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 22, 2004
10:00 a.m.
Dirksen Senate Office Building, Room 538**

My name is Eugene F. Maloney. I am Executive Vice President and Corporate Counsel with 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 16 years I have been a member of the faculty of Boston University School of Law, where I teach a course on the 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 which results in our community bank friends becoming more competitive, more profitable or being able to operate their business more efficiently. We are concerned that the current initiative to repeal Regulation Q 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. 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 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 cost to banks of paying interest on business checking accounts or the resulting impact on bank earnings. The record does not include the type of detailed analysis such as 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 1980's. The record also does not indicate that any significant attention has been given to the relationship between interest rate deregulation in the early 1980's and the subsequent thrift crisis.

The House committee report on the pending legislation includes a detailed estimate of the implications for federal tax revenues and the budgetary impact of paying interest on required reserve balances,[1] but not of the impact on bank earnings or assets.

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]

The witness representing the Independent Community Bankers of America testified that there are differences of opinion as to the cost impact of the legislation:

> There are wide differences of opinion regarding the anticipated effects of repealing the prohibition. For example, one analysis prepared by a banker who is opposed to repealing the prohibition on paying interest on business checking accounts indicated that if the bank's customers moved $20 million into interest bearing accounts at 5-1/2 percent, the interest cost would be the equivalent of 17 cents per share, affecting the price of the institution's stock by $2.38. Under this scenario, the bank would have to raise $21,509,304 in additional deposits to offset the cost of moving the $20 million in interest-free deposits to interest bearing accounts. This banker determined that such a cost would be prohibitive.
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> By contrast, another banker supporting the repeal of the prohibition argued that the current prohibition has been

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

[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).

> competitively damaging to the banking industry, especially community banking. He said many brokerage firms and other non-bank competitors have and will more aggressively continue to compete directly with commercial banks to develop and expand small business relationships. If the banking industry is not allowed to be competitive in offering interest-bearing commercial checking accounts, community banks may become more vulnerable to losing their most important business deposit and loan customers to non-bank and money center financial services providers that are not constrained by banking prohibitions.[4]

This witness also testified that the payment of interest on required reserves offered little benefit to smaller banks:

> So you can see, Mr. Chairman, the interest on reserves proposal would have little, if any, direct monetary benefit for most community banks. Indeed, it is the larger depository institutions that would benefit most from such a proposal.

I have not found any senior official at a community bank that is in favor of this initiative. Let me share with you why I think this is true. Since the record to date lacks any analysis of the economic impact of the repeal, we commissioned our own study which was conducted by Treasury Strategies of Chicago *(see Exhibit B)*. These are some of their key findings:

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[3] *Id*. at 24.

[4] House Hearing at 81(testimony of Robert I. Gulledge, Chairman/CEO of Citizens Bank, Inc., Robertsdale, Alabama, on behalf of the Independent Community Bankers of America).

1. On the basis of our in-depth consulting work in this arena, we estimate the profit at risk as a result of interest on business checking will be \$7-\$9 billion for the banking industry. We compute a specific exposure index for each of our client's business segments. The highest index value (exposure) is generally found in banks with a large concentration of small business customers. Banks serving the middle market also have high index values. Banks with concentrations of state and municipal deposits have below average risk and banks serving the largest corporations have the least risk.
2. For the banks studied by Treasury Strategies, we have determined that in order to break even on their small customer base, commercial banking segments will need to grow deposits or raise service charges by the following:

    <u>Small Business</u>:

    (a) grow deposits by 80%; or

    (b) raise service charges by 34%

    <u>Mid-size Companies</u>:

    (a) grow deposits by 35%; or

    (b) 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.