UNDERSTANDING THE EFFECTS OF THE REPEAL OF REGULATION Q ON FINANCIAL INSTITUTIONS AND SMALL BUSINESSES

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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UNDERSTANDING THE EFFECTS OF THE REPEAL OF REGULATION Q ON FINANCIAL INSTITUTIONS AND SMALL BUSINESSES

Thursday, March 1, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:34 a.m., in room 2128, Rayburn House Office Building, Hon. Shelley Moore Capito [chairwoman of the subcommittee] presiding.

Members present: Representatives Capito, Renacci, Luetkemeyer, Canseco; Maloney, Hinojosa, and Scott.

Also present: Representative Green.

Chairwoman CAPITO. We will go ahead and get started. Mrs. Maloney is busy elsewhere, but she said to go ahead and get started.

Would the witnesses to take their seats?

I want to thank everybody for coming today, and the hearing will come to order. We are scheduled to have a vote between 10:15 and 10:30, so we will see what happens.

I am going to give my opening statement.

In the wake of the stock market crash and the financial crisis leading up to the Great Depression, many steps were taken to enhance regulation of the financial sector. One such item was the Federal Reserve prohibition on banks paying interest on demand deposit accounts, commonly referred to as Regulation Q or Reg Q.

In the years leading up to the crash, there was an increasing trend of financial institutions competing with each other by offering higher interest rates on demand deposit accounts.

In 1933, Federal regulators responded by promulgating Reg Q, which prohibited the payment of interest on demand deposits. That is a little history lesson there for me and for you.

Since then, banks have utilized tactics to avoid the effects of Reg Q. In some cases, banks effectively paid interest to businesses by offering them sweep arrangements in which business deposits were transferred from business checking accounts, invested into commercial paper or repurchase agreements or mutual funds at the end of each day, and then transferred back the next day.

The Dodd-Frank Act included the repeal of Section 19(i) of the Federal Reserve Act in its entirety, thereby striking the statutory authority under which the Federal Reserve issued Reg Q. Since

July 21, 2001, banks have been able to pay interest on business checking accounts on a voluntary basis.

The repeal of Reg Q has been debated in the House of Representatives over the last decade. In fact, the House voted almost unanimously several times to move legislation that would have included a repeal of Reg Q.

That said, we are in a much different environment coming out of the financial crisis, and our witnesses will provide important insight into the effect the repeal of Reg Q is having on financial institutions and small businesses.

Since Mrs. Maloney is not here for the purpose of giving an opening statement, I would like to recognize Mr. Canseco for 2 minutes.

Mr. CANSECO. Thank you, Madam Chairwoman. And I thank you and welcome our witnesses here today.

Mr. McCauley, it is always good to have someone from San Antonio here as a witness. So thank you for being here today on this panel.

And thank you, Mr. Pollock, for coming.

Today, we examine the impact of banks now being allowed to pay interest on demand deposit accounts, the last vestige of a law that Congress passed during the Great Depression.

While the repeal of this last vestige of Reg Q has, by and large, been supported by industry participants for years, there is now concern amongst a number of community banks that Reg Q's repeal could leave them at a further disadvantage versus their larger counterparts.

I believe it is important today to hear the merits of both sides of this argument. While we, as Congress, should take measures that responsibly lift the burdens off of community banks, we must also make sure that we foster a competitive marketplace that takes into account the capabilities of banks of every size, as well as small businesses.

Again, I thank Mr. McCauley and Mr. Pollock for being here today, and I look forward to our discussion on Reg Q. I yield back.

Chairwoman CAPITO. Thank you.

Mr. Scott, would you like to make an opening statement or—Mr. Renacci, do you wish to make an opening statement? No?

Mr. Luetkemeyer? No?

We are having a dearth of opening statements, so back to you again, Mr. Scott.

Mr. SCOTT. Oh.

Chairwoman CAPITO. I am sorry to rush you. Take your time.

Mr. SCOTT. No problem. This is a very, very important hearing. And I certainly want to thank you, Madam Chairwoman, for holding this hearing to get the impact of the repeal of Regulation Q.

As we know, Dodd-Frank rescinded Regulation Q, which had prohibited banks from paying interest on business checking accounts. And after its repeal, member banks and Federal savings associations could pay interest on demand deposit accounts, but they are not required to do so.

Some supporters of Regulation Q's repeal have stated that small banks have been put at a competitive disadvantage due to their inability to cut fees in contrast with larger banks. And supporters for the repeal also include some small businesses that claim that they could not earn interest on their fee deposits, nor could they negotiate fee reductions.

So repeal of Regulation Q brings with it significant changes to the calculation of the account analysis for banks. In response to the passage of Dodd-Frank and Regulation Q's repeal, banks have several options in choosing to respond. One option is paying hard interest on the entire average account balance and thereby eliminating the soft interest credit. Another option is to proceed with paying a soft earnings credit on that portion of the average balance required to offset service charges, then paying hard interest on excess balances.

And of course, banks could opt for no change and pay no interest at all. I would be interested during this hearing to discover both the benefits and the risks of each of these options and what effect each of these options would have on the affected institutions as well as on the economy in general.

Thank you, Madam Chairwoman. I look forward to the witnesses.

Chairwoman CAPITO. Thank you.

I think that will conclude our opening statements. So I would like to take the opportunity to introduce the panel of witnesses for the purpose of making a 5-minute presentation, and then we will begin questioning.

First, we have Mr. Cliff McCauley, senior executive vice president of the Frost Bank of Texas.

Hold on just a second here. I see Mrs. Maloney is here.

Without objection—

Mrs. MALONEY. My apologies.

Chairwoman CAPITO. No problem.

Mrs. MALONEY. I thought it was at 10:00. Like Pavlov's dog, whatever the usual time is, is when I show up.

Okay. Thanks.

Chairwoman CAPITO. I was just recognizing Mr. McCauley. He is going to make his statement. Welcome.

STATEMENT OF CLIFF MCCAULEY, SENIOR EXECUTIVE VICE PRESIDENT, FROST BANK, ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION OF TEXAS

Mr. MCCAULEY. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, my name is Cliff McCauley. I am senior executive vice president of Frost Bank, headquartered in San Antonio, Texas.

For the last 20 years, my primary area of responsibility has been leading our correspondent banking line of business. I appreciate the opportunity to testify on behalf of the community banking industry about the potentially devastating effects of the repeal of Regulation Q.

In my role of working with community banks for over 30 years, I have become very familiar with the balance sheet structure and business model that has developed over the decades as they serve their communities and customers.

One very important part of this basic structure is the relationship that exists between banker and small-business owner. This model is built on relationship, service, close knowledge of the business, and credit support. This has been possible because of the longstanding effects of Regulation Q and is the foundation of the banker-business relationship.

The demand deposit account, or DDA, is the primary transaction account and repository for working capital of virtually every small business. It has been argued that for too long banks have denied paying interest on DDAs and that it would only be fair for small businesses to earn that interest on their daily balances.

There are many ways to measure value, and certainly investment dollars should be paid an expected return. But as mentioned previously, DDA transaction accounts are not investment accounts. They are working capital accounts with significant movement of funds to meet the needs of the business.

With the other account type restrictions of Reg Q being lifted many years ago, savings or investment funds have had the ability to earn a return and that process is very mature. The business DDA also has a value on a return, not just on interest dollars earned. It helps to support the relationship to cover service costs and to provide credit support for that business in a way that is meaningful.

Without these balances to support the relationship, businesses will be faced with higher service fees and increased borrowing costs.

These business DDA volumes also provide the pool of fixed-rate deposits that are so critical for the community bank model.

These business DDA deposits that are competed for based on service and relationship support are the vital source of funds that community banks use to make fixed-rate loans and purchase fixed-rate securities. These fixed-rate loans allow small businesses to enter into new ventures with borrowing cost certainty and thus create the new jobs that are so critical to our communities and our national economy.

Community banks are also the largest purchasers of local municipal and public entity debt issues that are so critical to the progress of our rural and less populated communities.

If a community bank no longer has a stable fixed-rate source of deposits to use to purchase fixed-rate local bonds without incurring unreasonable interest rate risk, it will require local entities to pay a higher interest rate to attract purchasers, further hurting their already strained budgets.

If the repeal of Reg Q is allowed to stand, and business DDA accounts succumb to the enticements of the highest bidder, the negative effects to community banks and small business are clear.

So who will be the beneficiary? It is my opinion that the too-big-to-fail institutions will utilize this new tool to attract deposits in the future since FDIC insurance premiums are now calculated on total assets rather than domestic deposits.

With their incentive to fund their balance sheets with wholesale funding now gone, paying interest on business checking will be an option to replace those dollars with a more stable source of funding.

If this does happen, it is unlikely that those funds will remain in the community for local purposes and small businesses will find themselves on their own in times of unforeseen need.

There is another side effect to the repeal that must be considered and that is the Transaction Account Guarantee program, or TAG, that gives unlimited FDIC coverage to non-interest-bearing balances. The irony of the repeal of Reg Q is that once interest is paid on these balances, the guarantee reverts to the $250,000 limit, which is not adequate for many businesses' primary transaction account.

With the unquestionable support of the Federal Government of these too-big-to-fail institutions, the community bank is at a significant disadvantage. I have heard many times that the desire is to eliminate too-big-to-fail, but actions such as the repeal of Reg Q play right into the vantage of those institutions.

For those businesses that from time to time do have investable funds, there is a better way to meet their needs and keep the funds in the local community banks without the repeal of Reg Q. Amending Regulation D to increase the number of allowable transactions in a money market account to not more than 30 per month would allow those banks and businesses desirous of an interest paying and earning relationship to do so without destroying the foundation of most community banking franchises.

There is still time to fix the problematic effects of this repeal while interest rates are at historic lows by reinstating Reg Q and passing Chairman Neugebauer's H.R. 2251 that accomplishes the amendment to Regulation D previously mentioned.

I appreciate the opportunity to be here today, and I will be happy to answer any questions.

[The prepared statement of Mr. McCauley can be found on page 24 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next panelist is Mr. Alex J. Pollock, resident fellow, American Enterprise Institute.

Welcome.

STATEMENT OF ALEX J. POLLOCK, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. POLLOCK. Thank you, Madam Chairwoman, Ranking Member Maloney, and members of the subcommittee.

While I am not from San Antonio, Congressman, I am from banking. I have lots of friends in the business from many decades.

In the past, during the 1970s, when I criticized the theory and effects of Regulation Q to one of those friends, these effects being to transfer huge amounts of money from small savers and from small businesses to banking profits, this friend who was a bank lobbyist memorably told me: "You have to understand, Alex, that Regulation Q is so embedded in the American banking system that it is permanent!"

This was a poor prediction, of course, as it turned out, although it took until 2011 to be completely falsified.

Because under Regulation Q banks were prevented by the government from paying interest on business demand deposits for so long, cumbersome methods were developed to compensate for this regulatory rigidity, as the chairwoman pointed out in her opening remarks. The Regulation Q effect on business demand deposits was also to encourage complex, implicit pricing arrangements, instead of clear, explicit pricing. This made things more difficult for small companies, which didn't and don't have internal bureaucracies.

As a small-business witness testified to the Senate Banking Committee, for example: "When I started my first business, I can recall vividly my astonishment at being told a business could not earn interest on its checking account. Later, as the business prospered, my banker suggested a sweep account. Boy, was it a paperwork nightmare."

This witness rightly asked why the government should force this complication on small business. Why indeed? It shouldn't.

Last year's repeal of the final remaining vestige of Regulation Q's 1930s thinking, as the chairwoman pointed out, at long last completed a pro-competitive process, which began with the Monetary Control Act of 1980. This final repeal was and is a good idea. We can easily see this by asking and answering half a dozen simple questions to clarify the economics of the matter.

If we want to have a competitive market economy, should Congress engage in price-fixing to benefit banks? Obviously not.

Should Congress prevent depositors from getting interest income that banks would be willing to pay? Obviously not.

Is it the business of Congress to try to prop up banking profits, for any kind of bank? Obviously not.

Should Congress force depositors to subsidize borrowers? Obviously not.

Does Congress know the right price for a business checking account? Obviously not. Only the competitive market can determine this, and it might determine multiple varieties of answers to that.

Should Congress promote competition in banking to the benefit of customers? Obviously, yes. That could hardly be more clear.

Moreover, the whole history of Regulation Q, as discussed in my written testimony, displays the folly of such regulatory schemes.

Customers are better served by encouraging competition than by suppressing it. This is especially true for smaller customers who lack negotiating power and are price-takers in the market, not price-makers.

