The Anticipated Effects of Depository Institutions Paying Interest on Checking Accounts

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April 11, 2007

Congressional Research Service
7-5700
www.crs.gov
RL30816

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

Since the 1930s, depository institutions have been prohibited by federal statute from paying interest on checking account balances. The main rationale was to promote bank safety and soundness. Unpredictable movements of deposits among banking institutions in response to interest rate competition were thought to make some banks vulnerable to failure. Another, but related, reason was that big money center banks were able to pay higher interest rates for deposits than smaller banks, and thus could bid deposits away from smaller country banks to make more speculative loans, such as for buying shares in the stock market. It was believed that the bidding away of deposits had the effect of misallocating financial resources away from productive to speculative uses.

To get around the prohibition, banks established inefficient implicit interest payment mechanisms to compete for deposits. These implicit mechanisms ranged from free or discounted banking services to gifts. Regulatory changes, over time, have also reduced the effectiveness of the prohibition. For example, the establishment of negotiable orders of withdrawal (NOW) accounts and automatic transfers between savings and checking accounts (called "sweeps") in effect allow depositors to earn interest on their checking balances.

On January 4, 2007, the Business Checking Fairness Act of 2007 (H.R. 41) was introduced in 110th Congress by Representative Nydia Velazquez. This bill would repeal the prohibition on depository institutions paying interest on any checking accounts and require bank regulators to conduct surveys of bank fees and services, including automated teller machines (ATMs) and credit card transactions. H.R. 41 was referred to the House Committee on Financial Services.

Should the prohibition on paying interest be rescinded, it would be expected to improve the efficiency of financial markets, even though paying interest would raise the costs of providing checking account services for some depository institutions. Institutions that would have higher costs are those currently paying little or no implicit or explicit interest on checking accounts. Those institutions already paying some implicit interest on checking accounts may experience a reduction in cost because these implicit interest rate mechanisms are inefficient and tend to misallocate financial resources. Most analysts believe that the transparency of explicit interest rate payments would lead to better decision making on the part of depository institutions and their depositors.

A repeal of the prohibition on paying interest could also have a beneficial effect on the conduct of monetary policy by the Federal Reserve. A long-term relative decline in demand deposits has been accompanied by a decline in reserve balances at the Fed. To the extent that paying interest on demand deposits increased reserve balances, the Fed would have more funds to invest in government securities, to the ultimate benefit of the Treasury.

This report will be updated as legislative developments warrant.

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Introduction

Since the 1930s, depository institutions have been prohibited by federal statute from paying interest on "checking account" or demand deposit balances. Depository institutions are banks, savings associations, and credit unions. To get around the prohibition, depositories have over the years established a number of implicit interest arrangements. On January 4, 2007, the Business Checking Fairness Act of 2007 (H.R. 41) was introduced in the 110th Congress by Representative Nydia Velazquez. This bill would repeal the prohibition on depository institutions paying interest on any checking accounts and require bank regulators to conduct surveys of bank fees and services, including automated teller machines (ATMs) and credit card transactions. H.R. 41 was referred to the House Committee on Financial Services. Similar legislation was considered in previous Congresses. This report examines the rationale for the prohibition, describes the effects it has had including the development and regulatory approval of measures to mitigate those effects, and concludes with an analysis of the anticipated effects of repealing the prohibition on depository institutions, on their customers, and on the conduct of monetary policy.

Origin of the Prohibition

Congress amended federal banking law in the mid-1930s to prohibit banks from paying interest on checking account balances.[1] Checking accounts, a term used interchangeably in this report with demand deposits, are distinguished from time deposits or savings deposits by being immediately available to the depositor without restrictions on or penalty for early withdrawal. Congress imposed the restriction because of concerns about the destabilizing effects on the banking system of deposit competition among banks. Unpredictable movements of deposits between banking institutions in response to interest rate competition, it was thought, could potentially cause some banks to fail. Another, but related, reason was that big money center banks were able to pay higher interest rates for deposits than smaller banks, and could thus bid deposits away from smaller country banks. It was believed that this would encourage more speculative loans, such as for buying shares in the stock market. Thus, the bidding away of deposits from small banks to large ones could have the effect of misallocating financial resources away from productive to speculative uses.

