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Dodd-Frank: Regulation Q Goes the Way of the Model T

A welcome change—at least, welcome to some banks—brought about by the Dodd-Frank Wall Street Reform and Consumer Protection Act will become effective next Thursday, July 21. On that date, the prohibition on the payment of interest on demand deposits, popularly called Regulation Q, will be repealed. The Federal Deposit Insurance Corporation ("FDIC") has finalized its regulation implementing the repeal, and yesterday the Board of Governors of the Federal Reserve System ("Federal Reserve") followed suit.

Following is a discussion of the background and impact of the change and some issues that banks should consider, if they have not done so already, in preparation for the change.[1]

Background

The prohibition on the payment of interest on demand deposits, which are effectively business checking accounts, was enacted in 1933 as part of the Glass-Steagall Act and implemented in the Federal Reserve's Regulation Q.[2] The prohibition was accompanied by restrictions on interest rates on savings and time deposits, all based on the misperception that large banks were attracting "hot money" to New York for lending in the stock market by paying high interest on deposits and thereby contributing to the 1929 stock exchange crash. While this theory has been put on the ash-heap of economic history,

[1] Hereinafter "Dodd-Frank," P.L. 111-203, 124 Stat. 1376. Section 627 of Dodd-Frank repeals Section 19(i) of the Federal Reserve Act and Section 18(g) of the Federal Deposit Insurance Act effective one year after enactment. A similar provision in the Home Owners' Loan Act, applicable to thrift institutions, was also repealed. The Federal Reserve's action is at 76 Fed. Reg. 42015 (July 18, 2011) ("Fed Rule"). The FDIC's action is at 76 Fed. Reg. 41392 (July 14, 2011) ("FDIC Rule"). The Fed Rule applies to national banks and State banks that are Federal Reserve members, and the FDIC Rule applies to all other FDIC-insured banks. U.S. branches and agencies of foreign banks are also covered.

[2] 12 C.F.R. Part 217 (2011).

and the other limits on deposit interest rates were abolished long ago, the prohibition has remained in place for a variety of reasons, none of which were compelling enough to prevent its repeal in Dodd-Frank.[3]

Several actions have been taken over the years in order to cope with the prohibition. A legislative change in 1980 allowed consumers, non-profit entities and governments to use savings deposits, on which interest could be paid, as checking accounts, known as "NOW" accounts; as a result, only for-profit business entities were restricted to demand deposits. Another action taken by banks themselves was to transfer balances out of a demand account at the close of business each day into some other type of instrument, since the prohibition applies to end-of-day balances. Repurchase agreements for U.S. Government securities was one alternative; the customer effectively enters into a "repo" with the bank overnight under which the customer owns the security for that period. Another alternative is to transfer the balance to an account in the name of the customer at a non-U.S. branch of the bank. Offshore deposits are not subject to the prohibition. In both cases the funds are transferred back to the demand deposit at the opening of business the next business day and used during the day for transactions. These arrangements are generically known as "sweeps" since the funds are swept out of the account temporarily.

The Federal Reserve and FDIC proposals to rescind their regulations requested comment on the possible economic and financial effects of the change of banks. Many banks commented that the prohibition should remain in effect because of the importance of demand deposits to their balance sheets and the increased costs they will likely incur, and some requested that the prohibition be continued under other authority. Both agencies indicated that they have no authority to maintain the prohibition. The comments give evidence that the reasons for maintaining the prohibition for 75 years remain meaningful to at least some banks.

Factors affecting how banks cope with the change

There are several cross-currents affecting the manner in which banks will cope with the change.

First, Dodd-Frank provided for deposit insurance coverage in an unlimited amount—not limited by the $250,000 ceiling imposed on deposit insurance coverage generally—for demand deposits on which no interest is accrued.[4] This provision is in effect for calendar years 2011 and 2012. Thus, during that period, many depositors that want the protection of full deposit insurance may want to forego earning interest on demand deposit balances.