To address quickly the specific questions asked by the committee:

"Has competition for business checking accounts increased?" To some extent, but because the Federal Reserve, as we all know, is manipulating short-term interest rates to approximately zero, I wouldn't expect to see major results at this point. We will see more when interest rates rise, as they inevitably will. But since we are in a time of zero interest rates, it is in fact a good time to do this transition—it makes it easier.

The subcommittee asks, "Are you concerned with unintended consequences?" No.

"Will small businesses benefit?" Yes. Regulation Q certainly caused subsidies to be extracted from small business depositors and transferred to banking revenues. This should be removed.

"How about the Federal Reserve's statement that this will get greater clarity in pricing?" I do believe that explicit pricing is clearer and better than implicit pricing.

In conclusion, Madam Chairwoman, about 35 years after my bank lobbyist friend told me it was impossible, we have finally arrived to the truly post-Regulation Q world, and this is a good thing.

Thank you again for the opportunity to be here.

[The prepared statement of Mr. Pollock can be found on page 29 of the appendix.]

Chairwoman CAPITO. Thank you. I want to thank you both.

I am going to put a general question out, and then I would like to hear both of your responses.

I guess I would like an assessment, if you have an assessment now, of how many institutions are actually offering interest on demand. I think Mr. Pollock addressed the fact that it is probably very low because of interest rates in general.

Mr. McCauley, you talked about the relationship between the repeal of Reg Q and the TAG program with the FDIC and what kind of relationship there is and might be because the TAG program is set to expire, I believe, at the end of this year.

Do we really have a complete picture, because of the low interest rates and maybe the TAG program as well, what the landscape will really be under the repeal of Reg Q?

So, Mr. McCauley, if you could kind of generally respond to those questions?

Mr. MCCAULEY. Sure. I think you are exactly right. Right now, there is very little movement because rates are at artificial lows and the entire banking system is awash in liquidity. So there is very little competition for deposits right now.

We will not see the effects of the repeal of Reg Q until monetary policy changes the excess reserves that are in the system and we start seeing an increase in interest rates.

At that point down the road is when it is going to become very critical and it is going to really—the effects of it are going to be seen within the banking community.

The TAG program is—the irony is that it is only for non-interest-bearing balances. And when you pay one basis point of interest on there, the TAG goes away.

Chairwoman CAPITO. Right.

Mr. MCCAULEY. It was put in place to help the community banks compete with the too-big-to-fail institutions with the implicit guarantee of the Federal Government.

Chairwoman CAPITO. Do you have any idea of how many institutions are currently choosing to pay interest on—

Mr. MCCAULEY. There are very few. Some of the large national institutions that have huge advertising budgets and are in need of deposits to fund credit card portfolios have made some moves in this regard.

And that further, by being able to do that, they have the possibility of disintermediating the funds from community banks. In today's world of electronic banking, you can bank anywhere. And so once those funds to chase interest earned on those demand deposit balances leave the community bank, then they are not going to be used in that local community.

Chairwoman CAPITO. Mr. Pollock, do you have a response to my questions? How many? And have we really seen the full effect and will we see it going forward in relationship to the TAG program?

Mr. POLLOCK. As I said in my testimony, Madam Chairwoman, we wouldn't expect to see a big effect now. This actually is a good time, as I said, to do the transition, so people can get ready.

As far as TAG goes, Mr. McCauley rightly said that there are a lot of things you are, as a customer, evaluating when deciding who to do any kind of business with, including banking business. You might like the local knowledge of a local bank. You might like the relationship. You are going to weigh that against the way it prices its deposits, the way it prices its credit.

You might include the fact that if I just forego interest, I can get an unlimited government guarantee on my money. You will put that into your decision.

What we ought to be doing always, in my opinion, in public policy is letting that competitive market work out those various tradeoffs because there is no way for anybody to sit in the central place and say this is how it should work. It is why we have a competitive market: to figure out the right answer.

Chairwoman CAPITO. In terms of, you mentioned the electronic banking, and certainly that is the way things are done now, will continue to be done in such a rapid-fire manner. And I think that is a good thing, because it really does move to the ease of customer satisfaction and it creates more of a national or international banking scenario when you can move your funds around rather quickly.

Do you think that—so you are envisioning, Mr. McCauley, a situation where the money is just going to be chasing the highest rate without the relationships that are born in a community bank. Is that essentially—

Mr. MCCAULEY. Yes, my experience in working with community banks for a long, long time is that the rate sensitivity of their customers is one of the highest things that they worry about. Customers will move for 5 basis points, 10 basis points, not really looking at the long-term ramifications of that.

That is fine with investment dollars because you are going to put those into a term investment and you are going to try to maximize your return.

When you start taking the transaction account so you have a community banker and a small business there, and they are enticed to move that money to the highest bidder, and say it is a credit card bank from out of territory that wants to fund a credit card portfolio, they can obviously pay a higher interest rate than the community banker can because of the returns on our credit card portfolio.

Once those funds leave that community bank to be deployed by that other bank, and those deposits are made electronically, they come out of that community in which they were originally deposited, that small-business owner then loses the support.

I hear many, many times from community bankers that this foundation of the relationship with the DDA is the reason that they stand behind their customers, because they support the balance sheet of the local community bank.

Chairwoman CAPITO. My time has expired here so—

Mr. MCCAULEY. Okay.

Chairwoman CAPITO. —I don't want to violate my own rules here.

Mrs. Maloney is recognized for 5 minutes for questioning.

Mrs. MALONEY. Thank you. And I thank both panelists. And, Madam Chairwoman, thank you.

First, I request unanimous consent to place into the record testimony from John Durrant, managing vice president of small business banking at Capital One Financial Corporation.

Chairwoman CAPITO. Without objection, it is so ordered.

Mrs. MALONEY. Capital One introduced clear interest banking checking. And this is the first bank, as I understand it, to market a business checking account that will offer high interest checking rates for the first 12 months and a market competitive rate thereafter. So thank you for accepting it.

And I would first like to respond to your testimony, Mr. McCauley. You characterized this action with Regulation Q as sort of a last minute, 11th hour action. But legislation has been pending, as Mr. Pollock mentioned, for many, many years. Since 1979, I found legislation calling for the repeal of Reg Q, possibly even before that.

And several times, literally several times, it has been debated on the Floor of Congress and passed by a wide margin on the Floor of Congress. And the longer I stay here, the more I really respect anything that can get a majority vote on the Floor of Congress, much less a wide margin.

I recall, along with many of my colleagues, having sat through numerous, numerous, numerous hearings, one chaired by your predecessor, Sue Kelly, who was Chair of this committee at one point, on this legislation of which she was the lead sponsor.

So clearly, this is not a new, undebated issue. It was offered on the Floor of Congress when Dodd-Frank was being debated. But I just wanted to clarify that it wasn't an 11th hour amendment. It had passed this body numerous times, passed out of this committee numerous times.

I would like to ask you about the sweeps process and if you could elaborate on it. As Mr. Pollock mentioned and others mentioned, there have been numerous attempts to try to go around Regulation Q prohibition since it was enacted in Glass-Steagall, one of which is the sweeps, the automatic transfer of one's savings accounts to one checking accounts. And many financial institutions have benefited from this practice, offering the service to their customers and collecting fees.

So I would like to know, has your bank taken advantage of these sweep activities and those like them? What are the fees for the sweep activities? How prevalent are they in your bank? Is it prevalent throughout the system?

If you could comment on the sweeps, the automatic transfer, and what the fees are and exactly how it works? Is it automatic? Do they opt into it—exactly how it works and have you been benefited from this and what the fees are?

Mr. MCCAULEY. Sweep accounts have been around for a long time, as already previously stated. Sweep accounts are mainly available to larger corporate entities, more sophisticated depositors that have larger amounts to sweep. There is a cost to that, the fees associated with it on a daily basis. It can either be a hard dollar figure, or it can actually be a spread of a few basis points.

Mrs. MALONEY. But how much is it usually, like $100, $35? What is the usual average sweep fee?

Mr. MCCAULEY. As far as hard dollars on a monthly basis?

Mrs. MALONEY. Yes.

Mr. MCCAULEY. It varies from institution to institution. I would say it would be less than $100 per month from the standpoint of a hard dollar fee if you looked at an average.

However, those sweep accounts have not been really available to smaller businesses, to smaller entities and to smaller financial institutions. That is the main concern, that they have never been able to do that, they didn't have the sophisticated systems to be able to do that, nor did they have the size of customers that would benefit from that.

And that is why we suggest the amendment of Regulation D to allow on-balance-sheet sweeps, if you will, to keep that money in the community bank.

Mrs. MALONEY. Okay. My time is almost up. I would like to ask Mr. Pollock, the main concern that I hear from my constituents, the small-business owners, is that they are forced to dedicate time and energy to transferring funds from one account to another to earn interest, and they say that they could better use this time serving clients and helping them grow their businesses.

How will this help them grow and create jobs, the number one concern before Congress, this elimination of Reg Q? And why do you think it has taken so long for this to happen, and why did they put it in there in the first place? I know you are a historian, too.

Mr. POLLOCK. Thank you, Congresswoman.

Of course, your small-business customers are right. They are engaging in this bureaucracy and trying to move things back and forth only because Congress put in this prohibition, which was then mirrored in the Federal Reserve's regulation. Congress caused this complication and expense to happen.

If you go back to 1933, in the banking act of that year, you will find that among the things Congress was trying to do with what became Regulation Q was to prop up banking profits by giving banks what seemed like free—or interest-free at least—money.

There was a lot of cartel-like thinking in the 1930s, which was displayed in a lot of the New Deal regulation. The regulators were viewed as a sort of cartel manager, as the Federal Reserve was in this case, to preside over a deposit product cartel where we fix the prices by regulationin order to try to prop up baking profits. This is not a good reason, I think we can say.

Mr. RENACCI [presiding]. Thank you.

I am now going to recognize myself for 5 minutes.

First off, I want to say that I am concerned about community banks being able to meet the requirements of many of the regulations of Dodd-Frank and being able to compete. But on this issue, I am trying to get a handle on it, and the way I have spelled it out is pre-repeal, small community banks did not pay interest. And large banks already sidestepped the issue by having sweep accounts.

Post-repeal, small community banks are not paying interest because interest rates are too low. And large banks are still sidestepping the issue by having sweep accounts.

So in essence, I think I heard, Mr. McCauley, in your testimony that nothing has really changed at this point till liquidity gets back into market.

But I question, even after the repeal, if pre-repeal, the large banks were already doing this, then post-repeal, aren't the small community banks really just going to be competing with themselves, between themselves, as the first institution maybe starts to put an interest on that account, and then the small community bank down the street has to do it?

I realize it is a cost. I was a small-business owner for 28 years. But I also believe in competition. So I am trying to just sort through that. And maybe you can tell me your thoughts on that.

Mr. McCAULEY. Historically, community banks have competed with each other, but it has been based on a level playing field of a zero interest rate for transaction accounts. They had to compete on the basis of service, relationship, knowledge of the business, and credit support. So there is no pure form of competition in that. When you get into a bidding war, it is an auction. It is going to the highest bidder.

As was already previously mentioned, the number one player so far has been Capital One, it is on the record, and they are doing that to fund a displaced credit portfolio that is not part of the local community.

So it is not only the competition within the community—sure, there is going to be competition between community banks—but now, with the outside competition coming in and being able to pay a much higher rate than any community bank could.

The other part of it is that the downside of that is it is going to result in higher borrowing cost. Everybody focusing on just the interest earned, that is one side of it. But when you take a bank and you make their entire balance sheet floating rate as far as their liabilities—the deposits—it is going to be very problematic for them to make fixed-rate loans. They are not going to be able to do it.

And so without those fixed-rate loans and that borrowing cost certainty, it is going to have a major impact on the small-business borrower who, many times, is also the small-business depositor. And so, there is another side to this with the borrowing cost and also investment in supporting local communities and their bond issues. Community banks, excuse me.

Mr. RENACCI. I was going to say, ultimately, I do understand that and I agree. The loser in this will always be—and it is sad to say—the consumer because as costs go up, as you increase your interest, you are going to have to charge a higher cost in the banking system to pay a loan. So I do understand that. That is why it is interesting to hear this.

But ultimately, I am still trying to go back to the small banks versus the large banks because I think you made that statement earlier. Do you believe, based on the system pre-repeal, that there is a real difference since the large banks are already using sweep accounts?

Mr. McCAULEY. The large banks have historically used it for larger customers. They didn't necessarily use that with small—it really has to do with the volume of funds that the customer has. A small customer in a larger bank did not utilize a sweep account.

Mr. RENACCI. Mr. Pollock, your thoughts on this?

