TESTIMONY OF

<u>EUGENE F. MALONEY</u>

BEFORE THE UNITED STATES SENATE
COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS

"CONSIDERATION OF REGULATORY REFORM PROPOSALS"

June 21, 2005
10:00 a.m.
Dirksen Senate Office Building, Room 534

"CONSIDERATION OF REGULATORY REFORM PROPOSALS"

My name is Eugene F. Maloney. I am Executive Vice President, Corporate Counsel and a member of the Executive Committee of Federated Investors, Inc. Federated is a Pittsburgh-based financial services holding company whose shares are listed on the New York Stock Exchange. Through a family of mutual funds used by or in behalf of financial intermediaries and other institutional investors, we manage approximately $200 billion. For the past 20 years, I have been a member of the faculty of Boston University School of Law where I teach a course entitled *Securities Activities of Banks*. Our mutual funds are used by over 1,000 community banks either within their own portfolios or in behalf of clients of their trust departments. These institutions are not our customers – they are our friends.

In connection with the proposed removal of Regulation Q, thereby permitting banks and thrifts to pay interest on business checking, my firm's position is that we are strongly in favor of any rule, regulation or legislation that results in our community bank friends becoming more competitive, more profitable or being able to operate their businesses more efficiently. We are concerned that the current initiative to repeal Regulation Q, if not evaluated in an historical context, will result in the exact opposite. This conclusion is based on my personal experience with the introduction of ceilingless deposit accounts in 1982 and the impact it had on our client base. Friends of long standing lost their jobs, their pensions and their self esteem because of the failure by governmental officials and members of Congress to fully think through the economic impact of ceilingless deposit accounts to our banking system and its profitability. This failure cost every man, woman and child in the United States $1,500.

In researching the history of ceilingless deposit accounts, which were to be "competitive with and equivalent to money market mutual funds," we found some fascinating information. At the meeting chaired by the Secretary of the Treasury to consider the features of the new account, the members were advised that if they set the minimum account size below $5,000, massive internal disintermediation would occur, and it would result in pure cost to the banks. The account size was set at $2,500. We have been to the national archives and declassified the minutes of subsequent meetings, and they make for astonishing reading. The members were fully briefed on the excesses committed by banks and thrifts and elected to do nothing to stop them. I brought some examples with me *(see Exhibits A-1, A-2)*.

We have seen nothing in the present record to suggest that any effort has been made to prevent a repeat of the past mistakes.

The legislative record indicates that only slight attention has been given to the banks' costs when paying interest on business checking accounts or the resulting impact on banks' earnings. The record does not include the type of detailed analysis that was performed by the staff of the Depository Institutions Deregulation Committee ("DIDC") during the DIDC's deliberations on whether to allow the payment of interest on business checking accounts in the early 1980s. The record also does not indicate that any significant attention has been given to the relationship between interest rate deregulation in the early 1980s and the subsequent thrift crisis.

When this matter was before Congress last year, the House committee report included a detailed estimate of the implications for federal tax revenues and the budgetary impact of paying interest on required reserve balances,[1] but <u>not</u> of the impact on the earnings or assets of banks.

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[1] H. Rep. No. 107-38 at 10-18 (Congressional Budget Office report).

During the House committee hearings, in response to questioning as to whether the legislation would "weaken any player in the market," Governor Meyer of the Federal Reserve Board replied, "No."[2] In response to a question as to whether the Board had any estimate as to the amount of deposits that are lost by banks due to the current prohibition against the payment of interest on business checking accounts, Governor Meyer replied, "No, I don't have any numbers to share with you."[3]

In anticipation of my appearance before the committee today, we commissioned a study by Treasury Strategies of Chicago to provide us with their views on the impact of the repeal of Regulation Q *(see Exhibit B)*.

Some of the key findings that we offer for your consideration are as follows:

- Companies now maintain liquid assets of approximately $5 trillion.
- Fifty-seven percent (57%) of corporate liquidity is now in deposits or investments that mature in 30 days or less.
- As we speak, banks are adjusting their balance sheets to mitigate interest rate risk to maintain their spread revenues.

This is a volatile mix. It becomes obvious that if higher-than-market interest rates are offered by banks to corporate customers, we risk a repeat of the 1980s debacle of massive movement of money to institutions that are ill equipped to rationally deploy it.

