interest rate applied to the average reserve balances at Federal Reserve Banks). However, the costs to the communities are much greater.

Figure 1
Bank Reserve Deposits
at Federal Reserve Banks



Data Source: Board of Governors of the Federal Reserve System

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[1] R.G. Anderson and R.H. Rasche, Federal Reserve Bank of St. Louis *Review*, November/December 1996.

[i] A bank must hold three percent in reserves on the first $42.8 million of transactions deposits, and ten percent thereafter. Transactions deposits include all those where withdrawals are permitted by transferable instrument, payment order, or telephone or preauthorized transfer for the purpose of making payments to third persons.

One method that banks use to lower the cost of sterile reserves is sweep accounts. As mentioned above, one type of sweep account automatically transfers a customer's deposit balances ***off*** the bank's books and into money market instruments or funds. A second type of sweep transfers money within the bank from a reservable transaction account (*e.g.*, NOW account) to a non-reservable account. Both of these reduce the accounts subject to reserving saving the institution a significant cost and providing customers with higher returns on their deposits.

The proliferation of sweep programs has led to a steady decline of reservable deposits since the middle 1990s – in fact, reserve balances at the Federal Reserve Banks dropped from almost $30 billion in 1994 to $6½ billion as of February. (See Figure 1.) Even this past year with deposit growth at **twice** the rate over the last five-year average, reserve balances were essentially flat.

As required reserves decline, banks are able to satisfy their reserve requirements with cash in vaults and ATM machines. In fact in March, vault cash exceeded required reserves by $11.1 billion. In this case, banks have no reason to keep reserve balances in the Federal Reserve System except for required check-clearing balances. Even check-clearing reserves are disappearing as lower-cost alternatives to the Federal Reserve are becoming more widely used. Some have argued that there is a floor on reserves at the Federal Reserve because of compensating balances that commercial borrowers maintain at banks. However, the experience of my bank and others is that compensating balances are becoming rarer because competition for commercial customers is forcing explicit pricing for deposit services. ***Simply put, unless a market interest rate is paid, we can expect reserve balances in the Federal Reserve to eventually disappear.***

Payment of interest on sterile reserves would reverse the downward trend in reservable balances. According to the May 1998 *Senior Financial Officer Survey* conducted by the Federal Reserve Board, almost half of the banks surveyed said they would economize on vault cash and would be more likely to meet a greater portion of their reserve requirements with interest-bearing accounts at the Federal Reserve. Moreover, several banks reported that they would dismantle their sweep programs, either immediately or eventually, presumably because of the high operational cost associated with these programs. Some banks stated that they would begin to offer new products to attract customers back to the bank from mutual funds. To reiterate, paying market rates would eliminate the inefficiencies and extra expenses that banks incur because of the sterile reserve penalty.

Not Paying Interest on Sterile Reserves Restricts Bank Services

My bank, and I am sure every other one, is forced to control expenses in every way possible to compete. We find that the competition for consumer and business deposits is intense. Moreover, non-bank financial firms are not subject to sterile reserve requirements. Money market funds and "cash management accounts" at securities firms substitute for bank deposits and even allow customers to write checks on their balances in these accounts. American banks also compete for deposits against foreign banks that are not subject to U.S. sterile reserve requirements. Table 1 demonstrates that, ***at ten percent, the U.S. is the only major industrial nation with reserve requirements above two percent.*** Larger firms with overseas operations have the easiest access to these foreign competitors. However, in today's Internet world, American depositors can access these accounts from their desktop computers.

Authorizing the payment of interest on sterile reserves would make our banks more competitive, particularly in international markets. The U.S. needs to level the playing field because foreign nations have been lowering the cost of sterile reserves.