Mr. POLLOCK. Congressman, I am with you on competition. The winners from competition are consumers and customers of all kinds. That is always true.

When we talk about money trying to be channeled in one place or another by regulation, we typically end up with inefficiencies and consumers losing. If the people in small towns, let us say, choose to put their money in a demand deposit with a credit card bank, at the same time those people are using the credit cards of that bank and spending the money in the local stores.

If we sit back, as I said before, from the center and try to say, we are going to design a set of rules to make all these flows work out the way we want, we will make them work much worse than a competitive market will.

Mr. RENACCI. Thank you. I am running out of time. So I will recognize Mr. Hinojosa for 5 minutes.

Mr. HINOJOSA. Thank you, Congressman Renacci.

I want to acknowledge Chairwoman Capito and Ranking Member Carolyn Maloney. I commend them for holding today's congressional hearing on the effects of Regulation Q.

I believe the repeal of Regulation Q has the potential to have a damaging effect on our community banks, which in turn may hurt the small businesses, some of our local school districts, and other entities that overwhelmingly rely on community banks for small-business loans.

I appreciate the concerns of my colleagues that Regulation Q represents an intrusion into the banking practices. I would counter, however, that we also should listen to the small banks that fear the effects of this repeal.

They are the banks serving rural America and other underserved areas which larger banks deem unprofitable. They are the banks making the loans to small businesses. They are the banks with relationships forged in those communities.

I would ask my colleagues on both sides of the aisle to listen to and consider the concerns expressed today.

My question for Mr. McCauley is, in my district in deep south Texas, community banks and credit unions are very important to the small businesses and to the families who have taken advantage of the low fixed mortgage rates that community banks are able to provide. Variable-rate mortgages were one component of the subprime crisis and encouraging fixed-rate mortgages, especially in underserved areas, as I mentioned.

It is important to protect the future health of the housing market. I would like to hear your prediction, sir, for how the repeal of Reg Q will affect the ability of community banks to provide fixed-rate loans to home buyers, and also tell me how this might affect the operations of community banks in those underserved areas in general.

Mr. MCCAULEY. Thank you, Congressman.

Yes, I am very familiar with your district and the community banks. I work with very many of them in your district.

Mr. HINOJOSA. We are pleased to have your chain of banks in deep south Texas. You all do a wonderful job.

Mr. MCCAULEY. Great. Thank you.

The fixed rate at zero deposit base that community banks have, statistics will show that it is about 20 to 25 percent, and most community banks have a non-interest-bearing deposit base of about 20, 25 percent. They have historically used this to make those fixed-rate loans, many of those to home buyers in those rural areas where no mortgage company is going to make that loan. And you are very aware of that. It is very problematic.

Without community banks making those fixed-rate home loans to those borrowers, it would be very difficult for them to get a mortgage and thus to purchase a home.

With the inability to have with certainty, rate certainty, to know that you have this base of fixed-rate deposits at zero to margin off of or make a reasonable spread on and make those mortgage loans, the banks won't be able to do it.

They could utilize higher cost Federal Home Loan Bank borrowings to match fund off of that, but it will be a higher cost to the borrower because those funds do have a cost to them versus the base of DDA deposits that they have always had.

So it is not only just the fixed-rate loans that they are able to make to the businesses, but also every community bank that I know does support their local community by making these mortgage loans and they are able to use fixed-rate funding because of that deposit base that they have with certainty.

And without that, the cost of borrowing will go up or they will go to variable rate mortgages which can be quite problematic in a rising rate environment.

And I think it is where we are right now. You are going to—the downside to community banking is, is to put them in a liability-sensitive position with rising rates and the deposit side of their balance sheet increasing in rate.

If they do have fixed-rate loans on the books, it is going to put them into a negative spread reminiscent of the S&L crisis. So they are going to be very cautious about making those.

Mr. HINOJOSA. In your opening remarks, you said that it would be some time—and I don't know exactly how long—before we really see what financial effect it would have on our community banks. Give me a timeline in your opinion of how long that would be?

Mr. MCCAULEY. That is anybody's guess. The Federal Reserve has put out that they are proposing to hold rates near zero through 2014. But we know if inflation does return or unemployment does reduce at a rate, that the Federal Reserve will have to start moving to control those, and it could move some predictions, the rates will move up very fast to control.

When that will be, I don't know. But if you look at just when you return rates to anywhere, the Fed funds rate and a normal rate between 3 and 5 percent, which is very normal over time, it will be devastating as far as the marginability of the banks, not from a profit standpoint, but being able to provide those loans at a fixed cost to the borrower, fixed-rate loans whether it be mortgage or a small business.

Mr. HINOJOSA. Thank you. My time has expired. I yield back.

Mr. RENACCI. Thank you.

Before I recognize Mr. Luetkemeyer, I would like to ask unanimous consent to insert 2 items into the record: a statement from the Independent Community Bankers of America; and the Hamilton Financial Index.

With that, I recognize Mr. Luetkemeyer for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

I would just like to start out with a quick story. In our local bank, the local officer, loan officer one day was confronted by an elderly gentleman who had a large deposit, a lot of money in the bank, and he wanted to ask him for a higher interest rate on his deposits because he thought he had enough money in there that he deserved more interest on his deposits.

And so the loan officer said, "I would love to give that to you, John, but your son, Robert has a loan with us on his car, a loan with us on his house, and a loan with us on his farm. And if you take the money out, we are not going to be able to loan him that money, number one. And number two, if we pay you more, we have to charge him more. Now, what do you want us to do?"

And that, to me, is what is going on here, is that while Reg Q was there initially for a stated purpose, of which I am not sure—I would like to have a discussion with Mr. Pollock in 1 minute here about profits on it, but at some point the dollars that we are using to make loans to small businesses and individuals come from the deposits of the community generally.

And the rates that are charged on those loans are reflective of what deposits are being paid so that there is a margin there. And if you pay more for deposits, you are going to charge more for the other services. That is the way it works. You have to maintain a margin on your interest rates as well as a profit margin to be able to keep your doors open.

So I am not sure exactly why they think this is a good deal because I think we are taking from one group and giving to another. We are picking winners and losers here over who has checking balances with us and who has loans with us. And I am not sure we need to be in the middle of doing that.

And so I guess a quick question for you, Mr. McCauley, is what percentage of your business deposits or what percentage of your deposits or business deposits versus personal deposits that you have in your bank?

Mr. MCCAULEY. Within our organization, we are primarily a commercial bank and so it would be predominantly commercial deposits versus retail.

Mr. LUETKEMEYER. Okay. Does your loan portfolio reflect the same amount of commercial loans versus personal loans then as well?

Mr. MCCAULEY. Absolutely.

Mr. LUETKEMEYER. So you have tied them together pretty well?

Mr. MCCAULEY. Absolutely. And I think almost every banking franchise does.

Mr. LUETKEMEYER. Right. So as a result, if you pay more for the deposits for your commercial deposits—or pay more for your commercial deposit—you are going to have to charge more for your commercial loans. Is that not right? It is pretty reflective.

Mr. MCCAULEY. Right. It is a simple yes.

Mr. LUETKEMEYER. Okay. With regard to the transactional account guarantee, how impactful do you think it will be if we allow this thing to expire, to your bank in particular?

Mr. MCCAULEY. I think it would be devastating to the community bank market. The implicit guarantee of too-big-to-fail has not been eliminated. And if you have any depositor who has any concerns, it is easy for the too-big-to-fail bank to say simply you don't have to worry about insurance limits with us because we know the government is not going to let us fail.

It will be devastating. It has leveled the playing field. We would like to say it is a level playing field, but we know it is not, and that the sovereign support credit given to the too-big-to-fail banks is very real. And customers are very, very educated about that.

So, deposits will flow out of the community bank market to those too-big-to-fail institutions in excess of the $250,000 limit when and if it is allowed to expire.

Mr. LUETKEMEYER. So as a result of that, do you feel that the dollars that are generated in a local community, that the local businesses are making, and then they would take those dollars out, and you would have less money to loan back to create more businesses and help more local folks?

Mr. MCCAULEY. Absolutely. Most businesses require more than $250,000 to maintain the transaction of their business.

Mr. LUETKEMEYER. Mr. Pollock, would you agree with that?

Mr. POLLOCK. I am not sure what "that" is, Congressman. I am sorry.

Mr. LUETKEMEYER. Mr. McCauley and I were discussing the transaction account guarantee and that if it expires at the end of the year, it is going to have a significant effect on especially small institutions as a result of the fact that the too-big-to-fail guys are able to point to that fact and the deposits will sort of gravitate that way. Do you feel that is accurate?

Mr. POLLOCK. Thank you, Congressman.

I do think there is in depositor behavior a looking to the bigger banks as safer. With respect to TAG, I do think there is an argument that if you are going to have the government guarantee the liabilities of banks, that such a deposit insurance system might have an unlimited amount for demand deposits, as opposed to investment accounts, as Mr. McCauley says. There is a reasonable argument to that. It all ought to be priced fairly.

Mr. LUETKEMEYER. Are we not—do the banks pay insurance on these accounts?

Mr. POLLOCK. Absolutely.

Mr. LUETKEMEYER. So in other words, the larger accounts are already insured by the FDIC?

Mr. POLLOCK. Yes.

Mr. LUETKEMEYER. And you are paying insurance on that?

Mr. POLLOCK. Yes, this is a totally bank-funded—

Mr. LUETKEMEYER. Okay.

Mr. POLLOCK. —insurance program.

And it should be, and that insurance premium, Congressman, needs to be a fair price. The government learns over and over that underpricing government guarantees of private liabilities is a big mistake, including in deposit insurance. We have learned that lesson.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. RENACCI. Thank you.

We have votes in about 10 minutes, so if the Members would be amenable, what I will try and do is, we have two Members left. We will get the two Members in, and then close the hearing.

So I recognize Mr. Scott for 5 minutes.

Mr. SCOTT. Thank you very much.

Mr. McCauley, Mr. Pollock, let me ask you, for those banks that are adjusting to this repeal of Reg Q, what would each of you recommend that they do to ensure that access to capital does not diminish while at the same time making sure that their operations are sound and stable?

Mr. POLLOCK. Is that to me, Congressman?

Mr. SCOTT. Yes, to each of you. I would like to get both of your responses. What are the recommendations to those that are adjusting so that they can stay viable?

Mr. POLLOCK. Congressman, that is, in my view, a variation on asking about the relationship of depositors and lenders. As I said in my testimony, we should not be trying to force depositors to subsidize borrowers. That is a mistake. We shouldn't force borrowers to subsidize depositors. That is why we want competitive markets, to establish prices among all of the actors in the markets.

I don't think we ought to be about, as a matter of public policy, guaranteeing that any particular competitor has funds at any particular price. I don't think trying to fix the price of funding or of any product in any business by the government is a good idea. That takes away the amazing power of competitive markets, which is what we ought to want to have in banking, as well as everyplace else.

Mr. SCOTT. Okay. Yes, sir?

Mr. MCCAULEY. How does a bank respond? How do they stay viable? What could they do to prepare? That is going to really depend upon market forces. There is very little that a community bank can do if interest rates rise and there is a huge increase in the price of those deposits. They are going to have to be very reactionary. The market forces will drive that.

I will say that the clarity issue question of the Fed and their comment that it will bring clarity as far as implicit interest versus explicit, that it is our understanding and learning from peer discussions and other software vendors and developers of systems that it is not going to get more simple. It is actually going to get more complex.

Mr. SCOTT. Do you think that this repeal will cause a sharp decline in the profitability of banks? I represent a State that has gone through just a tremendous onslaught of bank closings and failures of banks. So I am very, very concerned about what we do up here to make sure we are not hurting these banks.

Do you think the repeal of Reg Q will cause a sharp decline in the profitability of banks?

Mr. MCCAULEY. In a rising rate environment for a bank that has a high percentage of their deposits and non-interest-bearing DDA that become interest-bearing, their interest expense is going to go up very rapidly. And thus, yes, they are going to have to raise the cost of loans to maintain the same profitability. And if they can't do that, profitability will be diminished.

Mr. SCOTT. Do you think they should raise the cost of loans so that they can generate sufficient revenue to cover the increased cost of paying interest?

Mr. MCCAULEY. Absolutely.

Mr. SCOTT. All right.

Let me ask you, do you think, do you anticipate the banks, particularly small community banks, will lose deposits due to the increased competition of interest rates?

Mr. MCCAULEY. I believe that they will. I believe there will be a disintermediation to the larger institutions such as Capital One that has been previously mentioned that has obvious huge advertising budgets, and also an incentive to pay up for deposits to fund a very high price as far as interest rate credit card portfolio.

