Testimony of

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On behalf of

Independent Bankers Association of Texas

Before the

United States House of Representatives
Subcommittee on Financial Institutions and Consumer Credit

Hearing on

"Understanding the Effects of the Repeal of Regulation Q on Financial Institutions and Small Businesses"

March 1, 2012
Washington, D.C.

Opening

Chairman Capito, Ranking Member Maloney and members of the Subcommittee, I am Cliff McCauley, Senior Executive Vice President of Frost Bank in San Antonio, Texas. Frost is a $19 Billion bank, with all of our offices in Texas, and has been in existence since 1868. I am responsible for Frost's correspondent banking activities, and in that capacity, have the opportunity to deal directly with community bankers throughout the state of Texas. I am pleased to be here today to represent over 450 community banks in Texas who are members of the Independent Bankers Association of Texas (IBAT). Additionally, I am honored to have served as Chairman of IBAT, and I remain very active with that organization.

We very much appreciate you convening this hearing to explore the impact of the repeal of Regulation Q. It is our fervent belief that this seemingly small change in the law will have a very significant impact on a number of stakeholders going forward.

History and Background

Regulation Q dates back to the enactment of the Glass-Steagall Act in 1933. You will recall that most of the provisions regulating the payment of interest on various types of accounts were phased out in the Depository Institutions Deregulation Act of 1982. Prior to the enactment of the Dodd-Frank Act (DFA) in 2010, the only remaining provision of this regulation was the prohibition of paying interest on business checking (or "demand") accounts.

Over the years, various legislation has been introduced to repeal Regulation Q, yet has never been passed into law. One of the latest iterations, *The Business Checking Fairness Act*, was introduced in 2009 by Representative Scott Murphy (D-NY), the language of which was amended into the DFA in Conference very late in the process. The provision was subject to neither a hearing nor debate in either the House or Senate, and is now law (Section 627). We strongly urged the Federal Reserve Bank to delay the implementation of this repealer to study the impact of this significant change, but were unsuccessful. The change went into effect on the one year anniversary of passage of the DFA on July 21, 2011.

Impact on Community Banking

Small business relationships are the lifeblood of the vast majority of community banks. And perhaps as importantly, community banks are equally important to the creation, growth and vitality of small businesses across the country. Community banks make a disproportionately large number of loans to small businesses, and provide the "high touch" and flexible financial assistance necessary for this critical sector of the economy. In an economy hungry for job creation, it is crucial to continue this symbiotic relationship.

Small business relationships have formed the core of most community banks' business models. These relationships provided not only the basis for investment back into their respective communities through loans, but also served to provide a stable and significant level of long term funding at a fixed cost.

The longstanding community bank business model is based primarily upon a high level of service and long term relationships, two things community banks excel at when compared to “too big to fail” (TBTF) banks. When interest rates paid on operating deposits is factored in, these core deposits become subject to movement (or “disintermediation”) based upon the whims of “the highest bidder”, including TBTFs, who can aggressively price and equally aggressively advertise. One could quite easily surmise that these deposits, once moved to a TBTF bank, will likely not be reinvested in the communities from which they were derived. Additionally, it is reasonable to conclude that without the “raw materials” in the form of lendable deposits, along with a disruption in the customer/bank relationship, it will be more problematic for a community bank to provide additional funds to small business borrowers in stressful economic circumstances.

It is clear that already shrinking net interest margins will further contract with the additional competitively driven interest expense on business demand accounts. Enhanced competition from not only the TBTF institutions, but a credit union industry virtually indistinguishable from community banks, and able to operate without commensurate regulatory oversight or taxation, along with an ever-increasing level of regulatory and compliance costs, will further strain community bank profitability going forward.

One of the more positive provisions for community banking in the DFA was the change in the deposit insurance assessment base from domestic deposits to assets less tangible capital. Since community banks overwhelmingly fund their operations with domestic deposits, this was clearly a welcome – and equitable in our assessment – change. Perversely, the changes in the assessment base make deposits a relatively more attractive funding source for the TBTF institutions, thus putting even more pressure on pricing.

Additionally, we have been and continue to be supportive of the Transaction Account Guarantee (TAG) program. This initiative has been a great equalizer, and allowed community banks to compete with the implicit full guarantee of the Federal Government perceived by much of the public for the largest banks. As the TAG program covers only demand – or non-interest bearing – accounts, the migration of business deposits into the interest earning category will again disadvantage community banks vis-à-vis their TBTF competition. As an aside, we are hopeful of an extension of this program prior to the planned expiration at the end of this year.

One of the byproducts of the recent economic downturn has been a regulatory requirement of ever-increasing capital levels. In a difficult economy, bank earnings clearly suffer as has been evidenced over the past several years. Further, a significant portion of a bank’s perceived value is related to the level of core deposits. In combination, these two factors will not only reduce the value of the community bank franchise, but make the process of raising additional capital much more problematic.

