# Testimony of Governor Laurence H. Meyer

***Comments on H.R. 1585 and regulatory streamlining***

**Before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Banking and Financial Services, U.S. House of Representatives**

**May 12, 1999**

The Board of Governors appreciates this opportunity to comment on H.R. 1585, the "Depository Institution Regulatory Streamlining Act of 1999," introduced by Representative Roukema. The Board welcomes this legislation and supports its purpose of revising outdated banking statutes that are imposing costs without providing commensurate benefits to the safety and soundness of depository institutions, enhancing consumer protection, or expanding credit availability. As the members of this subcommittee are aware, unnecessary regulatory burdens hinder the ability of banking organizations to compete effectively in the broader financial services marketplace and, ultimately, adversely affect the availability and prices of banking services and credit products to consumers.

**Measures the Board Supports**

In my testimony today, I would like to highlight those provisions of this legislation that the Board supports and believes are particularly significant in reducing burden and promoting efficient regulation. The Board strongly supports allowing the Federal Reserve System to pay interest on required and excess reserve balances held by depository institutions at the Federal Reserve Banks, and it supports allowing banks to pay interest on demand deposits. (Attached to this statement is an appendix containing an expanded discussion of these topics.) The Board also strongly supports the protections embodied in Title V of this bill, the "Bank Examination Report Privilege Act", which promote effective bank supervision by enhancing the cooperative exchange of information between supervised financial institutions and their regulators.

While the Board also applauds many of the other measures contained in this bill, which eliminate restrictions that no longer serve a useful purpose and thereby enhance the ability of U.S. banking institutions to operate efficiently and effectively in increasingly competitive financial markets, there are a few provisions with which the Board has concerns. While I will discuss them, I do not wish these objections to detract from my central message--that the nation's banking system would benefit from the type of reform embodied in this legislation.

*Interest on Reserves and Interest on Demand Deposits*

The Board strongly supports provisions in section 101 of H.R. 1585, which would permit the Federal Reserve to pay interest on both required and excess reserve balances that depository institutions maintain at Federal Reserve Banks. Because required reserve balances do not currently earn interest, banks and other depository institutions employ costly procedures to reduce such balances to a minimum. The cost of designing and maintaining the systems that facilitate these reserve avoidance techniques represent a significant waste of resources for the economy. In addition, because some small banks do not have a sufficient volume of deposits to justify these costs, current reserve avoidance techniques tend to place smaller institutions at a competitive disadvantage.

The reserve avoidance measures utilized by depository institutions also could eventually complicate the implementation of monetary policy. Declines in required reserve balances through avoidance schemes could lead to increased volatility in the federal funds rate. Since last July, when I spoke to this subcommittee on the same topic, required reserve balances have fallen further and some episodes of heightened volatility in federal funds rates have occurred, although they were associated in part with stresses on global financial markets. Allowing the payment of interest on required reserve balances would reduce current incentives for reserve avoidance and would likely induce a rebuilding of reserve balances over time. If volatility in the federal funds rate nevertheless did become a persistent concern, the Federal Reserve at present has a limited set of tools to address such a situation; authorizing interest payments on excess reserve balances would be a useful addition to the Federal Reserve's monetary policy tools for this purpose. Several other major central banks, including the European Central Bank and the Bank of Canada, already have the power to pay interest on excess reserve balances.

If increased volatility in the federal funds rate did become a persistent feature of the money market, it would affect other overnight interest rates, raising funding risks for large banks, securities dealers, and other money market participants. Suppliers of funds to the overnight markets, including many small banks and thrifts, also would face greater uncertainty about the returns they would earn. Accordingly, allowing the Board to pay interest on required reserve balances would not only eliminate economic inefficiencies, but also alleviate risks that could affect monetary policy and the smooth functioning of the money markets.

Because the level of required reserve balances has fallen substantially in recent years, owing to the implementation of additional reserve avoidance measures by depository institutions, estimates of the revenue losses to the Treasury associated with paying interest on required reserve balances have dropped to a relatively low level. After taking account of the increases in revenue from a related measure, the payment of interest on demand deposits, the Congressional Budget Office recently estimated that the net federal budget costs of similar legislation pending in the Senate would be about $130 million per year over the next five years.