Second, demand deposits remain subject to a 10 percent reserve requirement under the Federal Reserve's Regulation D.[5] This means that, with minor exceptions, banks will have to maintain reserves in either vault cash or a balance at a Reserve

[3] For example, see "Regulation Q Prohibition Against Payment of Interest on Demand Deposits, Federal Reserve Board Staff Paper," enclosed with a letter to Alfonse M. D'Amato, Chairman, Senate Banking Committee (July 24, 1995). The authority to limit interest rates on savings and time deposits was repealed effective in 1986.

[4] Dodd-Frank, Section 343. The FDIC amended its regulation for this purpose at 75 Fed. Reg. 69577 (Nov. 15, 2010) ("FDIC Insurance Rule"). An amendment to Dodd-Frank enacted on December 29, 2010, added an exception to this requirement for Interest on Lawyers Trust Account, or "IOLTA", demand deposits so that these deposits could earn interest while having unlimited insurance, due to the special nature of IOLTAs. P.L. 111-343; see the discussion on the floor of the House of Representatives at CONG.RECORD H7727-28 (Nov. 20, 2010). The FDIC conformed its regulations accordingly. FDIC Financial Institution Letter 2-2011 (Jan. 21, 2011).

[5] 12 C.F.R. Part 204 (2011) ("Regulation D"). This reserve requirement also applies to NOW account balances.

Bank in the amount of 10 percent of their average demand deposit balances. Reserve requirements have long been considered a tax on the banks because neither vault cash nor Reserve Bank balances earn interest. This was changed in late 2008 when Congress authorized the Reserve Banks to pay interest on bank balances.[6] Currently the interest rate is 25 basis points, and the Federal Reserve plans to keep this rate below market rates for monetary control purposes. Thus, maintaining reserves will continue to impose a cost on banks that maintain customers' funds in demand deposit accounts.

Third, Dodd-Frank also mandates that insured banks pay FDIC insurance premiums on the basis of the total assets of the bank, and not on the basis of the amount of deposits on the bank's books. This change has been effective since April 1.[7] The consequence is that a bank will not have to pay a higher FDIC premium solely because of an increase in its deposit base. Thus, banks suffer no additional insurance assessment if deposit levels increase. One reason that banks encourage the taking of deposits at non-U.S. branches is to avoid reserve requirements and the payment of FDIC premiums.

Consequences for banks

The following issues need to be considered by banks in deciding what, if any, changes to make in their deposit offerings to customers and in their systems.

1. To pay or not to pay.

Should interest be offered on demand deposits? The issue is not as clear-cut as it might appear because of the availability of unlimited FDIC insurance feature if there is no interest, at least for the next 18 months. If depositors remain concerned about banks' financial condition generally, they may prefer unlimited insurance. If not, then they may prefer interest. There appears not to be a restriction on a bank offering both types of demand deposits so that customers can take their pick. One question may be whether the same customer can have two demand deposit accounts, one on which interest is paid and the other with no interest, with the interest-paying one holding less than $250,000 and the other one holding an additional amount. Such an arrangement is likely to be seen as an evasion of the statutory provision.

Banks that choose to pay interest on demand deposits have a significant disclosure obligation to consider in light of the unlimited-insurance feature and the inapplicability of that feature upon paying interest. All insured banks are required by the FDIC to post a notice, which banks appear to have placed in their websites and other deposit documents, in mandated form concerning the unlimited-insurance feature of non-interest demand deposits.[8]

There may be competition between FDIC-insured banks and U.S. branches of foreign banks on this point since almost none of the branches are FDIC-insured. As a result, they need not worry about whether customers want unlimited insurance. If they pay interest on all such deposits, FDIC-insured banks may feel pressure to do the same.

[6] See the Federal Reserve's announcement of October 6, 2008, explaining the background. 73 Fed. Reg. 59482 (Oct. 9, 2008).

[7] 76 Fed. Reg. 10677 (Feb. 25, 2011); FDIC Financial Institution Letter 8-2011 (Feb. 9, 2011). Many additional changes to calculation of deposit premiums were also made.

[8] FDIC Insurance Rule, 75 Fed. Reg. at 69581, adding Section 330.16 to the FDIC's regulations.