For instance, they can pay a high interest rate for deposits because of the high interest rates on a credit card portfolio versus a community bank that is making loans within the community.

Mr. SCOTT. Is there anything that could be done by the banks, by us, or by anyone to mitigate this damage?

Mr. Pollock, I think you wanted to—

Mr. POLLOCK. I would. Thank you, Congressman.

I think what is not to be done is to have the Congress, as I said in my testimony, try to support the profitability of banks or of any business. If they are losing business, it is because they are not competitive. We have to let customers, consumers, small businesses, all businesses decide what is the most valuable package of price, service, relationship, and quality among the various competing banks.

A big mistake, in my judgment, is for the Congress to say, we are going to pick one kind of competitor and try to make sure they are profitable.

Mr. SCOTT. I will yield back so we can have enough time. My time has expired.

Mr. RENACCI. Mr. Green, I know that you just stepped back in. We are going to go 5 and 5, but with you coming back, if you would like more than 1 minute, we will have to recess today or now and then come back after votes.

Mr. GREEN. Mr. Chairman, I am honored to take whatever is available.

[laughter]

Mr. RENACCI. Mr. Canseco for 5 minutes.

Mr. CANSECO. Thank you, Mr. Chairman. I appreciate the opportunity to ask these questions.

Mr. Pollock, you bring some very interesting points in your testimony regarding Reg Q's history and negative consequences that the policy has led to in the past, such as deposits leaving savings and loans in the 1960s when Reg Q was intended to keep them there.

We can all agree that there are good regulations and bad regulations. But in your opinion, why specifically is a prohibition on paying interest a bad regulation? And how can it further lead to negative consequences?

Mr. POLLOCK. Congressman, in my judgment, among the worst kind of regulations are price regulations where the government tries to fix the price of any product or service. That is all that Reg Q was and would be if we had it back. It is a price-fixing regulation, which is a bad idea and always turns into creating distortions which are unfortunate over time.

Mr. CANSECO. Thank you for that.

But, Mr. Pollock, do you think that a prohibition on interest on demand deposit accounts is price fixing?

Mr. POLLOCK. Absolutely, I do, sir.

Mr. CANSECO. And Mr. McCauley?

Mr. MCCAULEY. No, it is absolutely put in place for a purpose. And I think that you look at the past 70 years of it being in place, how it has really helped support the community banking industry. It unequivocally leads to the ability to make those fixed-rate loans and purchase those fixed-rate securities to support those communities.

Mr. CANSECO. Let me ask you specifically, could you, Mr. McCauley, explain how community banks specifically would become more liability-sensitive in the wake of Reg Q's repeal?

Mr. MCCAULEY. Sure. The liabilities of a bank are their deposits, what they owe back to their customers. And if your sensitivity is really related to rates moving one way or the other, if you are liability-sensitive, that means that as interest rates rise, your costs are going to go up; or as interest rates lower, your costs are going to go down as far as your deposit cost. There is nowhere for rates to go but up from where we are right now.

It puts community banks in an incredibly difficult position. It can be purported that it is a great time to do it. I think it is a terrible time to do it because you put community banks in a very intensely liability-sensitive position that they have never had to deal with on asset-liability management. So their interest rate risk volatility becomes extreme.

Mr. CANSECO. You mentioned in your testimony that demand deposits require a 10 percent reserve requirement at the Federal Reserve. Could you explain how that would hurt lending, especially by community banks, to the local areas that they serve?

Mr. MCCAULEY. Transaction accounts require a 10 percent reserve at the Federal Reserve. Today, those monies that are in money market accounts or other non-transaction investment accounts do not have a reserve requirement.

With the repeal of Reg Q, interest rates paid on demand deposit accounts that are transaction accounts to attract funding into that, those funds that did not have a reserve requirement will now have, which will take 10 percent of all of those deposits out of the system to be loaned and to support the local communities.

Mr. CANSECO. So let us assume I am a small businessman who has a working relationship with a community bank and I keep my checking accounts there. What side should I be on here? Should I be in favor of Reg Q or against Reg Q?

Mr. MCCAULEY. I think you should be in favor of Reg Q with the amendment of Reg D because we have a solution. There is a better way than repealing Reg Q. It is to reinstate Reg Q and amend Reg D. That way we can keep those funds on a balance sheet of a community bank without the machinations of a sweep or the expense of a sweep account.

Mr. CANSECO. Mr. Luetkemeyer pointed out something very interesting, that if I am getting interest payments on my demand deposit account, it is also going to affect the loan rate that I am going to get on any loan that I have, whether it is a car loan or a business loan. Is that correct?

Mr. MCCAULEY. That is correct. There is a direct relationship.

Mr. CANSECO. Let me pursue some of that. I have 40 seconds left. But you touched upon something that I need to have elaborated here.

I know from being in business in Texas and banking in Texas, many of our community banks go out there and bid on government accounts to attract those deposits in there. It is certainly not a lending relationship; it is a depository relationship with schools, city, county, etc.

Tell me how that would affect you one way or the other with or without Reg Q.

Mr. MCCAULEY. Most community banks do this as an accommodation to their local municipal governments to support them on their accounts. They have investment accounts they pay an interest on. If they are now going to get in a competitive environment and pay an interest rate on the demand accounts, it is going to further deteriorate their ability to do that, because it is not a profitable account for them.

Mr. CANSECO. And one more question, if I may. So therefore, it is going to affect those consumers other than governmental depositors when they ask for loans from the institution.

Mr. MCCAULEY. Absolutely, the cost will be higher.

Mr. CANSECO. Thank you.

Mr. RENACCI. Thank you.

Mr. Green for 1 minute.

Mr. GREEN. Thank you, Mr. Chairman.

Let me speak quickly. Let me thank you, Mr. McCauley, for being here today. I claim a little bit of you in Houston, Texas. And community banks are especially important to us in the State of Texas, to have banks with the owner in the community. They know the people in the community. It means something to have community banks.

With reference to competition, I support competition, but there are some concerns that I will have to raise. When the big box stores come in, they drive out the mom-and-pops. Community banks are the equivalent of mom-and-pops. If we don't do something, we have to protect them to make sure that we have what we know to be a viable institution that helps communities.

I would add only this as I close. With these community banks, we have an opportunity to make sure that small businesses can work with small banks so that they can continue to thrive. I will do what I can to be helpful. I have some thoughts, and perhaps I will get a chance to share them at a later time.

Thank you very much, Mr. Chairman.

Mr. RENACCI. Thank you, Mr. Green.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing.

Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

This hearing is adjourned.

[Whereupon, at 10:32 a.m., the hearing was adjourned.]

A P P E N D I X

March 1, 2012

Opening Statement of Representative Carolyn Maloney
Capital Markets Subcommittee Hearing on "Understanding the Effects of the Repeal of Regulation Q on Financial Institutions and Small Businesses"
March 1, 2012

Thank you and welcome to the panel.

Today's hearing will look at the repeal of Regulation Q which was included in the Dodd-Frank Financial Reforms we enacted in 2010 and has been law since July 2011. Reg Q was a component of Glass Steagall and prohibited banks from offering interest bearing business checking accounts.

Since 1979 efforts to repeal Regulation Q have been introduced in this chamber over 20 times by members of both parties, including one by the Chair of this subcommittee.

I and many Democrats, co-sponsored the Chairlady's bill, which passed by a 392-25 margin.

Similar bills have passed 7 other times with overwhelming bipartisan support.

The Federal Reserve and proponents of the repeal have found that it will strengthen the banking sector, attract funds from other sectors of the financial system, and provide greater clarity in the market.

So I guess I would say I am a bit confused why we are here re-litigating an issue that has been widely accepted and has become law.

While I understand that there are some concerns about the competitive disadvantage that paying interest on business checking accounts may give to some institutions over others, I believe we can spend our time discussing other matters. And I think both sides would agree.

The American people need relief from the havoc that this most recent economic crisis has wreaked on the housing market and employment conditions.

There are over 40 legislative proposals pending before this subcommittee that could help to do just that.

I mean no disrespect to the witnesses that have agreed to be here and testify before us. We appreciate your willingness to do so.

I thank the Chairman and I yield back the balance of my time.

Testimony of

Cliff McCauley
Senior Executive Vice President
Frost Bank
San Antonio, Texas

On behalf of
Independent Bankers Association of Texas

Before the

United States House of Representatives
Subcommittee on Financial Institutions and Consumer Credit

Hearing on
"Understanding the Effects of the Repeal of Regulation Q on Financial Institutions and Small Businesses"

March 1, 2012
Washington, D.C.

Opening

Chairman Capito, Ranking Member Maloney and members of the Subcommittee, I am Cliff McCauley, Senior Executive Vice President of Frost Bank in San Antonio, Texas. Frost is a $19 Billion bank, with all of our offices in Texas, and has been in existence since 1868. I am responsible for Frost's correspondent banking activities, and in that capacity, have the opportunity to deal directly with community bankers throughout the state of Texas. I am pleased to be here today to represent over 450 community banks in Texas who are members of the Independent Bankers Association of Texas (IBAT). Additionally, I am honored to have served as Chairman of IBAT, and I remain very active with that organization.

We very much appreciate you convening this hearing to explore the impact of the repeal of Regulation Q. It is our fervent belief that this seemingly small change in the law will have a very significant impact on a number of stakeholders going forward.

History and Background

Regulation Q dates back to the enactment of the Glass-Steagall Act in 1933. You will recall that most of the provisions regulating the payment of interest on various types of accounts were phased out in the Depository Institutions Deregulation Act of 1982. Prior to the enactment of the Dodd-Frank Act (DFA) in 2010, the only remaining provision of this regulation was the prohibition of paying interest on business checking (or "demand") accounts.

Over the years, various legislation has been introduced to repeal Regulation Q, yet has never been passed into law. One of the latest iterations, *The Business Checking Fairness Act*, was introduced in 2009 by Representative Scott Murphy (D-NY), the language of which was amended into the DFA in Conference very late in the process. The provision was subject to neither a hearing nor debate in either the House or Senate, and is now law (Section 627). We strongly urged the Federal Reserve Bank to delay the implementation of this repealer to study the impact of this significant change, but were unsuccessful. The change went into effect on the one year anniversary of passage of the DFA on July 21, 2011.

Impact on Community Banking

Small business relationships are the lifeblood of the vast majority of community banks. And perhaps as importantly, community banks are equally important to the creation, growth and vitality of small businesses across the country. Community banks make a disproportionately large number of loans to small businesses, and provide the "high touch" and flexible financial assistance necessary for this critical sector of the economy. In an economy hungry for job creation, it is crucial to continue this symbiotic relationship.

Small business relationships have formed the core of most community banks' business models. These relationships provided not only the basis for investment back into their respective communities through loans, but also served to provide a stable and significant level of long term funding at a fixed cost.

The longstanding community bank business model is based primarily upon a high level of service and long term relationships, two things community banks excel at when compared to "too big to fail" (TBTF) banks. When interest rates paid on operating deposits is factored in, these core deposits become subject to movement (or "disintermediation") based upon the whims of "the highest bidder", including TBTFs, who can aggressively price and equally aggressively advertise. One could quite easily surmise that these deposits, once moved to a TBTF bank, will likely not be reinvested in the communities from which they were derived. Additionally, it is reasonable to conclude that without the "raw materials" in the form of lendable deposits, along with a disruption in the customer/bank relationship, it will be more problematic for a community bank to provide additional funds to small business borrowers in stressful economic circumstances.

It is clear that already shrinking net interest margins will further contract with the additional competitively driven interest expense on business demand accounts. Enhanced competition from not only the TBTF institutions, but a credit union industry virtually indistinguishable from community banks, and able to operate without commensurate regulatory oversight or taxation, along with an ever-increasing level of regulatory and compliance costs, will further strain community bank profitability going forward.

One of the more positive provisions for community banking in the DFA was the change in the deposit insurance assessment base from domestic deposits to assets less tangible capital. Since community banks overwhelmingly fund their operations with domestic deposits, this was clearly a welcome – and equitable in our assessment – change. Perversely, the changes in the assessment base make deposits a relatively more attractive funding source for the TBTF institutions, thus putting even more pressure on pricing.

Additionally, we have been and continue to be supportive of the Transaction Account Guarantee (TAG) program. This initiative has been a great equalizer, and allowed community banks to compete with the implicit full guarantee of the Federal Government perceived by much of the public for the largest banks. As the TAG program covers only demand – or non-interest bearing – accounts, the migration of business deposits into the interest earning category will again disadvantage community banks vis-à-vis their TBTF competition. As an aside, we are hopeful of an extension of this program prior to the planned expiration at the end of this year.