Table 1
Reserve Requirements on Transactions Accounts

Nation	Highest Reserve Requirement	Interest on Reserves
Canada	0.00%	N.A.
European Monetary Union	2.00%	Yes
Japan	1.30%	No
Switzerland	0.00%	N.A.
United Kingdom	0.35%	No
United States	10.00%	No

Sources: Bank of England, Bank of Japan, European Central Bank

The lack of interest on sterile reserves also has other important implications for banks and their customers. First, the penalty on reservable deposits discourages banks from developing new transactions deposit products, aside from sweep programs. And second, a sterile reserve requirement distorts the market for repurchase agreements (RPs). RPs for anything other than Treasury or federal agency debt with a maturity of less than seven days are treated as demand deposits, and are therefore subject to reserve requirements. As a result, banks avoid using shorter-term RPs as liquidity vehicles. This arbitrary differentiation limits banks' liquidity strategies – a limitation of special concern in light of the fact that the stock of Treasury securities is dwindling.

In sum, receiving market interest on reserve balances at the Federal Reserve would make banks more competitive. It would also alleviate the need for banks to make unnecessary, costly adjustments and encourage them to develop new deposit products along with sweep accounts (if they choose to keep them). Bank deposit services to their local communities would benefit as a result.

Interest on Sterile Reserves Would Facilitate Monetary Policy

Most importantly interest on sterile reserves would facilitate monetary policy. As noted above, the prohibition of interest on bank reserve deposits at the Federal Reserve Banks has led to the decline in the level of required reserve balances. Concerns have been raised that the drop in reserves may eventually raise the volatility of the federal funds rate and make it more difficult for the Federal Reserve to conduct monetary policy. By paying a market rate of interest on reserves, the Federal Reserve could maintain any reserve level it deemed appropriate to help manage monetary policy – if it chooses to continue to use bank reserves for this purpose – and control excessive volatility of the federal funds rate.

Interest on Sterile Reserves will Increase Net Federal Revenues in the Long-Run

The most commonly cited barrier to the payment of interest on sterile reserve balances is a projected negative impact on Federal budget receipts. The Federal Reserve earns interest on bank reserve balances from the interest it receives from investing the funds in Treasury securities. In the past, the Federal Reserve has earned enough to more than cover its budget and contribute the excess to the Treasury. The argument has been that interest paid on bank reserve balances would, therefore, reduce the amount transmitted to the Treasury.

If a market rate of interest is not paid on reserves, balances will continue to decline to the point where there will be nothing for the Federal Reserve to invest to earn interest. If, on the other hand, the Federal Reserve is allowed to pay interest on reserve balances then it can bring in net income as the difference between what it earns on and pays for the funds. Any spread on acquired balances would represent a net increase in Federal Reserve earnings and in Treasury receipts in the long run.

It appears that the short-term impact on Federal Reserve earnings would be minimal, and that the initial outlays of the program could be recouped fairly quickly. This expense will be offset as market interest rates bring reservable deposits back into banks, and the Federal Reserve gains net interest earnings on the corresponding bank reserves. ***The net impact on annual Federal Reserve earnings should turn from negative to positive within a few years – sooner if banks attract reservable deposits back more quickly.*** In sum, the early net outflows could easily be paid back within a decade or less.

Conclusion

ABA strongly supports the approach of authorizing a new non-reservable 24-transactions money market deposit-type account. If Congress does decide to eliminate the prohibition on paying interest on business accounts, it is critical that ***an adequate transition period be provided*** to give banks and their customers time to unwind current contracts and other arrangements. In the interim, it is important to note that small businesses will have gained the opportunity to make their bank transaction balances productive through the 24-transfer provision.

ABA strongly supports proposals to allow the Federal Reserve to pay interest on bank reserve balances. Without this authority, these balances will eventually disappear. Paying interest on these reserves would enable the Federal Reserve to better control the federal funds rate and will increase bank transactions deposit services. Since the bill would increase Federal Reserve and Federal budget net receipts over the longer run, it is a "win-win" for all concerned.

Mr. Chairman, we are prepared to work with you and the members of this Committee on this important bill.