Regulation Q Repeal

The Impact on Small Business and Community Banking

The longstanding prohibition on paying interest on commercial checking accounts was reversed in a “repealer” in H.R. 4173, The Wall Street Reform and Consumer Protection Act of 2009 (Dodd-Frank Act). We believe this particular “stroke of the pen” will have significant detrimental impacts on community banks as well as the small business customers they have historically served. Please consider the following observations and concerns:

- Demand deposits are among the most relational deposit products we have.
  - Since no interest is paid on them, they are competed for where relationship, service and credit support are the keys.
  - Many banks that have not succeeded on a relationship level will see as a new funding source just like any other rate related product.
  - The demand deposit account (DDA) is the foundation of the Banker/Business relationship.
  - If relationships are disrupted due to seeking higher rates, the business may well lose a long standing ally in times of need.
  - Some have said this gives smaller banks the ability to compete with the large banks for these deposits, but surveys show that Community Banks mostly compete with each other.
  - If the rate for these deposits is set by the “Too Big To Fail” banks, it will simply drive up interest expense in Community Banks.
  - The “Too Big To Fail” banks no longer have the incentive of funding from alternative sources due to the change in the FDIC assessment base.
  - The “Too Big To Fail” banks will most likely turn to more stable and less costly DDA accounts to fund their balance sheets. This could set the market rate for these deposits.
  - Once interest is paid on Business DDA, the Transaction Account Guarantee (TAG) unlimited deposit insurance coverage is no longer applicable. $250,000 FDIC limit applies. This will disadvantage Community Banks, who are not implicitly or explicitly considered “Too Big To Fail”.

- The market value of a well run community bank will be diminished.
  - A large portion of a bank’s value is related to the value of the core deposit franchise.
  - Now that demand deposits will pay interest, their value is significantly less.
  - Couple this with the elimination of Interstate Branching restrictions and, depending on the rate paid on DDA when rates normalize, the value of a community bank franchise could be reduced anywhere from fifteen to thirty percent! (Based on 20 percent DDA deposits and a three percent rate)

- The largest source of fixed rate core deposits will go away.
  - No longer will these fixed rate deposits at (0%) be available to fund fixed rate assets.
  - A new safety and soundness concern emerges as interest rate volatility risk increases for Community Banks.
  - No locked spread on fixed rate investment securities or loans.
  - If banks are no longer able to purchase fixed rate Bank Qualified municipal bonds, the cost to smaller issuers will go up, harming those entities and an already fragile municipal market.

- The repeal of Reg. Q adds to the problem of community banks becoming liability sensitive.
  - Now every DDA dollar will be subject to rising rates from a historical low point.
  - Combine all deposit products being subject to rising rates with the interest rate “floors” many community banks put in place and you have a formula for severe margin compression for at least a 200 basis point rise in rates.
  - This formula is reminiscent of the S&L crisis when deposit rates were deregulated and institutions were put in a negative spread position with their fixed rate assets.

- The amount of funds in the banking system for lending and investing will be <u>directly</u> reduced!
  - Depositors (or bankers) may see it as easier to just leave funds in a DDA rather than moving to a time deposit classified product (MMA, etc.).
  - If this occurs, every dollar that moves from a MMA to a DDA will result in an immediate loss of ten cents in investable/loanable funds due to Federal Reserve Bank (FRB) reserve requirements. There are no reserves required on time deposits.
  - The interest on reserves will not cover the interest lost from the elimination of Reg. Q and there is no guarantee that the FRB will continue to pay interest on reserves.

- The small business customer will be adversely impacted.
  - Without DDA balances to cover the cost of services used, the customer will now be faced with cash fees.
  - Every commercial account will need to be put on Account Analysis to avoid the loss of service income. This will be a new disruptive event to the Small Business owner during a time of economic recovery.
  - It will result in higher loan rates without the zero rate DDA to support the borrowings.
  - Without the relational DDA account to offset special circumstances, the business customer will lose a long standing cushion when abnormalities occur.

- Will Community Banks be able to compete?
  - Indications are that the “Too Big To Fail” banks will be ready with many options on paying interest on business DDA accounts.
  - This will take significant programming efforts since no DDA system was structured to account for interest.
  - Core deposit systems may not be ready to provide the options necessary for Community Banks to compete.

- There is a solution . . .
  - Amend Reg. D to lift the artificially low limit on the number of transactions that can occur in a Money Market Account (MMA).
  - For those banks that want to attract interest bearing deposits from business customers, the option is to sweep excess funds to a MMA each day to meet their funding needs and satisfy the interest needs of businesses.
  - This option leaves the core relational DDA account in place while meeting the needs of banks and businesses with a daily interest option without having to sweep to an alternative off balance sheet product.