One of the byproducts of the recent economic downturn has been a regulatory requirement of ever-increasing capital levels. In a difficult economy, bank earnings clearly suffer as has been evidenced over the past several years. Further, a significant portion of a bank's perceived value is related to the level of core deposits. In combination, these two factors will not only reduce the value of the community bank franchise, but make the process of raising additional capital much more problematic.

Other "Unintended Consequences"

Community banks have relied upon this stable source of fixed rate deposits to invest in longer term assets, whether they be loans or securities offerings of local public entities. The change in Reg Q may well create significant safety and soundness concerns as more of the liability portion of the balance sheet becomes interest rate sensitive. Think back to the S&L crisis in the 1980's . . . due to market driven (primarily money market accounts) and legislative changes (the partial repeal of Reg Q interest rate controls), many institutions found themselves funding long term fixed rate assets with volatile and more costly deposit accounts, resulting in a negative spread. Similarly, bank investments in small issuer fixed rate municipal securities, 7 to 10 year fixed rate mortgage loans, intermediate term loans to small business with a fixed rate, etc. will result in a further squeeze when rates "normalize". Further, this dramatic change in funding costs and liability mix will impact the ability of both small municipal issuers and small business borrowers seeking a longer term fixed rate, and will certainly result in higher costs to offset the bank's interest rate risk.

With rates at historically low levels, and absolutely no place to eventually go but up, this dynamic could well create significant stress on a number of community banks over the coming several years.

The level of funding available in the banking system as a whole will be directly reduced. The Federal Reserve Bank requires a "reserve" on transaction (i.e., demand) accounts. This "reserve requirement" is presently set at 10%, and those funds are not available for lending/investment. There are no such requirements on time deposits. We believe this dynamic will reduce the level of lendable funds at a less than optimal time in the economic cycle.

While on the surface, the ability for small business customers to be paid interest appears to be of benefit, there are some clear downsides. The vast majority of banks utilize "account analysis" for business accounts. The cost of transactions and maintenance of the account(s) is detailed, along with the implicit earnings factor of the "free" deposits. The costs – in many cases substantial, based upon the type of business and level of activity – can be offset with the earnings credit from the deposits. Additionally, credit is given on loan rates based upon "compensating" balances. If indeed the bank is driven by competitive factors to pay interest on those deposits, the credit allocated to offset those costs will obviously be lower, resulting in hard costs to the customer, both on the deposit and loan relationship.

Is There a Solution?

Prior to implementation of the repeal of Reg Q, we and others strongly urged the Fed to consider amending Regulation D to increase the number of allowable transactions in a money market account to not more than 30 per month. Legislation (H.R. 2251) to direct the Fed to amend Reg D was filed last summer just prior to the finalization of the rule implementing the statutory change repealing Regulation Q. This would allow those business entities wishing to earn interest on their deposit relationships an alternative to existing (and expensive) sweep accounts – which in most cases take lendable funds out of the community – or for larger commercial customers, overnight repurchase arrangements. Additionally, this option would significantly lessen the impact of the Fed's reserve requirement on demand accounts. We strongly believe that such a reasonable modification would meet the needs of all parties, and not be nearly as disruptive as what we anticipate with the monumental changes subsequent to the Reg Q repeal.

Closing

We recognize that there is disagreement within the banking industry regarding this significant change to our funding structure as community banks. With over 7,000 banking institutions across America, there are many different competitive issues, charter types, economic environments and business strategies. What I can say with certainty is that I believe this 11^{th} hour amendment to a several thousand page bill represents a "sea change" in the fundamental business model of the vast majority of community banks, and will have dramatic and lasting unintended consequences not only on our industry, but will negatively impact the very customers we seek to serve. I would add that the challenges facing our segment of the industry are daunting, and while there appears to be a universal recognition that "community banks are different, and didn't cause or even contribute to the mess we find ourselves in", we continually get "caught up in the backwash" of well-intended regulatory and legislative mandates that increase our costs and make our mission of serving our customers and creating economic activity and jobs more and more difficult. As one of my colleagues states, it's "death by a thousand cuts". We sadly believe that the repeal of Regulation Q, if left in place, will be judged in several years to be one of the most damaging provisions resulting from an economic disaster in which community bankers were as much a victim as anyone.

We believe that there is still a window of opportunity to reverse this damaging amendment, and would urge Congress to fully examine the impact of the repeal of Regulation Q on community banks and the customers they serve. Clearly, the full impact of this draconian change will not be felt by community banks or their customers until we return to a more "normal" interest rate environment. In a perfect scenario, the prohibition on the payment of interest would be reinstated, Regulation D would be amended to provide up to 30 withdrawals per month to provide the needed flexibility for small business customers wishing to earn interest on excess balances, and we would avoid the potentially disruptive and damaging impact of this ill-advised legislation.

Again, I very much appreciate the opportunity to discuss this important issue before this Committee, and would be happy to provide additional information to you or your staff.

Testimony of

Alex J. Pollock
Resident Fellow
American Enterprise Institute

To the Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
U.S. House of Representatives

March 1, 2012

Hearing on the Repeal of Regulation Q

Ending Government Price Fixing in Deposits At Long Last

Madam Chairman, Ranking Member Maloney, and members of the Subcommittee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI in 2004 to work on financial issues, I was the President and CEO of the Federal Home Loan Bank of Chicago for 13 years, and spent in all 35 years working in financial services. In addition, I have extensively studied the history of banking and financial markets.

Last year's repeal of the final remaining vestige of Regulation Q, the prohibition of payment of interest on business demand deposits, at long last completed a pro-competitive process which began with the Monetary Control Act of 1980. The repeal was and is a good idea. We can easily see this by asking and answering half a dozen simple questions, to make the matter clear. These are:

1. Should Congress engage in price fixing to benefit banks?

   Obviously not.

2. Should Congress prevent depositors from getting interest income that banks would be willing to pay?

   Obviously not.

3. Is it the business of Congress to try to prop up banking profits?

   Obviously not.

4. Should Congress force depositors to subsidize borrowers?

   Obviously not.

5. Does Congress know the right price for a business checking account?

   Obviously not.

6. Should Congress promote competition to benefit the customers of banks?

    Obviously, yes.

I am tempted to say "Q.E.D." at this point and stop. But perhaps we do need to consider how Regulation Q, a rule so obviously opposed to competitive economic principles, managed to get enacted and survive, albeit subject to frequent fiddling, for nearly eighty years. The history of Regulation Q displays the folly of such schemes.

What did the Congress of 1933 think it was doing when it created interest rate ceilings on deposits, including a prohibition on paying interest on demand deposits, which became the rules of Regulation Q?

Well, they were trying to reduce competition and thus increase banking profits, goals now rightly out of fashion. As stated by Alton Gilbert, a scholar at the Federal Reserve Bank of St. Louis, one objective was "to increase bank profits by limiting the competition for deposits." In this respect, in other words, they wanted to make bank deposits a government-sponsored cartel, with the Federal Reserve as the cartel manager. So they put the government into the role of price fixing and preventing depositors from getting the interest income they might otherwise have earned.

In the findings of the Monetary Control Act, the Congress of 1980 accurately observed the results of this program, which had by then been clear for a long time: "The Congress hereby finds that limitations on interest rates which are payable on deposits and accounts discourage persons from saving money, create inequities for depositors, impede the ability of depository institutions to compete for funds...."

Another original reason for the ceilings, according to Gilbert, was to address "bank protests about the cost of federal deposit insurance premiums." Federal deposit insurance was also being established in the Banking Act of 1933. "Some members of Congress believed that the savings in interest expense resulting from interest rate ceilings on deposits would exceed the deposit insurance premiums"—an interesting political trade at the time.

Later, in the 1960s, Regulation Q rules tried to direct savings into financing housing, rather than industry and commerce, by giving savings and loans a slightly higher interest rate ceiling than commercial banks had. This was the then well-known and now forgotten "quarter point differential." In spite of this intention, the far bigger effect of the ceiling was to cause housing credit crunches. These happened when market interest rates went over the ceilings and deposits were withdrawn from thrifts, thus cutting off funds from mortgage lending, of which they at the time were the principal providers. This was a severe problem in the credit crunches of 1966 and 1969 and on into the 1970s—a problem caused by Regulation Q.

One regulatory response to this problem was to favor large depositors at the expense of small ones. In 1970, deposits of over $100,000 were made exempt from Regulation Q, while the ceilings remained for the smaller deposits. Thus huge amounts of money were effectively transferred from small depositors to bank profits—a result following logically from the goals of 1933, but clearly a perverse result, and equally perverse, this included transfers from small businesses with checking accounts to bank profits.

Also in 1970, in the Emergency Home Finance Act, Congress chartered Freddie Mac, to provide funding to mortgages unhindered by deposit rate ceilings. There is no need to go into the unhappy history of Freddie Mac and Fannie Mae, but note that Freddie Mac was the son of Regulation Q: one government intervention set up to address the effects of a previous government intervention.

During the 1970s, when I criticized theory and effects of Regulation Q, a banking lobbyist memorably told me, "You have to understand that Regulation Q is so imbedded in the American banking system that it is permanent." A poor prediction, as it turned out, although it took until 2011 for it to be completely falsified.

Because banks were prevented by the government from paying interest on business demand deposits for so long, cumbersome methods were developed to compensate for this regulatory rigidity. The banks would provide "free" payments and operating services because the business customers were providing "free" funding to the bank. This meant each bank had to set a theoretical (and debatable) "earnings credit" for the funds, instead of the interest it might have paid, and the theoretical fees for operating services (or "penny prices") were measured to see how much of the earnings credit they consumed.

In other words, the Regulation Q effect on business demand deposits was to encourage complex implicit pricing arrangements, instead of clear explicit pricing, and large companies employed treasury personnel to track, measure and negotiate these arrangements. This was more difficult for small companies without internal bureaucracies, of course.

Regulation Q also resulted in complicated devices to get around its prohibition. A small business witness testified to the Senate Banking Committee in 2005 that when "I started my first business, I can vividly recall my astonishment at being told that a business could not earn interest on a checking account." Later, "as the business prospered, my banker suggested a 'sweep account.' Boy, was it complicated...a paperwork nightmare." He rightly asked why the government should force this complication on small businesses? Why indeed?

In general, I believe that explicit pricing, or at least the possibility of explicit pricing, i.e. interest rates for funds and cash fees for services, is superior to forcing implicit pricing by regulation. Likewise, allowing straightforward deposit arrangements is better than forcing complicated work-arounds.

Also in general, customers are better served by encouraging competition than by suppressing it. This is especially true for smaller customers who lack negotiating power and are price takers.

To address the specific questions asked by the Subcommittee:

1. Has competition for business checking accounts increased since the repeal of the last vestige of Regulation Q last year? Because the Federal Reserve has manipulated short term interest rates to approximately zero, I would not expect to see major competitive results from the repeal at this point. When interest rates rise, as they inevitably will in time, I believe we will see such increased competition, to the advantage of business customers. Since we are in a time of essentially zero interest rates, this is in fact a good time for the repeal and the transition, so banks can more easily get ready for the post-Regulation Q world.

2. Are you concerned with any unintended consequences? No. There will certainly be consequences not foreseen, because market competition always creates new possibilities and

product variations. Having improvements which are invented by markets, although we could not previously imagine them, is what we want to happen.

3. Will small businesses benefit? I believe they will benefit from more competitive markets. It is a possible argument that Regulation Q caused borrowers to get subsidies from depositors--if it did, these subsidies will be replaced by market prices. Regulation Q certainly caused regulatory subsidies from small business depositors to bank profits, which will be removed. This is a good thing.

4. What are your thoughts about the Federal Reserve's statement that the repeal will provide greater clarity? As discussed above, I believe explicit pricing is indeed clearer than implicit pricing.

It used to be thought that providing checking accounts was the dominant function in funding a commercial bank. But demand deposits had in the past a far greater role in bank funding than they do now. Sixty years ago, banks were heavily funded by these non-interest bearing deposits. Checkable deposits represented about 65% of total commercial bank assets in 1952. At the time of the Monetary Control Act in 1980, this was down to 24%--still big enough to perhaps have persuaded the Congress of that day to leave the price control on business demand deposits in place, while dismantling all the rest of Regulation Q. By 2011, this proportion was further down to only 8.5%.

So for the banking system as a whole, the adjustment to the post-Regulation Q world is much easier than it would have been in past times.

An op-ed writer opined in 2010 that "the nation's bankers, particularly community bankers, now have a golden opportunity. It is the repeal of Regulation Q...that would allow banks to offer their best business customers fairer value for their checking deposits on a fully transparent and more accountable basis than before." This suggests the right kind of attitude for banks to take.