Other “Unintended Consequences”

Community banks have relied upon this stable source of fixed rate deposits to invest in longer term assets, whether they be loans or securities offerings of local public entities. The change in Reg Q may well create significant safety and soundness concerns as more of the liability portion of the balance sheet becomes interest rate sensitive. Think back to the S&L crisis in the 1980's . . . due to market driven (primarily money market accounts) and legislative changes (the partial repeal of Reg Q interest rate controls), many institutions found themselves funding long term fixed rate assets with volatile and more costly deposit accounts, resulting in a negative spread. Similarly, bank investments in small issuer fixed rate municipal securities, 7 to 10 year fixed rate mortgage loans, intermediate term loans to small business with a fixed rate, etc. will result in a further squeeze when rates "normalize". Further, this dramatic change in funding costs and liability mix will impact the ability of both small municipal issuers and small business borrowers seeking a longer term fixed rate, and will certainly result in higher costs to offset the bank's interest rate risk.

With rates at historically low levels, and absolutely no place to eventually go but up, this dynamic could well create significant stress on a number of community banks over the coming several years.

The level of funding available in the banking system as a whole will be directly reduced. The Federal Reserve Bank requires a "reserve" on transaction (i.e., demand) accounts. This "reserve requirement" is presently set at 10%, and those funds are not available for lending/investment. There are no such requirements on time deposits. We believe this dynamic will reduce the level of lendable funds at a less than optimal time in the economic cycle.

While on the surface, the ability for small business customers to be paid interest appears to be of benefit, there are some clear downsides. The vast majority of banks utilize "account analysis" for business accounts. The cost of transactions and maintenance of the account(s) is detailed, along with the implicit earnings factor of the "free" deposits. The costs – in many cases substantial, based upon the type of business and level of activity – can be offset with the earnings credit from the deposits. Additionally, credit is given on loan rates based upon "compensating" balances. If indeed the bank is driven by competitive factors to pay interest on those deposits, the credit allocated to offset those costs will obviously be lower, resulting in hard costs to the customer, both on the deposit and loan relationship.

Is There a Solution?

Prior to implementation of the repeal of Reg Q, we and others strongly urged the Fed to consider amending Regulation D to increase the number of allowable transactions in a money market account to not more than 30 per month. Legislation (H.R. 2251) to direct the Fed to amend Reg D was filed last summer just prior to the finalization of the rule implementing the statutory change repealing Regulation Q. This would allow those business entities wishing to earn interest on their deposit relationships an alternative to existing (and expensive) sweep accounts – which in most cases take lendable funds out of the community – or for larger commercial customers, overnight repurchase arrangements. Additionally, this option would significantly lessen the impact of the Fed's reserve requirement on demand accounts. We strongly believe that such a reasonable modification would meet the needs of all parties, and not be nearly as disruptive as what we anticipate with the monumental changes subsequent to the Reg Q repeal.

Closing

We recognize that there is disagreement within the banking industry regarding this significant change to our funding structure as community banks. With over 7,000 banking institutions across America, there are many different competitive issues, charter types, economic environments and business strategies. What I can say with certainty is that I believe this 11th hour amendment to a several thousand page bill represents a "sea change" in the fundamental business model of the vast majority of community banks, and will have dramatic and lasting unintended consequences not only on our industry, but will negatively impact the very customers we seek to serve. I would add that the challenges facing our segment of the industry are daunting, and while there appears to be a universal recognition that "community banks are different, and didn't cause or even contribute to the mess we find ourselves in", we continually get "caught up in the backwash" of well-intended regulatory and legislative mandates that increase our costs and make our mission of serving our customers and creating economic activity and jobs more and more difficult. As one of my colleagues states, it's "death by a thousand cuts". We sadly believe that the repeal of Regulation Q, if left in place, will be judged in several years to be one of the most damaging provisions resulting from an economic disaster in which community bankers were as much a victim as anyone.

We believe that there is still a window of opportunity to reverse this damaging amendment, and would urge Congress to fully examine the impact of the repeal of Regulation Q on community banks and the customers they serve. Clearly, the full impact of this draconian change will not be felt by community banks or their customers until we return to a more "normal" interest rate environment. In a perfect scenario, the prohibition on the payment of interest would be reinstated, Regulation D would be amended to provide up to 30 withdrawals per month to provide the needed flexibility for small business customers wishing to earn interest on excess balances, and we would avoid the potentially disruptive and damaging impact of this ill-advised legislation.

Again, I very much appreciate the opportunity to discuss this important issue before this Committee, and would be happy to provide additional information to you or your staff.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
CLIFF McCAULEY	IBAT
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: G C McCauley	

Please attach a copy of this form to your written testimony.