The Board strongly supports allowing the immediate payment of interest on demand deposits held by businesses. The current prohibition against paying interest on such deposits is an anachronism that no longer serves any public policy purpose. This prohibition was enacted in the 1930s, at a time when Congress was concerned that large money center banks had earlier bid deposits away from country banks to make loans to stock market speculators. This rationale for the prohibition is certainly not applicable today: Funds flow freely around the country and among banks of all sizes. The absence of interest on demand deposits is no bar to the movement of money from depositories with surpluses--whatever their size or location--to the markets where funds can be profitably employed.

Moreover, although the prohibition has no current policy purpose, it imposes a significant burden both on banks and on those holding demand deposits, especially small banks and small businesses. Smaller banks complain that they are unable to compete for the deposits of businesses precisely because of their inability to offer interest on demand deposit accounts. Small banks, unlike their larger counterparts, lack the systems to offer compensating balance schemes and sweep accounts that allow these banks to offer businesses credit for or interest on excess demand balances. Small businesses, which often earn no interest on their demand deposits because they do not have account balances large enough to justify the fees charged for sweep programs, stand to gain the most from eliminating the prohibition of interest on demand deposits.

For these reasons, the Board strongly supports immediate repeal of the prohibition of interest on demand deposits. In contrast, Section 102 of H.R. 1585 would allow payment of interest on demand deposits to begin on October 1, 2004. During a transition period lasting until that time, the bill would authorize a 24-transaction-per-month money market deposit account (MMDA). Demand deposits could be swept into this new MMDA account in order to earn interest. The 24-transaction MMDA would be fully reservable, and therefore would not contribute to further declines in required reserve balances and the complications that might entail for the implementation of monetary policy.

While a relatively short transition period prior to the implementation of direct payments on demand deposits would not be objectionable, delaying direct interest payments on demand deposits for any extended period, such as the five years or so proposed in the bill, is not advisable. Such a long delay would be associated with further wasteful sweep activities and would disadvantage small banks and their business customers relative to the larger organizations already using sweep programs that can be modified to incorporate a new MMDA product.

Finally, the Committee has asked the Board to comment specifically on the impact on the banking industry of repealing the prohibition on paying interest on business checking accounts. For banks, interest on demand deposits will increase costs, at least in the short run. Larger banks (and securities firms) may also lose some of the fees they currently earn on sweeps of business demand deposits. The higher costs to banks will be partially offset by interest on reserve balances, and over time, these measures should help the banking sector attract liquid funds in competition with nonbank institutions and direct market investments by businesses. Small banks, in particular, should be able to bid for business demand deposits on a more level playing field vis-a-vis both nonbank competition and large bank sweep programs. Moreover, large and small banks will be strengthened by fairer prices on the services they offer and by the elimination of unnecessary costs associated with sweeps and other procedures currently used to try to minimize the level of reserves.

*Bank Examination Report Privilege*

The Board endorses Title V of the bill, the "Bank Examination Report Privilege Act" ("BERPA"). BERPA would take three steps to promote effective supervision of depository institutions by helping to preserve candor in communications between such institutions and their examiners. First, BERPA would clarify that a supervised institution may voluntarily disclose information that is protected by the institution's own privileges, such as the attorney-client privilege, to a federal banking agency without waiving those privileges as to third parties. Some courts have ruled that disclosure of information to examiners waives an institution's privileges in private civil litigation and, as a result, some institutions have attempted to withhold information from their supervisors. By ensuring that privileges are not waived when data is given to examiners, BERPA would overcome the present reluctance of many institutions to disclose information for fear of losing common-law privileges.