In my opinion, the Dodd-Frank Act had a few good points in it, and the repeal of the last vestige of Regulation Q is definitely one of them.

Thank you again for the opportunity to share these views.

Testimony of John Durrant, Managing Vice President, Small Business Banking
Capital One Financial Corporation

House Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

Hearing Entitled: "Understanding the Effects of the Repeal of Regulation Q on Financial Institutions and Small Businesses"
March 1, 2012

Chairman Capito, Ranking Member Maloney and members of the Subcommittee, I greatly appreciate this opportunity to offer testimony for the record on the issue of Interest Checking for Small Business customers on behalf of Capital One Financial Corporation.

Capital One Financial Corporation (www.capitalone.com) is a financial holding company whose subsidiaries, which include Capital One, N.A. and Capital One Bank (USA), N. A., had $128.2 billion in deposits and $206.0 billion in total assets outstanding as of December 31, 2011. Headquartered in McLean, Virginia, Capital One offers a broad spectrum of financial products and services to consumers, small businesses and commercial clients. Capital One, N.A. has approximately 1,000 branch locations primarily in New York, New Jersey, Texas, Louisiana, Maryland, Virginia and the District of Columbia. A Fortune 500 company, Capital One trades on the New York Stock Exchange under the symbol "COF" and is included in the S&P 100 index.

Capital One applauds the Chair and the Subcommittee for holding this hearing on a topic of great importance to American small businesses, particularly in the face of challenging economic times.

Background to Launch of the Clear Interest Business Checking product (CIBC)

When Regulation Q was first promulgated in 1933, it prohibited Federal-Reserve-System-member banks from offering interest-bearing checking accounts to business customers in an effort to spur the flow of credit. Section 627 of the Dodd-Frank Act that was signed in to law in July 2010 repealed Section 19(i) of the Federal Reserve Act in its entirety, effective July 21, 2011, which made it possible for banks and credit unions to offer interest on demand deposit accounts (DDAs).

With the repeal of the legislation, Capital One recognized an opportunity to better serve the needs of many businesses (generally those with $250K - $2MM in annual sales revenue). Research and customer insights suggested these customers wanted more value out of their banking relationships. We found that their desire for simplicity and worry free banking products was not being well met by existing products in the marketplace. Specifically, there was a substantial gap in product offerings between high cost / high transaction "analysis" checking accounts that pay earnings credit on deposit balances and more basic low cost / low transaction DDA products which did not provide any specific monetary value back to the customer.

To help fill the gap, Capital One launched Clear Interest Business Checking (CIBC) in July of 2011. Capital One believed that the legislative change would enable us to provide incremental value to many small businesses for their primary checking deposits business. The product automatically pays interest on checking balances between $10,000 and $100,000 on a monthly basis. The offering design includes up to 300 free transactions per month, free online banking with bill pay, a free debit card and access to our team of small business specialists. This structure was intended to address our customers' desire for a simple checking account that provides great value without constant management of per transaction fees or the need to frequently transfer balances between accounts. We believed that this product would provide a compelling reason for small businesses to switch to Capital One as their primary bank as well as increase loyalty among existing customers.

Small Business Customer Response

Capital One has been very pleased by the overall reaction to the CIBC product launch from customers, our bankers and industry experts. Small businesses and bankers have shown great enthusiasm for the CIBC product. We believe that the majority of checking accounts in the marketplace prior to the repeal forced a large segment of small businesses into products that either provided little value relative to their deposit levels or failed to deliver on the simplicity and ease desired. Qualitative feedback indicates that the CIBC product effectively delivers the intended combination of value and simplicity that is attractive to many customers.

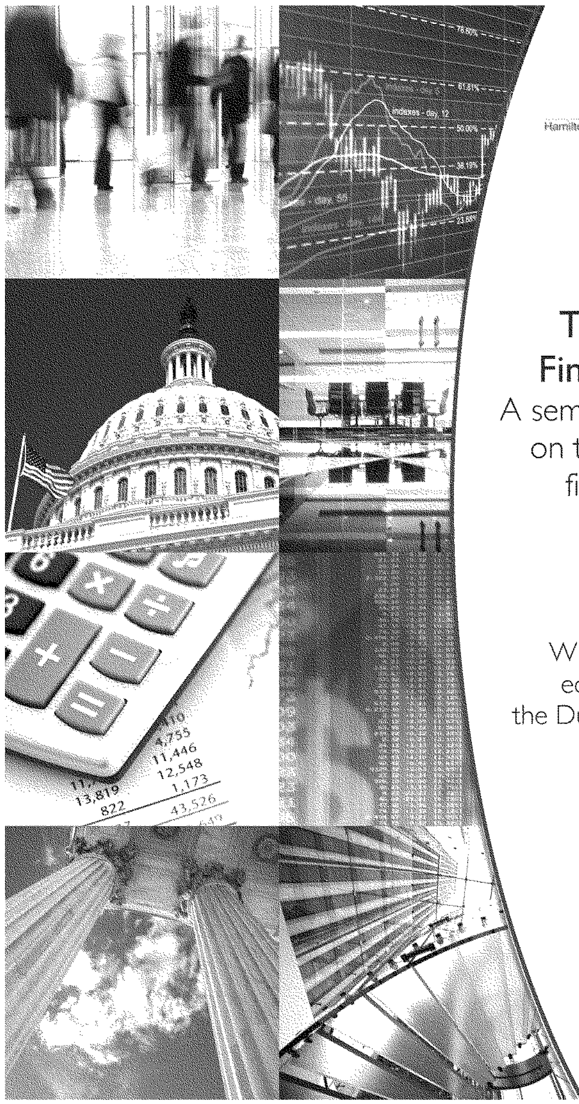
We also believe that the current rate environment is likely to have muted the attractiveness of the CIBC product. While very competitive relative to other offerings, some small businesses have told us that the absolute value generated by the 1.10% introductory rate on the CIBC product is not compelling enough to dislodge them from their current banking provider. As macro economic factors improve and the value of deposits increases, we will continue to evaluate the rates we pay on this product. We expect competition among banks for deposits to increase and could see increased use of products like CIBC in the marketplace.

Future Plans for Interest Checking Products

In this environment where many question the commitment of banks to serve the needs of their customers, we are pleased to offer the CIBC product to small business customers and intend to continue to do so. In addition, over time, we plan to evaluate the expansion for our interest bearing checking accounts across the small business spectrum. Our research suggests smaller businesses (those who keep less than $10,000 in their DDA) would find an interest bearing DDA attractive and larger businesses (those who keep more than $100,000 in their DDA) often seek simpler solution for their checking needs.

* * *

Chairman Capito, Ranking Member Maloney, we thank you for this opportunity to provide testimony to your Subcommittee.



HPS
Hamilton Place Strategies | HPSinsight

The Hamilton Financial Index:

A semi-annual report on the state of our financial services industry

February 2012

With a review of the economic impact of the Durbin Amendment

About Hamilton Place Strategies

Hamilton Place Strategies is a consultancy based in Washington, DC with a focus at the intersection of business and government. HPS Insight conducts in-depth analysis on public policy issues.

This report was prepared under the direction of Matt McDonald, a partner at HPS. Prior to HPS, Matt was a consultant for McKinsey & Co., an aide to President Bush and served as an advisor to senior leaders in both government and business. He received his MBA at the MIT Sloan School of Management and has a degree in economics from Dartmouth College.

Patrick Sims and Russ Grote of HPS conducted the analysis contained in this report.

Introduction

America's financial institutions are significantly safer and stronger than in years past. Both banks and insurance companies are well capitalized, addressing ongoing risks and are in a strong position to deliver value and support to the economy as the recovery continues.

Our financial services often exist as a backdrop to our lives, with not much thought beyond the swipe of a card. We may not realize it, but financial services firms have changed significantly since 2008 and are stronger for those changes. This is not to say that today's economic climate is without challenges. U.S. financial institutions and the global economy are still recovering and there remain issues to work through.

This is the first in a series of semi-annual reports to coincide with the Federal Reserve Chairman's Humphrey-Hawkins testimony before Congress. The aim of these reports is to provide a clear evaluation of the safety and soundness of the financial services sector and the value it provides to the economy during the crisis and the ongoing recovery.

This report introduces the Hamilton Financial Index, a snapshot of both risk in the system and how firms are meeting the challenge. We also look at regulatory issues and the intended and unintended impact on the financial sector and the economy. The regulatory spotlight begins with a look at the outcomes of implementing the Durbin Amendment.

This report has been commissioned by the Partnership for a Secure Financial Future. It was prepared independently by Hamilton Place Strategies, and the conclusions contained in this report are our own.

Hamilton Place Strategies

Matt McDonald
Partner

CONTENTS

Executive Summary

Overall, the financial sector has made remarkable changes to strengthen itself against ongoing risks. It continues to provide robust value to the economy while simultaneously addressing the exogenous economic challenges in the current environment.

The key findings of the report are:

- The new Hamilton Financial Index, which measures the safety and soundness of the financial services industry, has risen since the crisis. It is now 15 percent above normal levels of safety and soundness.

- US commercial banks' Tier 1 Common Capital levels are at an all-time high and the ratio of loans to deposits has declined 20 percent since 2007, pointing to a strong foundation for higher levels of lending.

- Insurance firms' Capital and Surplus are also at all-time highs despite an increase in unexpected expenses from natural disasters in 2011.

- Insurance companies had record payouts to the many individuals who suffered from natural disasters in 2011.

- While business loans have lagged due to a slow recovery, consumer loans increased dramatically during the recession, helping individuals weather the crisis.

- The private sector continued to reduce outstanding debt in 2011, declining 17 percent from the highs.

- The total U.S. retirement market is valued at $17 trillion, an increase of 21 percent since 2008.

- Lastly, our regulatory spotlight found that in the first four months of the Durbin Amendment's implementation, consumers have seen no decline in merchant prices and reduced account benefits from their debit cards. Foreseeable but unintended consequences of this regulation have resulted in a clear loss of value for consumers.

The Hamilton Financial Index:
A Snapshot of Firm and Systemic Risk

What is the appropriate capital level for a financial institution to hold in order to absorb losses resulting from unexpected shocks to the system?

This question comes up frequently and is heavily debated. Industry professionals ask the question from a performance standpoint – what level of capital can we hold, but still remain profitable? At the same time, lawmakers look to regulations to increase industry-wide safety.

It is important that both industry and regulatory leaders come together to figure out what is appropriate, and mitigate any unintended consequences.

Rarely does one look at how much risk there is in the system and compare it to another metric such as capital. More often, they are viewed as separates. However, placing the two together is increasingly seen as a key measurement of the safety and soundness of the financial services industry.

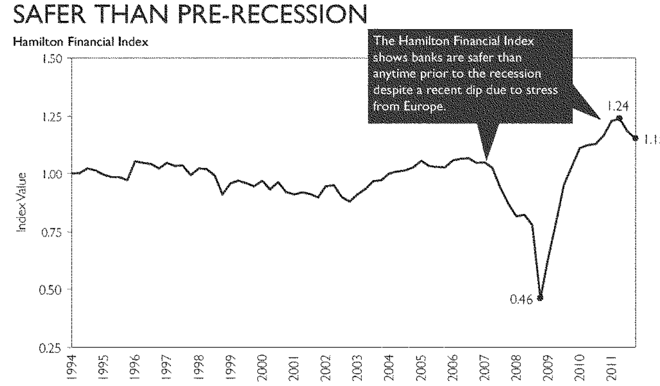
Therefore, the Hamilton Financial Index combines both systemic risk and capital levels into one index to provide a snapshot of the safety and soundness of the financial sector. The results show a significantly safer financial sector with an index value 15 percent above "normal" levels (Exhibit 1).

Key Findings:

- The Hamilton Financial Index combines firm-level and systemic level views of risk to show an overall snapshot of risk within the Financial Services Sector
- The Hamilton Financial Index value exhibited "normal" levels around a value of 1 prior to the financial crisis
- At the end of 2011, the Hamilton Financial Index was at 1.15, dramatically up from crisis levels of 0.46 and 15 percent above even normal pre-crisis levels

Exhibit 1

HAMILTON FINANCIAL INDEX SHOWS BANKS SAFER THAN PRE-RECESSION



Source: HPS Insight, St. Louis Federal Reserve, SNL Financial

Methodology

The Hamilton Financial Index is measured by using two commonly accepted metrics:

1. The St. Louis Federal Reserve Financial Stress Index captures 18 market indicators and is a well-established indicator of financial stress

2. Tier 1 Common Capital Ratio for commercial banks measures financial institutions' ability to absorb unexpected losses in an adverse environment

To get the index value, we simply subtract the quarterly average of the Financial Stress Index from the quarterly Tier 1 Common Capital Ratio for the commercial banking industry. In order to index the values, we used the first time-series data point, the first quarter of 1994, as the divisor for all periods. This set the first data point equal to one. Therefore, all data points are relative to the value of one.