Effects of The Prohibition

Inefficient Implicit Pricing

From the outset, many analysts believed that the prohibition on paying interest on checking accounts would distort the price of deposits and related bank services. The interest rate ceiling of zero would not prevent banks from competing for checking deposits. Bank profits depend on attracting deposits in order to acquire income-earning assets, such as commercial loans and mortgages. To compete for deposits, banks and other depository institutions began to pay

[1] The Banking Act of 1933 actually placed ceilings on the interest that banks could pay on different kinds of deposits. Checking deposits have a ceiling of zero, which is effectively a prohibition of paying interest on these accounts.

"implicit interest rates" (i.e., services or other considerations) in lieu of formal interest payments.[2] For business deposits, the implicit interest payments took the form of bundling banking products and services and offering them to business customers at a discount as compensation for maintaining their checking deposits with a bank. Items in these bundles included discounted interest rates on loans, and negotiated minimum balances that must be maintained to receive certain banking services free or at significant discounts.

Similar offers were made to non-business depositors. For personal checking accounts, the implicit interest payments took the form of giving some customers free checking accounts and/or other discounted banking services such as discounted interest rates on loans. In the 1970s, it was not uncommon for banks to give away toaster ovens and other gadgets as inducements to depositors.

These implicit interest rate mechanisms, however, are inefficient because they tended to misallocate financial resources. Without an explicit price, the supply of these services and the demand for them are unlikely to reach equilibrium. Depository institutions often developed servicing capacities that turned out either to over supply or under supply the needs of their customers. If the services are under supplied, customers are likely to seek those services elsewhere. If the services are over supplied, the depository institutions have lost profits by supplying unneeded services. In either case, financial resources are not deployed optimally. The prohibition on paying interest for demand deposits creates a lack of price transparency in garnering deposits, which leads to inappropriate decision making on the part of business customers as well as the depository institutions.

The Adoption of NOW Accounts

The high rates of inflation in the 1970s increased the need for depository institutions to compete aggressively for deposits. Depository institutions found themselves with an increasing mismatch between the interest they earned on assets and interest paid to acquire new assets and deposits. Money market accounts offered by non-banking institutions provided strong competition. The interest rate payment prohibition frustrated depository institutions' competition for deposits. In response to these pressures, banks began to seek ways to offer customers the opportunity to earn interest on funds that could be used to transfer money to third parties, but which also evaded the restrictions applying to demand deposits. In 1972

> A number of state-chartered mutual savings banks in New England began offering accounts that were technically not demand deposits, but upon which negotiable orders of withdrawal (NOW) could be used to transfer funds to third parties. These NOW accounts were not subject to the prohibition of interest payments.... Commercial banks in New England were permitted to offer NOW accounts in order to compete.[3]

The NOW account innovation spread to other parts of the country and, by 1980, Congress enacted the Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221). This law deregulated interest rates paid on savings deposits, but not checking accounts. Even though the zero-interest ceiling on demand deposits remained, depository institutions everywhere were now allowed to offer interest-bearing checking accounts as NOW accounts.

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[2] Credit unions, which are depository institutions but relatively small ones, were able to pay "dividends," indistinguishable from interest, on their checking account balances.

[3] See CRS Report 98-474, *Payment of Interest on Demand Deposits: An Economic Analysis*, by G. Thomas Woodward.

Sweeping Business Checking Accounts

Another mechanism designed to circumvent the zero-interest rate ceiling was the innovation of regularly "sweeping" the balances in demand or transaction accounts. Sweeps are arrangements between depository institutions and business customers that allow the institutions to sweep the businesses' checking account balances out of those accounts each evening and put them into interest earning accounts. The next day the balances are transferred back into the businesses' checking accounts to meet the businesses' daily transactions. Sweeps, thus, give the businesses the advantage of gaining interest on their transaction balances when they are not in immediate use. Because of the high cost to depository institutions of setting up and operating sweep accounts, they are established almost exclusively for business accounts. "Sweep accounts" existed in practice before 1994 when the Federal Reserve officially allowed depository institutions to sweep checking deposits.