Second, BERPA would establish uniform procedures that govern how a third party may seek to obtain confidential supervisory information from a banking agency. BERPA would require third parties to request such information directly from the federal banking agencies, under regulations and procedures adopted by the agencies. Third parties may turn to the courts only after exhausting their administrative remedies. Finally, BERPA would define what constitutes confidential supervisory information and would strengthen the protection afforded to such information. In this regard, the measure would also require Federal courts to afford to confidential supervisory information of state and foreign bank supervisory authorities the same status with regard to privilege as is afforded to the confidential supervisory information of the Federal banking agencies.

By protecting disclosures by depository institutions to their examiners and by safeguarding supervisory information based on such disclosures, BERPA would prevent unwarranted disclosures that would have a chilling effect on the examinations process. Taken together, these measures would enhance the ability of the federal banking agencies to assess and to protect the safety and soundness of depository institutions.

The banking agencies may have some further suggestions for refining the language of sections 501 and 502, and we would be pleased to work with the Subcommittee on those suggestions.

*Other Burden Reduction Provisions*

There are other parts of this bill, as well, that would relieve regulatory burden without giving rise to safety and soundness, supervisory, consumer protection, or other policy concerns. For example, section 311 would eliminate the outdated and largely redundant requirement in section 11(m) of the Federal Reserve Act, which currently sets a rigid ceiling on the percentage of bank capital and surplus that may be represented by loans collateralized by securities. Current supervisory policy, as well as national and state bank lending limits, address concerns regarding concentrations of credit more comprehensively than section 11 (m), but do so without the unnecessary constraining effects of this section of the Federal Reserve Act.

Section 312 would eliminate section 3(f) of the Bank Holding Company Act, which applies certain restrictions that govern the nonbanking activities of bank holding companies to the activities conducted directly by savings banks under state law. Since the enactment of section 3(f), the courts have found that the insurance and other nonbanking prohibitions of the Bank Holding Company Act do *not* apply to the direct activities of banks. Eliminating section 3(f) would put savings banks that are subsidiaries of bank holding companies on equal competitive footing with their state bank counterparts, allowing savings banks and their subsidiaries to engage in those activities that are permissible for state banks under state law.

Section 303 of the bill authorizes the banking agencies to act jointly to allow up to 100 percent of the fair market value of an institution's purchased mortgage servicing rights to be included in its Tier 1 capital. Currently, only 90 percent of the value of such assets can be included. Developments since Congress enacted current law in 1991 have greatly reduced the concerns that prompted the existing capital "haircut." Accordingly, the Board believes the change envisioned in Section 303 would reduce regulatory burden without compromising safety and soundness. The Board also suggests changing all the section's references concerning "purchased mortgage servicing rights" to "mortgage servicing assets" to reflect current accounting terminology.

In another area, the alternative consumer credit disclosure mechanism permitted by section 401 will be less burdensome to creditors, and just as helpful to consumers, as the disclosure requirement embodied in current law. Congress has already eliminated the requirement that creditors disclose a historical table for closed-end variable rate loans. Taking similar action with respect to open-end variable rate home-secured loans would reduce regulatory burdens without sacrificing consumer protections.

**Areas of Concern**

Although the Board supports most of the provisions in the bill, there are a few sections of the legislation that cause us concern. These provisions may give certain entities unfair competitive advantages, may harm the safety and soundness of depository institutions, or are unnecessary.

*Nonbank Banks*

Two sections of the bill would eliminate limitations that have been applied to nonbank banks. Section 223 would allow nonbank banks, and FDIC-insured credit card banks, to offer business credit cards, even where these business loans are funded by insured demand deposits. Section 222 would remove the activity limitations and cross-marketing restrictions that currently apply to nonbank banks. It would also liberalize the divestiture requirements that apply when companies violate the nonbank bank operating limitations and allow nonbank banks to acquire assets from credit card banks. Eliminating these restrictions on nonbank banks, at first glance, may have intuitive appeal. However, there are important reasons for the Board's concern about these provisions.