The value of one also happens to be the average of all time periods from the first quarter of 1994 to the fourth quarter of 2011. Observed values around one are consistent with the historical norm of a safe financial industry.

St. Louis Fed Financial Stress Index

The first variable in the Hamilton Financial Index is the St. Louis Financial Stress Index, which combines 18 market variables segmented into three sections: interest rates, yields spreads and other indicators.

Interest rates help determine the market's assessment of risk across a number of different sectors and time periods. High interest rates represent an increase in financial stress. The interest rates in this section are:

- Effective federal funds rate
- 2-year Treasury
- 10-year Treasury
- 30-year Treasury
- Baa-rated corporate
- Merrill Lynch High-Yield Corporate Master II Index
- Merrill Lynch Asset-Backed Master BBB-rated

Yield spreads help determine relative risk across time and space. For example, the Treasury-Eurodollar (Ted) and London Interbank Offering Rate–Overnight Index Swap (LIBOR-OIS) spreads capture risk not just in the U.S., but also throughout the globe. A higher yield spreads suggest greater systemic risk. The yield spreads in this section are:

- Yield curve: 10-year Treasury minus 3-month Treasury
- Corporate Baa-rated bond minus 10-year Treasury
- Merrill Lynch High-Yield Corporate Master II Index minus 10-year Treasury
- 3-month LIBOR-OIS spread
- 3-month (TED) spread
- 3-month commercial paper minus 3-month Treasury bill

Other indicators fill in important pieces not captured by interest rates or yields. The Chicago Board Options Exchange Market Volatility Index captures the market's expectation of volatility with higher volatility associated with increased stress in the financial system. The indicators in this section are:

- J.P. Morgan Emerging Markets Bond Index Plus
- Chicago Board Options Exchange Market Volatility Index (VIX)
- Merrill Lynch Bond Market Volatility Index (1-month)
- 10-year nominal Treasury yield minus 10-year Treasury Inflation Protected Security yield (breakeven inflation rate)
- Vanguard Financials Exchange-Traded Fund (equities)

Each indicator captures an aspect of financial stress within the system with some overlap. Collectively, they provide a snapshot of systemic risk in financial markets.

St. Louis Fed Financial Stress Index										
	2001	2003	2004	2005	2006	2007	2008	2009	2010	2011
High	0.58	0.68	-0.27	-0.68	-0.98	0.40	4.82	3.73	0.56	0.88
Low	0.12	-0.09	-0.65	-0.82	-1.04	-1.12	0.93	0.58	0.18	-0.07
Average	0.28	0.28	-0.44	-0.76	-1.01	-0.48	2.03	1.99	0.34	0.33

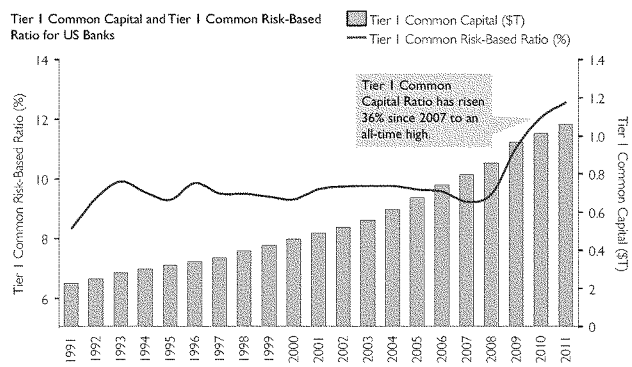
Tier I Common Capital, Risk-Weighted Assets and Tier I Common Ratio

The second variable in the Hamilton Financial Index is the Tier I Common Ratio, which is calculated by taking the industry's Tier I Common Capital (numerator) as a proportion of its Risk-Weighted Assets (denominator). Tier I Common Capital acts as a cushion in case of unexpected losses. Therefore, any increase in Tier I Common Capital (numerator) improves safety and soundness, all else equal. Concordantly, any decreases in the holding of risky assets as measured by Risk-Weighted Assets (denominator) will improve a bank's capital position.

$$\textit{Tier One Common Capital Ratio} = \frac{\textit{Core Equity Capital}}{\textit{Total Risk Weighted Assets}}$$

Exhibit 2

CAPITAL LEVELS AND TIER I COMMON CAPITAL RATIO ARE AT AN ALL-TIME HIGH



Source: FDIC, SNL Financial

Tier I Capital is the core measure of a bank's financial strength from a regulator's point of view. It is based on core capital, which consists primarily of common stock and disclosed reserves. Tier I Common Capital is a more strict measurement than Tier I Capital in that it excludes preferred shares and minority interest, often seen by the industry as non-common elements.[1]

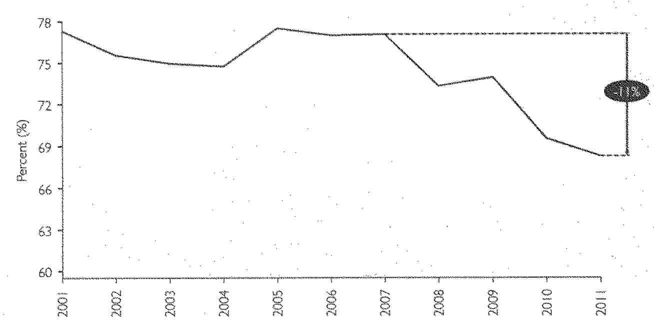
At the end of 2011, the banking industry had an aggregate Tier 1 Common Capital over $1.1 trillion and a Tier 1 Common Capital Ratio of 12.56 percent, an all-time high (Exhibit 2).[2] The ratio boasts a remarkable 36 percent increase from its low-point in 2007, and a 51 percent increase from 1991, the first period on file. This increase follows a steady decline between mid-2006 to the crisis in the fall of 2008.

Along with increases in Tier 1 Common Capital, Risk-Weighted Assets have declined. As a portion of Total Assets, Risk-Weighted Assets have decreased 11 percent since 2007, and continue to trend downward (Exhibit 3). Reduction of risk-weighted assets over the past several years has lead to an overall increase to the Tier 1 Common Capital Ratio.

Exhibit 3

US COMMERCIAL BANKS HAVE REDUCED THEIR HOLDINGS OF RISK-WEIGHTED ASSETS

Risk-Weighted Assets as a Percent of Total Assets for US Banks



Source: FDIC, SNL Financial

Risk-Weighted assets are the portions of assets that are assigned a higher level of credit risk as per regulatory guidelines, and are the denominator in the Tier 1 Common Capital Ratio.

The combination of increased capital levels and reduced risky assets results in less leveraged and safer financial institutions. Per the FDIC's Quarterly Banking Profile (Q3'11), "At the end of the quarter, more than 96 percent of all FDIC-insured institutions, representing more than 99 percent of total industry assets, met or exceeded the quantitative requirements for well-capitalized status."[3]

The combination of increased capital levels and reduced risky assets results in less leveraged and safer financial institutions.

The Hamilton Financial Index Summary

As of the fourth quarter of 2011, the Hamilton Financial Index was valued at 1.15, 15 percent above the historical norm. This value is down from a high of 1.24 in the second quarter of 2011, though significantly higher than the index bottom of 0.46 in the third quarter of 2008.

We can see the decline in safety and soundness prior to the financial crisis. In mid-2007, before both the recession and the financial crisis, the index begins to dip below one. The index value declines to 0.82 in the quarter prior to the collapse of Lehman Brothers in the third quarter of 2008.

> Financial institutions are in a better position today than they were even in the years prior to the crisis.

Unlike prior to the crisis, current capital levels are at an all-time high and stress has been reduced, although not completely. The St. Louis Federal Reserve Stress Index showed higher levels of stress during the debt ceiling negotiations and the European crisis. These events caused the Hamilton Financial Index value to drop, despite high capital levels in recent quarters. If market stress subsides, we expect the index to increase back toward all-time highs.

The Hamilton Financial Index weighs both the level of risk in the financial system and the amount of capital financial institutions hold to deal with that risk. Importantly, it shows that financial institutions are in a better position today than they were even in the years prior to the crisis.

Safety and Soundness:
Foundation for Growth

Bank capital levels and systemic stress indicators provide a helpful look into how effectively financial institutions can mitigate market risk. The Hamilton Financial Index outlined in section one illustrates the achievements of the industry since the crisis.

In addition to these metrics, this section outlines other important indicators that measure the safety and soundness of the financial services industry.

The Loan-to-Deposit (LTD) Ratio measures a bank's liquidity. Our observations of changes in this ratio indicate that the industry is more safely funded by a higher proportion of deposits and less reliant on other borrowings than prior to the crisis. The industry is now more liquid than in years past.

This section also outlines key performance measures for financial services firms, and goes on to evaluate additional metrics for the insurance industry, namely Property & Casualty (P&C) and Life & Health (Life) sectors. Observations in these industries also indicate a strong recovery, and in some cases, the data illustrates that the industry is in better shape than in pre-crisis periods.

Key Findings:

- Banks' core funding has increased as Loan-to-Deposit ratios has fallen 20 percent since 2007
- Property and Casualty and Life Insurers have increased their Capital and Surplus levels 16 percent and 25 percent respectively, since 2008
- US financial institutions have significantly reduced their exposure to Europe's periphery during 2011, including a 34 percent reduction in exposure to Spain

Finally, this section details potential impediments to growth and stability, addressing the impact of catastrophic events on the insurance industry, deterioration of asset quality in bank lending and financial institution exposure to the European crisis.

Overall, the current snapshot of the financial sector shows the industry moving quickly in the right direction to protect all of us from further shocks.

Loan-to-Deposit (LTD) Ratio

How banks and financial institutions receive their funding is an issue that receives constant attention, and rightly so. In the event of a liquidity crisis, the ability to fund operations bears the key to survival. Liquidity was a central challenge for firms during the 2008 crisis. A simple examination of the banking industry's LTD Ratio is a common measure of liquidity.

The LTD Ratio assesses a bank's liquidity. Deposits are considered the core funding of a bank's operation. Therefore, a higher LTD ratio means that a bank might not have enough liquidity to cover any unforeseen fund requirements. A lower ratio may indicate that a bank is not earning as much as it could. Balance is necessary.

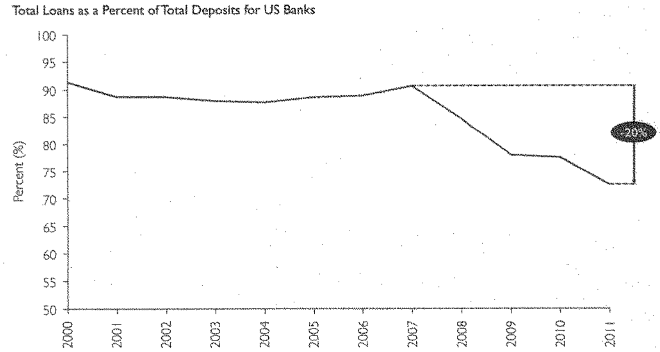
In regards to liquidity, banks are now in a much safer place and poised to lend at higher levels as the economy grows.

From 2000 to 2008, the banking industry had an average LTD Ratio of 88.58. It reached its peak in 2007 at 90.65. Due to an increase in deposits and lower amount of loans, the ratio now sits at 72.53, a 20 percent decrease from pre-crisis highs (Exhibit 4). In regards to liquidity, banks are now in a much safer place and are poised to lend at higher levels as the economy grows

Exhibit 4

CORE FUNDING INCREASES AS LOAN-TO-DEPOSIT RATIO FALLS 20% SINCE 2008

Total Loans as a Percent of Total Deposits for US Banks



Source: FDIC, SNL Financial

Insurers' Capital & Surplus (C&S)

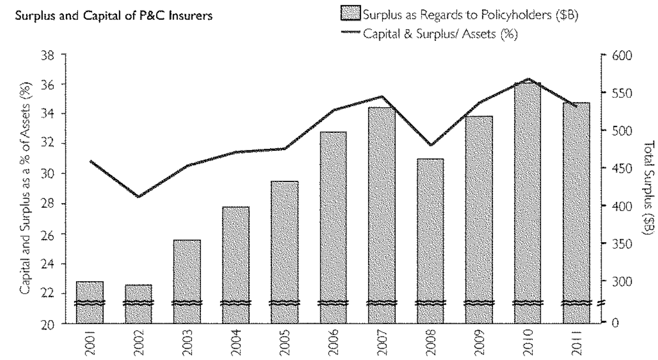
Although the financial crisis affected banks more than most industries, the insurance industry also suffered due to the market downturn. At the time of the financial crisis, outside of insurance companies with a high degree of exposure to mortgage securities, such as AIG, the U.S. International Trade Commission considered the insurance industry "...one of the healthier subsectors of the financial institutions industry."[4]

One commonly accepted way to measure the capitalization of the insurance industry is with the metric Surplus as Regards to Policyholders, known as Capital and Surplus (C&S). The Property & Casualty Insurance sector (P&C), which includes reinsurance companies, maintains high C&S levels despite a series of catastrophic events in 2011 caused by natural disasters. As of the third quarter, the aggregate Surplus value was $535.4 billion, a 16 percent increase compared to 2008 when it was at $461.8 billion (Exhibit 5).