Treasury Strategies *(see Exhibit B)* has suggested the following options to prevent this from occurring:

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[2] "Proposals to Permit Payment of Interest on Business Checking Accounts and Sterile Reserves Maintained at Federal Reserve Banks," Hearing before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, 107th Cong., 1st Sess. (March 13, 2001) ("House Hearing") at 18 (Testimony of Laurence H. Meyer, Member, Board of Governors of the Federal Reserve System).

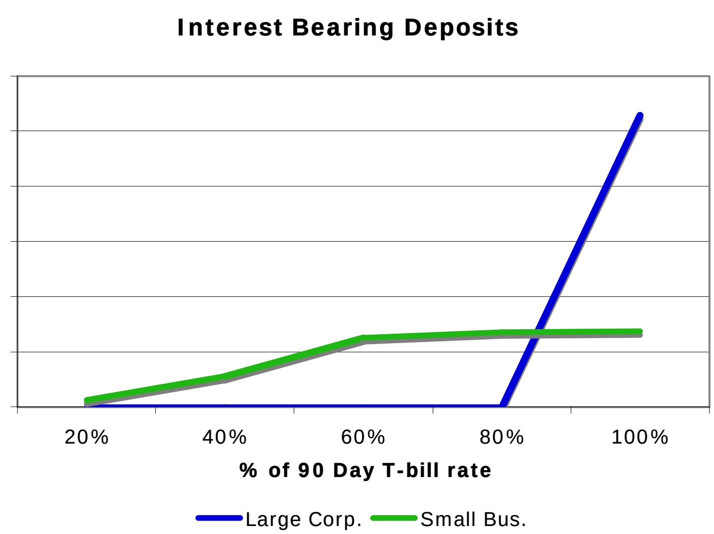
[3] *Id*. at 24.

1) Do not increase from 6 to 24 the number of permissible transfers per month into MMDA accounts

The House version calls for this increase. However, since MMDA accounts currently enjoy lower reserve requirements and are not limited in the rates they may pay, this would become the surviving vehicle. In effect, this would be tantamount to full repeal on day one without any phase-in period or risk management safeguards.

2) Cap the interest rates payable on these deregulated accounts during the phase-in period.

Our elasticity studies show that medium sized and small business begin to adjust their deposit/investment behavior when rate offerings reach 40% of the 90 day Treasury bill rate and complete their adjustments when rates reach 80%. By contrast, larger companies begin their adjustment process at the 80% point and will move virtually all of their short-term investments if rate offerings reach 110% of the Treasury bill rate.



Therefore, an approach to an orderly transition would be to initially allow payment of interest at up to 40% of the 90-day Treasury bill rate. Then, this could rise 10% every six months and be phased out after three years.

3) Limit the amount of interest-bearing business demand deposits a bank can hold as a percentage of its capital.

Bank capital is an excellent protection against risk. As corporate cash moves from other investments and into banks, banks will have to deploy that cash in the form of more loans and investments. This could lead to excesses or dislocations if unchecked. Limits on the amount of deregulated deposits that a bank can initially take in to a specific percentage of its capital would provide an appropriate safeguard.

One approach in this regard might be to limit deposits in this deregulated account initially to an aggregate of XX% of a bank's total capital. This limit could be raised by YY% every six months and eliminated altogether after three years.

4) Limit interest payments to just uninsured deposits.

Bank depositors enjoy the benefit of insurance on the first $100,000 of their deposit. Investors in mutual funds or direct money market instruments do not have the same protections. If the market for 'business cash' is deregulated, the playing field for this cash should be leveled. This would not only allow for effective and transparent rate competition, but also induce banks to insure that they pursue safe and sound policies.

There are two possible approaches to implementing this safeguard. One is to allow for payment of interest on only the uninsured portion of a company's deposit. The other is to establish a distinct, uninsured account type that could pay interest on the entire deposit. A phase-in period for the latter option is appropriate.

5) Collateralize the deregulated deposits.

Banks are currently required to post collateral to safeguard public sector deposits. In many cases, banks must set aside U.S. government securities equal to 100% or more of each deposit.

Requiring banks to collateralize these deregulated deposits would insure their safe deployment. At the same time, banks could still earn a spread on the rates paid versus their earnings on the collateral itself.

Money market mutual funds are in fact backed by a specific portfolio of marketable securities. Collateralization of interest- bearing demand deposits is analogous.