Nonbank banks--which, despite their popular name, are federally insured, national or state-chartered banks--came into existence by exploiting a loophole in the law. By means of this loophole, industrial, commercial, and other companies were able to acquire insured banks and to mix banking and commerce in a manner that was then, and remains today, statutorily prohibited for banking organizations. In 1987, in the Competitive Equality Banking Act ("CEBA"), Congress closed the nonbank-bank loophole. At that time, Congress chose not to require the 57 companies operating nonbank banks to divest these institutions. Instead, Congress permitted the companies owning these banks to retain their ownership so long as they complied with a carefully crafted set of limitations on the activities of nonbank banks and their parents. In a unique statutory explanation of legislative purpose, Congress stated in CEBA that these limitations were necessary to prevent the owners of nonbank banks from competing unfairly with bank holding companies and independent banks.

Fewer than 15 nonbank banks currently claim the grandfather rights accorded in CEBA. The Board is concerned that removal of the limitations and restrictions that apply to nonbank banks would enhance advantages that this relative handful of organizations already possess over other owners of banks and would give rise to the potential adverse effects about which Congress has in the past expressed concern. In addition, removal of limitations would permit the increased combination of banking and commerce for a select group of commercial companies, a mixture that the House Banking Committee recently considered and decided not to permit in the context of a broader effort to modernize our financial laws.

The Board continues to believe that the questions of whether and to what extent it is appropriate to enhance the position of nonbank banks are questions most fairly determined in connection with broad financial modernization legislation. In that broader context, it may be possible to relieve some of the restraints placed on the handful of existing nonbank banks without seriously disadvantaging the majority of banking organizations that do not have the privileges enjoyed by nonbank banks.

*Call Report Simplification*
Section 302 of the bill largely restates section 307 of the Riegle Community Development and Regulatory Improvement Act ("Riegle Act"). The Board and the other Banking agencies, working through the Federal Financial Institutions Examination Council (FFIEC), have made substantial progress in implementing the mandate of section 307 of the Riegle Act and the Board believes that this section of the bill is unnecessary.

Thus far, in response to Section 307, the federal banking agencies have eliminated approximately 100 Call Report data items; placed revised instructions and forms on the Internet for the Call Report, the Bank Holding Company (BHC) Reports, and the Thrift Financial Report (TFR); adopted Generally Accepted Accounting Principles ("GAAP") as the reporting basis for all Call Reports (and consistent with the reporting basis for the BHC reports and the TFR); produced a draft core report that is consistent with the TFR report and resolves most of the definitional differences between the reports; condensed four sets of Call Report instructions into one; provided an index for Call Report instructions; implemented an electronic filing requirement for all institutions submitting Call Reports (consistent with existing mandatory electronic filing for the TFR and optional electronic filing for the BHC reports); placed much of the Call Report data and some of the BHC data on the Internet; and reported to Congress on recommendations to enhance efficiency for filers and users.

The agencies surveyed users of the information to identify additional Call Report items that could be eliminated, while retaining items that are essential for safety and soundness and other public policy purposes. The FFIEC's Reports Task force is analyzing the results of the survey of Call Report users throughout each of the agencies to identify all of the current purposes served by the information. After the surveys are analyzed, the Task Force will recommend ways to further streamline the reporting requirements and continue to refine a set of common, or "core", reporting items. The agencies have not determined an implementation date, given year 2000 concerns for the banking industry and the regulatory agencies, and given that banking institutions have requested a minimum lead time of one year to implement a "core" report. However, we believe significant progress that has been made by the agencies to date and the agencies' on-going efforts suggest that this section of the draft bill is not necessary.

**Closing Thoughts**
The legislation being considered by the Subcommittee today builds on two prior reform measures, the Community Development and Regulatory Improvement Act of 1994 and the Economic Growth and Regulatory Paperwork Reduction Act of 1996, that the Board supported. Those were useful measures that achieved meaningful reductions in regulatory burden. Those bills--coupled with the Board's independent initiatives to make our regulations simpler, less burdensome, and more transparent--have had a practical, bottom-line, effect: fewer applications need to be filed with the Board, and banking organizations have saved substantial regulatory, legal, compliance, and other costs. Those statutory and regulatory changes have enhanced the competitiveness of banking organizations and have benefitted the customers of these financial institutions. Nonetheless, more can and should be done.