Sweep accounts are more beneficial to larger depository institutions than to small ones. Large institutions are required to keep reserves on their checking accounts. Smaller institutions often are not. These required reserves earn no interest and consequently are costly to large depository institutions which could invest these reserves if they weren't required. The benefit to sweep accounts is that even though checks are drawn on them, no reserves are required to be set aside for these accounts. Thus, institutions escape the cost of maintaining non-interest-earning required reserves.[4] Furthermore, larger banks are able to attract more deposits by offering higher interest rates than smaller institutions because large banks are able to make arrangements with securities dealers to offer rates based on the much higher rates of returns available on short-term non-bank investments.

The major disadvantage to sweep accounts for some banks is their cost. According to testimony of America's Community Bankers,

> The problem is that sweep accounts are expensive and can be very labor intensive, especially for smaller institutions. Though there are software programs that handle sweeps automatically, these programs are typically too expensive for smaller community banks and savings institutions to acquire and operate.[5]

The Legislative Response

On January 4, 2007, H.R. 41 was introduced in the 110th Congress and referred to the House Committee on Financial Services. So far, the committee has taken no action on the bill and no similar bill has been introduced in the Senate. In the 109th Congress, on May 26, 2005, the House Financial Services Committee passed the Business Checking Freedom Act of 2005, but the bill was not taken up by the Senate. The Business Checking Fairness Act of 2007 would do the following:

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4 CRS Report RL30874, *Proposals to Allow Federal Reserve Banks to Pay Interest on Reserve Balances: The Issues Behind the Legislation*, by Walter W. Eubanks.

5 U.S. Congress, House Committee on Banking and Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *H.R. 1585—Depository Institutions Regulatory Streamlining Act of 1999*, hearings , 106th Cong., 1st sess., May 12, 1999(Washington: GP0, 1999), p. 209.

- Amend federal law to authorize interest-bearing or dividend-bearing transaction accounts. It would permit up to 24 transfers per month to another account of the owner in the same institution.
- Authorize the payment of interest on reserves by a Federal Reserve bank at least quarterly on balances maintained there on behalf of a depository institution.
- Amend the Federal Reserve Act to require the Board to survey biennially and report biennially to Congress on bank fees and certain services.
- Amend the Financial Institution Reform, Recovery, and enforcement Act of 1989, and the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, to repeal certain reporting requirements.

In short, H.R. 41 would repeal the prohibition on payment of interest on demand deposits effective at the end of a two-year period beginning on the date of enactment of the act. In the interim, to enable depository institutions and businesses to ease into a market environment where interest is paid on checking accounts, the provisions would provide statutory authority for sweeps. This would have the effect of giving statutory weight to the 1994 Federal Reserve regulation that allowed depository institutions to make sweeps. Sweeps are also referred to as transfers, and would be allowed as many as 24 times per month.

The Congressional Budget Office (CBO) has not yet done a cost estimate for H.R. 41. However, CBO completed an estimate for the Business Checking Freedom Act of 2005, H.R. 1224, in the 109th Congress. CBO estimated that H.R. 1224 would not have any net effect on annual federal revenues over the 2006-2009 period, but would decrease revenues after 2009. That revenue loss would total approximately $1.8 billion over the 2010-2015 period.[6]

What Could Be Expected If the Prohibition Were Repealed?

Permitting depository institutions to pay interest on demand deposits would be likely to change the competitive environment. It would give depository institutions additional flexibility in pricing services related to deposits. In the current environment, non-depository institutions, such as money market and mutual funds, brokerage houses, and other financial services providers are able to offer businesses interest-paying transaction accounts with ATM access and other services. Depository institutions, on the other hand, are explicitly prohibited from doing so. The new competitive environment resulting from repealing the prohibition of paying interest on checking accounts would have an impact on depository institutions, businesses, consumers, monetary policy, and the U.S. Treasury.