An approach to implementing this could be to begin with the requirement that each bank back these deposits, in the aggregate, 100% with U.S. government and agency obligations. This figure could be reduced by 10% every six months and phased out after three years.

6) Implement a phased approach.

Record levels of short-term liquidity relative to bank deposits, the volatility of the flow of funds among investment instruments, and the balance sheet readjustment that banks are navigating due to the rising rate environment combine to make this a less than ideal time to repeal Regulation Q. We would recommend deferring implementation to a more stable environment, perhaps six to twelve months following enactment.

Once implemented, some combination of the buffers cited above should be put into place and phased out over an additional three-year period. This would allow for a smooth transition and avert serious market dislocations.

Other anticipated fallout we expect to occur should the repeal go forward are:

1. Increased credit risk that will raise the banks' rate of loan charge offs; and
2. Pressure on banks' profitability and subsequent increases in charges for discrete services. Some statistics on this point are: (a) profit risk of $4 billion; (b) increased interest expense of $6 to $7.5 billion per year; and (c) for the banks studied by Treasury Strategies, it has been determined that in order to break even on their business customer base, banks will need to grow deposits or raise service charges by the following:

With Respect to Small Business:

- grow deposits by 80%; or
- raise service charges by 34%

With Respect to Mid-size Companies:

- grow deposits by 35%; or
- raise service charges by 16%

The reason I am here today is to make a fact-based attempt to prevent history from repeating itself.

I appreciate being given the opportunity to share my thoughts with the Committee. I would be pleased to take questions.

Exhibit A-1.

Att. Jo 12/14

Exhibit A-2.

Atlanta Constitution 11-30-82

FIRSTRATE

First Rate from First Atlanta. The new investment account everyone is talking about.

Several First Atlanta executives recently sat down to answer questions about First Rate.

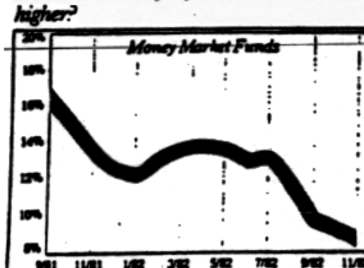
What exactly is First Rate?

"First Rate is First Atlanta's new investment account that offers individuals the highly attractive interest and liquidity previously available only with very high deposits or money market funds."

How high is First Rate's interest rate?

"During the first month, from December 14, 1982 to January 14, 1983 First Rate will pay 18.65% interest."

Current money market funds are paying around 9%. Why is your rate so much higher?*



*Based on Donoghue average of 11/17/82.

"We're offering 18.65% to attract current money market fund customers and indicate our own commitment to offer our customers the best possible product. Just as we have since 1865, the year our bank was founded. And now, 18.65% is the First Rate from First Atlanta."

You said you were paying 18.65% the first month. What happens after that?

"The rate will vary, just as it currently does with money market funds. Our rate will be based on current market conditions with our commitment to keep it competitive."

How much money do you need to get in?

"You can open a First Rate account with $2,500 or more. Which, as you probably know, is considerably less than most money market funds."

You said these accounts were also insured.

"That's correct. Every depositor will be insured up to $100,000 by the FDIC. No money market fund can offer that."

You certainly seem to be going after the money market funds.

"We are. It has always frustrated us to see brokerage houses in New York and money market funds in Boston take money out of Georgia that should stay in Georgia... working for the people here. There is simply no reason anyone who currently keeps $2,500 or more in a money market fund shouldn't switch it to a First Rate account. We offer much higher initial interest. Competitive interest after that. The same total liquidity. Plus $100,000 FDIC insurance. Plus access like no money market fund could ever offer."

18.65%

You make a very strong case.

"This is, we feel, the most exciting and attractive account we've ever offered in our 117 year history. That any bank, for that matter, has ever offered the individual investor."

How would someone sign up?

"Just stop in any First Atlanta banking center or call our Investors Hotline at 231-8100. Outside Atlanta call 1-800-282-7289. And ask about First Rate."

Every day, thousands of people come in First for a number of excellent reasons. Our First Rate account is just one of them.

The First National Bank of Atlanta

FIRSTATLANTA

A maximum deposit of $250,000 will be accepted at the 18.65% interest rate.

EXHIBIT B

ASSESSING THE IMPACT

OF THE

REPEAL OF REGULATION Q

Prepared by Treasury Strategies, Inc.

June 2005