The Board applauds the efforts of the Subcommittee to continue to eliminate unnecessary government-imposed burdens. The Subcommittee has fashioned legislation that, in the main, builds upon past successes in regulatory reform and relieves regulatory burdens on banking organizations. In a few areas, however, the bill may not achieve meaningful reform but instead would lead to competitive inequities or raise safety and soundness and other concerns.

The Board has long endorsed regulatory relief and financial modernization strategies that promote regulatory equity for all participants in the financial services industry, minimize the chances that federal safety net subsidies will be expanded into new activities and beyond the confines of insured depository institutions, guarantee adequate federal supervision of financial organizations, and ensure the continued safety and soundness of financial organizations. The Board would be pleased to work with the Subcommittee and its able staff to reach these goals through legislation.

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## Appendix

*Additional Views of the Federal Reserve Board on Interest on Reserves and Demand Deposits*

The Board strongly supports proposals to allow payment of interest on demand deposits and on the required and excess reserve balances that depository institutions maintain at Federal Reserve Banks. We have commented favorably on such proposals on a number of previous occasions over the years, and the reasons for those positions still hold today.

These legislative proposals are important for economic efficiency: Unnecessary restrictions on the payment of interest on demand deposits and reserve balances distort market prices and lead to economically wasteful efforts to circumvent them.

Because of recent financial market innovations, the proposals are also important for monetary policy. Balances that depository institutions must hold at Federal Reserve Banks to meet reserve requirements pay no interest. Reserve requirements are now 10 percent of all transaction deposits above a threshold level. Requirements may be satisfied either with vault cash or with balances held in accounts at Federal Reserve Banks. Depository institutions have naturally always attempted to reduce such non-interest bearing balances to a minimum. For over two decades, some commercial banks have done so in part by sweeping the reservable transaction deposits of businesses into nonreservable instruments. These business sweeps not only avoid reserve requirements, but also allow firms to earn interest on instruments that are, effectively, equivalent to demand deposits.

In recent years, developments in computer technology have allowed depository institutions to begin sweeping consumer transaction deposits into nonreservable accounts. As a consequence, the balances that depository institutions hold at Reserve Banks to meet reserve requirements have fallen to quite low levels. These consumer sweep programs are expected to spread further, threatening to lower required reserve balances to levels that may begin to impair the implementation of monetary policy. Should this occur, the Federal Reserve would need to adapt its monetary policy instruments, which could involve disruptions and costs to private parties as well as to the Federal Reserve. However, if interest were allowed to be paid on required reserve balances and on demand deposits, changes in the procedures used for implementing monetary policy might not be needed.

The prohibition of the payment of interest on demand deposits was enacted in the mid-1930s. At that time, Congress was concerned that large money center banks might have earlier been bidding deposits away from country banks to make loans to stock market speculators, in the process depriving rural areas of financing. It is unclear whether the rationale for this prohibition was ever valid, but it is clear that this rationale is no longer applicable today. Funds flow freely around the country, and among banks of all sizes, to find the most profitable lending opportunities, using a wide variety of market mechanisms, including the federal funds market. The absence of interest on demand deposits is no bar to the movement of funds from depository institutions with surpluses--whatever their size or location--to the markets where the funding can be profitably employed. In fact, small firms in rural areas are able to bypass their local banks and invest in money market mutual funds with transaction capabilities. Indeed, smaller banks complain that they are unable to compete for the deposits of businesses precisely because of their inability to offer interest on demand deposits.

The prohibition of interest on demand deposits distorts the pricing of transaction deposits and associated bank services. To compete for the liquid assets of businesses, banks set up complicated procedures to pay implicit interest on what are called compensating balance accounts. These accounts, which represent a sizable fraction of demand deposits, earn credits that can be used to pay for a firm's use of other bank services. Banks also spend resources--and charge fees--for sweeping the excess demand deposits of businesses into money market investments on a nightly basis. To be sure, the progress of computer technology has reduced the cost of such systems over time. However, the expenses are not trivial, particularly when substantial efforts are needed to upgrade such automation systems or to integrate the diverse systems of merging banks. Such expenses waste the economy's resources, and they would be unnecessary if interest were paid on both demand deposits and the reserve balances that must be held against them.