The Impact on Depository Institutions

Repealing the prohibition could cause depository institutions to dismantle inefficient implicit price mechanisms which could increase the profitability of providing checking account services.

[6] U.S. Congressional Budget Office, *Cost Estimate H.R. 1224, Business Checking Freedom Act of 2005,* May 10, 2005, p.1.http://www.cbo.gov/showdoc.cfm?index=6353&sequence=0&from=6.

Most depository institutions are already paying some form of interest on their deposits. For these institutions, there could be some reduction in costs by being able to offer an explicit interest rate on demand deposits. Institutions with implicit interest rates that exceed the interest rate after repeal could experience significant savings that could have an impact on their profitability. Smaller depository institutions may also augment their bottom line by being able to compete more easily in attracting demand deposits without investing in expensive, complicated implicit-interest-paying mechanisms.

Not all depository institutions, however, would benefit from repeal of the prohibition on paying interest on demand deposits, since costs would rise for some. Most analysts expect costs to increase for depositories with the largest amount of demand deposits on which they are not now paying any interest—explicitly or implicitly. These depository institutions would face pressures to begin paying interest in order to keep their depositors after repeal. Consequently, they would be expected to experience a decline in profits in providing demand deposit services.

A Relative Decline in Demand Deposits Reduces the Impact of Repeal

In the 1970s checking deposits declined to little more than 50% of all deposits in commercial banks. **Table 1** shows that demand deposits at commercial banks have continued to decline, falling from 21% in 1984 to about 10% as of December 2004. This means that demand deposits are not a growing part of depository institutions' business in relation to time deposits.[7] The trend also means that depositories are already paying interest on most of their deposits, and repealing the prohibition would have less impact on profits than in the 1970s. Furthermore, even though **Table 1** shows a huge change in demand deposits at savings banks (due mainly to the growth of savings banks doing more commercial lending), demand deposits are still a small portion of savings banks' total deposits. In December 2006, 95.6% of savings banks deposits are time deposits on which they pay explicit interest. In short, even though some depositories are expected to benefit and others are expected to experience losses, the declining trend in demand deposits will reduce the significance of both impacts on depository institutions.

Table 1. Demand Deposits Compared to Total Deposits at Commercial Banks and Savings Banks

($ in millions)

Dates	Commercial Banks			Savings Banks		
	Total Deposits	Demand Deposits	As a % of Total Deposits	Total Deposits	Demand Deposits	As a % of Total Deposits
Dec. 31, 2006	6,731,362	516,356	7.7	1,093,737	48,405	4.4
Dec. 31, 1984	1,962,827	414,136	21.1	944,733	1,856	0.2

Source: Federal Deposit Insurance Corporation.

[7] The terms time deposits and savings deposits are used interchangeably because historically all savings deposits had specified maturities. Though passbook savings accounts are available upon demand, banks could legally delay payments for up to six months. Penalties for early withdrawals are another distinguishing feature among time deposits.

Some analysts believe paying interest on checking deposits would increase demand deposits relative to time deposits. If the prohibition were repealed, checking deposits would pay interest and would be more liquid than most time deposits. However, there are forces at work against such a reversal of the declining trend in demand deposits. According to the Federal Deposit Insurance Corporation's statistics, as of December 31, 2006, there were 7,402 commercial banks in the United States. The top 88 banks held 74% of total deposits. As mentioned above, large banks are required to keep reserves against demand deposits, which earn no interest. Since no reserves are mandated on time deposits, the incentive is to increase time deposits relative to demand deposits. Paying interest on an already costly liability is contrary to profit-maximizing behavior. As a result, the impact of repeal would likely fall short of leveling the playing field between demand deposits and time deposits.