2. Sweep mechanics.

As noted above, banks have developed “sweep” arrangements in the past in order to pay earnings on demand balances. The question is whether banks should continue with these arrangements. There are several reasons to do so. By sweeping balances out of demand deposit accounts at the close of business each day, banks will avoid having to maintain 10 percent reserves. Also, since the mechanism for sweeps is in place and customers have signed up, it may be easier simply to allow the existing arrangements to remain.

The benefit of unlimited insurance during 2011-2012 applies while the balance is in the account. If a sweep has not yet been executed at the time that the bank is declared insolvent, then the depositor would continue to have the benefit of unlimited insurance. This assumes that, under FDIC posting rules, the balance will be treated by the FDIC as remaining in the account as of the moment of insolvency.[9] Deposits at non-U.S. branches are not “deposits” for purposes of FDIC insurance, a point discussed further below.

3. Freebies for demand deposits.

The Federal Reserve and FDIC had to develop rules concerning the offering of gifts by banks in the late 1970s in order to deal with banks attempting to compete with money market funds, which were offering much higher rates of interest than banks were allowed to offer under Regulation Q. After interest rate ceilings were abolished in 1986, the rules on gifts remained effective for purposes of the prohibition on demand deposit interest. The Federal Reserve revoked its rules on this point because they would have no reason to exist for its purposes. However, the FDIC recognized that its rules would be useful for determining whether a bank offering gifts for demand deposits would be paying interest for purposes of having unlimited insurance, and it retained them.[10]

4. Foreign branches.

Deposits on the books of U.S. banks’ foreign branches are not “deposits” for purposes of Regulations D and Q so long as a U.S. office of the bank has not guaranteed repayment; in other words, a customer placing funds on deposit at a non-U.S. office must be subject to “country risk,” which is that the country of the branch could impose restrictions on repayment of the deposit and the U.S. head office would not be obligated to repay it.[11] With no prohibition on demand deposit interest, it would be feasible for U.S. banks to offer such a guarantee in order to give comfort to any branch depositor concerned about local country conditions. However, a guaranteed deposit would be subject to reserve requirements under Regulation D.

A deposit at a non-U.S. branch is not within the definition of “deposit” for purposes of FDIC insurance and accordingly is not insured in the event that the bank becomes insolvent. Effectively such a depositor is a subordinated creditor; in a liquidation of the bank, such a depositor would be paid only after full repayment of both FDIC-insured deposits and other deposits

[9] 12 C.F.R. § 360.8 (2011).

[10] FDIC Rule at 41393-94. In general, gifts that would not constitute “interest” are goods, credit or cash in amounts less than $10 for deposits of less than $5,000 and $20 for deposits of $5,000 or greater, subject to various limitations. The FDIC Rule also preserves Federal Reserve staff interpretations that banks requested be retained as useful precedent even though the Federal Reserve revoked all of them.

[11] Regulation D, Section 204.1(c)(5). Any deposit of a U.S. resident at a non-U.S. branch must be in an amount of $100,000 or more to be treated as offshore. Regulation D, Section 204.2(t).

pursuant to the depositor preference provision of applicable law. Prior to Dodd-Frank, the advantage to the banks of such deposits is that they did not have to pay FDIC premiums on them; the calculation was applicable only to all “deposits” as defined. However, Dodd-Frank requires the FDIC to calculate premiums on the basis of each insured bank’s total assets, regardless of the amount of deposits. Accordingly, banks would not have a marginal cost for FDIC premiums if their U.S. head office were to guarantee deposits booked at their non-U.S. branches. It is not at all clear whether guaranteeing non-U.S. branch deposits would be meaningful to a significant class of customers.

Conclusion

It is nice to clear away yet another impediment imposed by Glass-Steagall to banking operations, but the impact of being allowed to pay interest on demand deposits is very unclear. Over 75 years of operating under the old prohibition, plus the advantage of unlimited deposit insurance, may make the new opening uneventful. We may have to await 2014, when unlimited deposit coverage expires, to see banks directly pay interest on demand deposits.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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