The prohibition of interest on demand deposits also distorts the pricing of other bank products. Because banks cannot attract demand deposits through the payment of explicit interest, they often try to attract these deposits, aside from compensating balances, through the provision of services at little or no cost. When services are offered below cost, they tend to be overused--an additional waste of resources attributable partly to the prohibition of interest on demand deposits.

However, the potential gains in economic efficiency cannot be fully realized by paying interest on demand deposits alone. As has been demonstrated in the case of the consumer checking accounts, on which interest is paid, the absence of interest on the reserve balances that must be held against such transaction deposits has in itself provided strong enough incentive for banks to start sweep programs. The costs that banks incur to design and maintain the automation systems needed to implement such sweep programs are another instance of economic waste. The payment of interest on required reserve balances could remove the incentives to engage in such reserve avoidance practices.

In light of the resources used by depository institutions to try to circumvent reserve requirements, the reason for having such requirements might be questioned. Indeed, reserve requirements have been eliminated in a number of other industrialized countries. It may be helpful, therefore, to review the historical and current purposes served by reserve requirements.

Although the word "reserves" might imply an emergency store of liquidity, required reserves cannot actually be used for this purpose, since they represent a small and fixed fraction of a bank's transaction deposits. Reserve requirements have at times been employed as a means of controlling the growth of money. In the early 1980s, for example, the Federal Reserve used a reserve quantity procedure to control the growth of M1. For the most part, however, the Federal Reserve has looked to the price of reserves--the federal funds rate--rather than the quantity of reserves, as its key focus in implementing monetary policy.

While reserve requirements no longer serve the primary purpose of monetary control, they continue to play an important role in the implementation of monetary policy in the United States. They do so by helping to keep the federal funds rate close to the target rate set by the Federal Open Market Committee. They perform this function in two ways: First, they provide a predictable demand for the total reserves that the Federal Reserve needs to supply through open market operations in order to achieve a given federal funds rate target. Second, because required reserve balances must be maintained only on an average basis over a two-week period, depositories have some scope to adjust the daily balances they hold in a manner that helps stabilize the federal funds rate. For instance, if the funds rate were higher than usual on a particular day, depository institutions could choose to hold lower reserve balances, and their reduced demand would help to damp the upward pressure on the funds rate. Later in the two-week period, they could make up the shortfall in their average holdings of reserve balances.

Depository institutions hold balances in their accounts at Federal Reserve Banks for reasons other than satisfying their two-week average requirements. Some balances are needed as a precaution against the chance that payment orders late in the day might leave a depository with an overdraft on its account, and the Federal Reserve strongly discourages overdrafts. On days when payment flows are particularly heavy and uncertain, or when the distribution of reserves is substantially displaced from normal, depository institutions tend to hold balances for precautionary purposes well above required levels.

Unlike the two-week average demands, these daily precautionary demands cannot help smooth the funds rate from one day to the next. They are also difficult to predict, making it harder for the Federal Reserve to determine the appropriate daily quantity of reserves to supply to the market. In the absence of reserve requirements, or if reserve requirements were very low, the daily demand for balances at Reserve Banks would be dominated by these precautionary demands, and as a result, the federal funds rate could often diverge markedly from its intended level.

An example of the volatility that can arise in the federal funds market because of a low level of required reserve balances occurred in early 1991. The Federal Reserve had reduced certain reserve requirements in late 1990 as a means of easing funding costs to banks during the credit crunch period. The cut in requirements reduced required balances at Reserve Banks for many depository institutions to below the balances needed for precautionary purposes, and the federal funds rate consequently became very volatile. On a typical day in that period, the funds rate strayed over a range of about 8 percentage points and missed the target for the average of daily rates by 1/2 percentage point. After a couple of months, stability returned to the federal funds market because depository institutions made improvements in their reserve management and because strong growth in deposits again boosted the level of required reserve balances above precautionary demands for many institutions.