The Impact on Businesses

Repealing the prohibition on paying interest on checking accounts would be likely to have a greater impact on small businesses than larger firms. To remain competitive, depository institutions have been offering larger business customers cash management services, which make best use of their cash on hand before they pay their bills. The bigger companies no longer let their cash sit idly in checking accounts, giving depository institutions interest free loans until it is used to pay bills. Large business customers have been demanding and receiving interest on their checking account balances, mostly through complicated implicit interest mechanisms, such as sweeps. In contrast, many smaller business customers have been unable to earn interest on their deposits for the main reason that small business customers' balances are too small to make it worthwhile for depository institutions to pay them implicit interest.

Small businesses are at a disadvantage even when they are offered some implicit interest. According to testimony of the National Federation of Independent Business,

> We found that the sweep account resulted in a flood of paper from the bank: each day a reconciliation statement letting us know how the money had been shifted around. And because this is done via the mail, there is always a two-to-three day delay in information flow so we never have an accurate, up-to-the minute view of the flow of funds among our banking accounts.... Sweep accounts are a bookkeeping nightmare for a small business.[8]

While sweep accounts and other implicit payments to garner demand deposits have become more customer friendly than in 1998, small businesses are likely to gain more than large ones if explicit interest payment were allowed.

The Impact on Consumer Checking Accounts

Repealing the prohibition on paying interest on all checking accounts would have an impact on personal checking accounts, particularly on NOW accounts and money market deposit accounts (MMDAs). The repeal would effectively eliminate the special status of NOW accounts, or alternatively, checking accounts would be the same as NOW accounts, earning competitive interest rates.

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[8] U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs. *Financial Regulatory Relief and Economic Efficiency Act of 1998,* report to accompany S. 1405, 105th Cong., 2nd sess., S.Rept. 105-346, (Washington: GPO, 1998), p. 236.

It is less clear how MMDAs would be affected by the repeal. Money market deposit accounts were introduced in 1982 to make banks competitive with security firms' money market mutual funds, which pay a higher interest rate than NOW accounts. They are liquid, but not as liquid as checking accounts or NOW accounts. For example, an MMDA depositor must maintain a minimum balance, and may make a maximum of six preauthorized transfers, of which no more than three can be checks of $500 or more each. Even though MMDAs are "checkable" accounts, the wording of the repeal legislation does not indicate how MMDAs would be affected. If MMDAs continue to offer significantly higher interest than ordinary checking accounts, depositors may continue to tolerate their lower liquidity.

The Impact on Monetary Policy

The repeal of the prohibition could have an impact on the Federal Reserve (the Fed) and monetary policy. To the extent that repeal would cause demand deposits at depository institutions to increase—a reversal of the three decades of relative decline in demand deposits—there could be benefits to the Fed. The decline in demand deposits was accompanied by a decline in required reserve balances at the Fed. The Fed has argued that the continued negative trend could potentially impair its ability to conduct monetary policy.[9] As mentioned above, depository institutions are required to maintain reserves against demand deposits. A growth in required reserve balances at Federal Reserve Banks could enhance the Fed's ability to conduct monetary policy (increasing and decreasing the money supply and, thus, interest rates). These increased reserve balances at the Fed would also provide the Federal Reserve with more funds that it would invest in government securities. The overwhelming part of returns from these investments would be remitted to the Treasury as government receipts. The Congressional Budget Office estimates that these effects, however, would not be significant.[10]

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[9] U.S. Congress,. House Committee on Banking and Financial Services, *Bank Reserves Modernization Act of 2000*, hearing, 106th Cong., 2nd sess., May 3, 2000, unpublished, Statement of Laurence H. Meyer, Member, Board of Governors of the Federal Reserve System. http://www.house.gov./banking/5300mey.htm.

[10] U.S. Congress, House Committee on Financial Services, *Business Checking Freedom Act of 2005*, Report to accompany H.R. 2114, 109th Congress, 1nd session, H.Rept. 109-081 p. 18. http://www.congress.gov/cgi-lis/cpquery/R?cp109:FLD010:@1(hr081).