Since that time, depository institutions have become much more adept at managing their reserve positions, and their need for precautionary balances on a typical day has declined considerably. In fact, they are now managing to operate with lower aggregate required balances at Reserve Banks than they had in early 1991, and the federal funds rate is nevertheless much more stable. A number of measures taken by the Federal Reserve have helped to foster stability, including improvements in the timeliness of account information provided to depository institutions, more frequent open market operations geared to daily payment needs, and improved procedures for estimating reserve demand. In addition, the Federal Reserve Board recently decided to shift to lagged reserve requirements, which has also contributed to some reduction in uncertainty about reserve demand.

The additional improvements in reserve management in recent years have been needed because required reserve balances have dropped substantially-- from about $28 billion in late 1993 to about $7 or $8 billion today. This decline has not occurred because of further cuts in required reserve ratios by the Federal Reserve, but because of the new retail sweep programs implemented by depository institutions. These programs use computerized systems to sweep consumer transaction deposits, which are subject to reserve requirements, into personal savings accounts, which are not. The spread of such retail sweep programs has not yet fully run its course, and considerable uncertainty shrouds its eventual outcome. We expect that the effects of future declines in required reserve balances on the volatility of the federal funds rate will not necessarily proceed gradually; the rather modest effects on volatility seen so far may not preclude a more outsized reaction as reserve balances fall even lower.

Heightened volatility in the federal funds rate is of concern for a number of reasons. To be sure, the transmission of volatility in the funds rate to volatility in longer-term rates is likely to be muted because of the averaging out of upticks and downticks in the overnight rate. However, even in the absence of much transmission to longer-term rates, increased volatility in the federal funds rate would affect other overnight interest rates, raising funding risks for most large banks, securities dealers, and other money market participants. Suppliers of funds to the overnight markets, including many small banks and thrifts, would face greater uncertainty about the returns they would earn. Market participants concerned about unexpected losses would incur additional costs in managing their funding to limit the heightened risks.

Countries that have eliminated reserve requirements do not generally experience a great deal of volatility in overnight interest rates because they are able to use alternative procedures for the implementation of monetary policy. One type of procedure, for instance, establishes a ceiling and a floor to contain movements of the overnight interest rate. The ceiling is set by a penalty interest rate on loans provided freely by the central bank through what is called a Lombard facility. The floor is established in effect by the payment of interest on excess reserves because banks would not generally lend to private parties at an interest rate below the rate they could earn on a risk-free deposit at the central bank. For the Federal Reserve to be able to set a similar interest rate floor, it would need authority to pay interest on excess reserves. The legislation before the Subcommittee would provide such an authorization. As regards a ceiling on the funds rate, a change in the Federal Reserve's approach to the discount window would be necessary, as we have no penalty interest rate and instead subject borrowing applications to an administrative review. Alternative means of establishing a ceiling could be considered.

If interest were allowed to be paid on both demand deposits and required reserve balances, as the legislation also provides, adjustments in the procedures for implementing monetary policy might not be needed. Such interest payments would likely boost the level of transaction deposits substantially, as some business and household sweep programs were unwound, and as banks became more able to compete for the liquid funds of businesses. The increased transaction deposits could ensure that required reserve balances would remain above the level of daily precautionary needs for many institutions, thus helping to stabilize the federal funds rate, while also improving economic efficiency as previously noted.

The magnitude of the prospective responses to these measures is uncertain, however. Some corporations may not find the interest paid on demand deposits high enough to induce them to shift out of other liquid instruments. Also, some banks may retain consumer sweep programs in order to seek higher investment returns than the Federal Reserve would pay on reserve balances. If interest were allowed on required reserve balances, the Federal Reserve would likely pay a rate close to the rate available on an overnight repurchase agreement. Higher yields are of course available on investments of greater risk and longer maturities.

Because of the uncertainties involved, the Federal Reserve needs to be able to pay interest on excess reserves as well as on required reserve balances, and at differential rates to be set by the Federal Reserve. The ability to pay interest on excess reserves would provide an additional tool that could be used for monetary policy implementation, but one that might not need to be used, if interest on required reserve balances and demand deposits resulted in a sufficient boost to the level of those balances. Even if not used immediately, it is important that the Federal Reserve have the full range of tools available to other central banks, given the inventiveness of our financial markets and the need for the Federal Reserve to be prepared for potential developments that may not be immediately visible.

The bill includes a long delay before the direct payment of interest on demand deposits would be authorized, during which time a reservable 24-transaction money market deposit account (MMDA) would be allowed. This new type of account would be fully reservable and therefore would not raise concerns about further declines in reserve balances that could potentially complicate the implementation of monetary policy. Each month, twenty-four transfers out of this MMDA could be made. Because there are not more than twenty-four business days in a month, banks would be able to sweep balances from demand deposits into these 24-transaction MMDAs each night, pay interest on them, and then sweep them back into demand deposits the next day. Thus, this type of account would permit banks in effect to pay interest on demand deposits, but perhaps more selectively than would be the case with direct interest payments. Some transition period leading up to the direct payment of interest on demand deposits would be appropriate, as many banks would likely take some time in any case to develop competitive interest-bearing demand deposit products. However, the delay should be relatively short. The 24-transaction MMDA, which would be useful only during the transition period before direct interest payments became effective, would entail extra expenses associated with new sweep arrangements and would be able to be implemented at lower cost by banks already having sweep programs. Other banks would face a competitive disadvantage during the transition period; moreover, some businesses would not benefit from this MMDA.

The payment of interest on reserve balances would tend to reduce the revenues received by the Treasury from the Federal Reserve, while the payment of interest on demand deposits would increase those revenues. Treasury revenues would be directly reduced by the payment of interest on existing reserve balances. However, there would be some offset to this direct revenue loss. The level of reserve balances would rise because of the interest payments, and the Federal Reserve would therefore be able to increase its holdings of government securities. The Federal Reserve on average would earn a higher yield on those securities than the rate it would pay on required reserve balances. On net, Treasury revenues are still likely to fall with the payment of interest on required reserve balances, but the recent declines in such balances have reduced that revenue loss considerably. Similarly, interest payments on demand deposits would increase the level of demand deposits, as well as the reserve balances held against them on which the Federal Reserve would also earn a positive interest rate spread. The size of this further offset to the Treasury's revenue loss on required reserve balances is subject to considerable uncertainty.

In the long run, the benefits of the proposed legislation will likely be distributed rather widely among bank customers. The biggest winners should be small businesses that currently earn no interest on their checking accounts. They will gain from the interest earned and from being able to relax procedures used to hold to a minimum the size of their checking account deposits. Larger firms will benefit as well, in part by saving on some sweep fees.

For banks, interest on demand deposits will increase costs, at least in the short run. Larger banks and securities firms may also lose some of the fees they currently earn on sweeps of business demand deposits. The higher costs to banks will be partially offset by interest on reserve balances, and over time, these measures should help the banking sector attract liquid funds in competition with nonbank institutions and direct market investments by businesses. Small banks in particular should be able to bid for business demand deposits on a more level playing field vis-a-vis both nonbank competition and large bank sweep programs. Moreover, large and small banks will be strengthened by fairer prices on the services they offer and by the elimination of unnecessary costs associated with sweeps and other procedures currently used to try to minimize the level of reserves.

In the early 1980s, the Congress decided to deregulate interest rates on all household deposits and to allow money market deposit accounts for businesses. It is now time to extend the benefits of deposit interest rate deregulation to the ordinary checking accounts of businesses. Eliminating price distortions on demand deposits and on required and excess reserve balances would spare the economy wasteful expenditure, increase the efficiency of our financial markets, and facilitate the conduct of monetary policy.


**Last update: May 12, 1999, 2:00 PM**