Given the nature of the industry, the Life Insurance sector (Life) had less exposure to losses from catastrophic events in 2011. As of the third quarter of 2011, the Life Insurance sector had C&S of $313.6 billion, the highest on record. Moreover C&S as a percentage of assets bounced back rapidly during the crisis and currently stands 12.5 percent above the crisis low-point and slightly above its pre-crisis levels (Exhibit 6).

Exhibit 5

P&C INSURERS REBOUNDED QUICKLY FROM THE RECESSION, AND NEVER FELL BELOW 2002 LEVELS

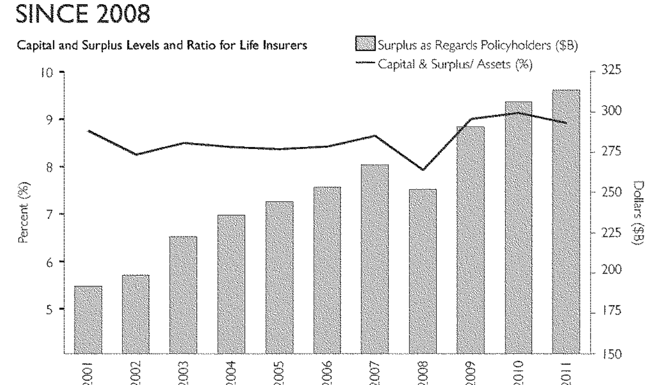


Source: NAIC, SNL Financial

Surplus as Regards to Policyholders represents the difference between the statutory admitted assets and the statutory liabilities. Surplus is viewed as the net financial resources available to support growth.

Exhibit 6

LIFE INSURERS CAPITAL AND SURPLUS HAS RISEN SINCE 2008



Source: NAIC, SNL Financial

Rebound in Performance

Beyond capital levels, commercial banks' and insurance companies' market performance is critical to ongoing safety and soundness. Improved performance allows banks to raise more equity. And, if a financial institution can more easily raise capital, it will be able to provide more lending to businesses and consumers.

Improved performance allows banks to raise more equity. And, if a financial institution can more easily raise capital, it will be able to provide more lending to businesses and consumers.

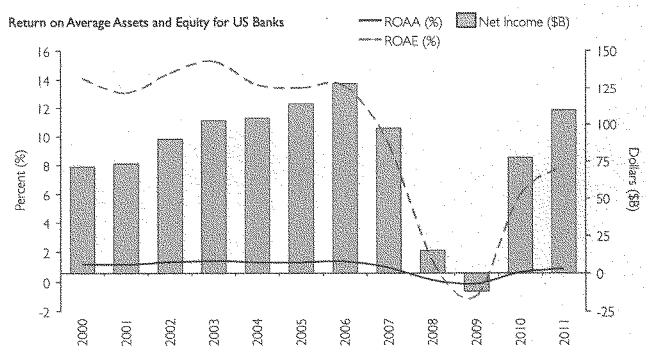
Bank Net Income, Return on Average Assets (ROAA) and Equity (ROAE)

The banking and insurance industries are not only well capitalized, but their ability to increase net income provides extra cushion in the event of an unexpected crisis.

For banks, 2008 and 2009 were frightful times. Bank Net Income took a nosedive in 2008, going from $97.5 billion in 2007 to just $15.1 billion in 2008. While still profitable in 2008, the industry eventually took on the full-effect of the financial crisis and saw red in 2009 with a Net Income of negative $11.7 billion. Since then, the industry's recovery is well underway. Bank Net Income in 2010 was $77.6 billion and $109.6 billion in 2011, just shy of its 2005 level (Exhibit 7).

Exhibit 7

PERFORMANCE MEASURES BOUNCED BACK QUICKLY FROM 2009 LOWS



Source: FDIC, SNL Financial

Insurance Net Income, Return on Average Assets (ROAA) and Equity (ROAE)

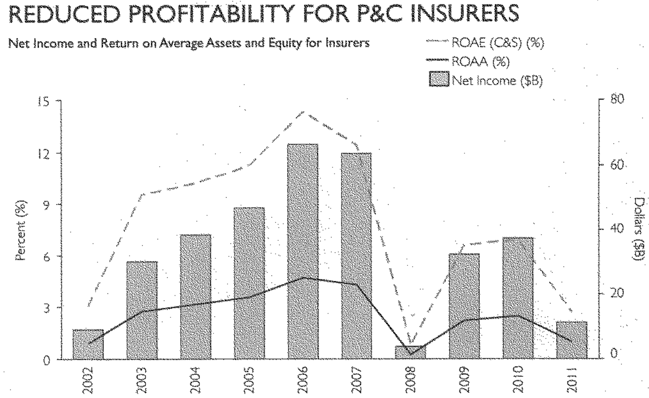
P&C Insurance Net Income also took a major hit in 2008. As previously discussed, the insurance industry's operations differ from that of banking (lending), and therefore the P&C industry did not experience a Net Income loss from the financial crisis.

The industry did, however, see Net Income plummet from $63.6 billion in 2007 to just $3.7 billion in 2008 due to losses in investment holdings. The industry began to recover in 2009 and 2010, with Net Income of $32.2 and $37.2 billion, respectively. Following that, 2011 was a year filled with catastrophic events on a historic and global scale that eroded insurers' earnings. While still profitable and above crisis levels, 2011 Net Income is well below pre-crisis levels (Exhibit 8).

Exhibit 8

DESPITE A STRONG REBOUND, DISASTERS IN 2011 REDUCED PROFITABILITY FOR P&C INSURERS

Net Income and Return on Average Assets and Equity for Insurers



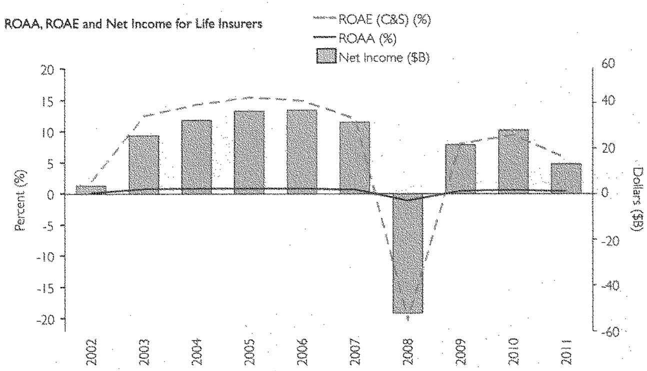
Source: NAIC, SNL Financial.

While the P&C sector's income remained positive in 2008, the Life sector did not. Industry Net Income dropped to a negative $52.3 billion in 2008 from a positive $31.6 billion in 2007. The recovery took place in 2009 with Net Income roaring back to $21.5 billion and again to $28.0 billion in 2010 (Exhibit 9). Volatility in the markets contributed to lower earnings in 2011, but the industry is expected to stay profitable and stable based on strong balance sheet fundamentals cited above.[5]

Exhibit 9

RETURNS AND NET INCOME HAVE IMPROVED SINCE 2008 FOR LIFE INSURERS

ROAA, ROAE and Net Income for Life Insurers



Source: NAIC, SNL Financial

Potential Roadblocks to Growth and Stability

Based on the Hamilton Financial Index and the supplementary metrics outlined in this section, the financial services sector has improved its balance sheet and is in a significantly better position to absorb any unexpected shocks.

While these indicators are useful in providing a high-level view of systemic risk, we can also look more closely at the performance of assets on a bank's books and gauge the amount of risk still in the system.

Outlined below is an examination of the potential impact of catastrophic events, noncurrent loans, specifically in real estate, and the European debt crisis on the financial industry. While these risks are important to monitor, as discussed above, financial institutions' ability to handle shocks has never been better.

Catastrophic Events

Losses associated with tornados in the South and Midwest were labeled by the Insurance Information Institute as the fifth-costliest catastrophic event in U.S. history. Hurricane Irene and several other natural catastrophes across the globe, such as the Japanese earthquakes, also contributed to the highest combined losses in industry history.

While these risks are important to monitor, as discussed above, financial institutions' ability to handle shocks has never been better.

Industry losses were relatively offset by the large amount of premiums being written, but it was nonetheless a tumultuous year of natural disasters.

A year-end industry report by Fitch Ratings, a global credit ratings agency, stated that events in 2011 led to the highest loss experienced since 2005, the year of Hurricanes Katrina, Rita and Wilma. Still, the industry is expected to recover in 2012 through a return to underwriting discipline and improved earnings. Fitch assigned the P&C industry a "stable" outlook.[6]

Asset Quality – Noncurrent Loans & Charge-offs

At the beginning of the 2008 financial crisis, loans with poor credit quality began to default, and banks began to face liquidity and solvency issues. While the Troubled Asset Relief Program (TARP) has turned a profit for taxpayers and helped rid banks of many risky assets, the sluggish recovery has continued to take a toll on the quality of loans. More specifically, as housing prices continue to fall wiping out home equity, unemployment and stagnant wages make it difficult for individuals to pay debts.

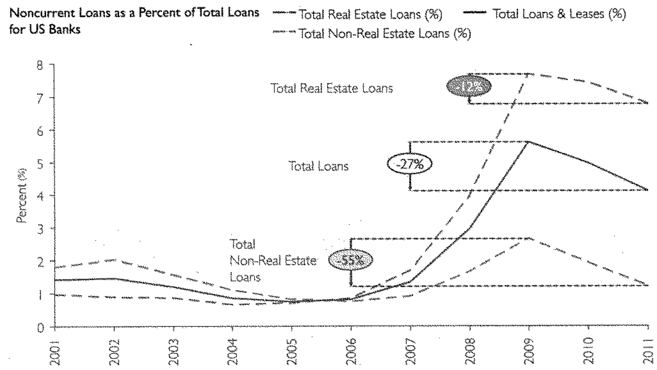
Therefore, a continued concern is whether a significant amount of these loans may still be on banks' books. We can look at some aggregates to partially gauge banks' success in cleaning up their balance sheets.

The industry measures the amount of loans at risk of defaulting by calculating the amount of Noncurrent Loans as a percent of Total Loans. Noncurrent Loans are loans that are behind on the payment schedule and are at greater risk for default.

As a portion of Total Loans, Noncurrent Loans were at a low of 0.75 percent in 2005. In 2008 the industry reached a point where the ratio was closing in on three percent, a level not seen since the early 1990s when the banking industry was recovering from the Savings and Loan Crisis of the late 1980s (Exhibit 10).

Exhibit 10

NONCURRENT LOANS AS A PERCENT OF ALL LOANS ARE IMPROVING ACROSS THE BOARD



Source: FDIC, SNL Financial

$$\text{Percent of Noncurrent Loans} = \frac{\text{Loans} > 90 \text{ days past due} + \text{Nonaccrual Loans}}{\text{Total Loans}}$$

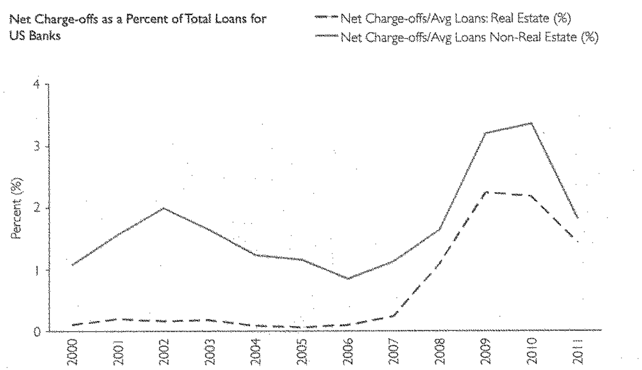
2009 was the peak of distress and Noncurrent Loans represented 5.6 percent of Total Loans outstanding. As banks began to work through these loans by restructuring and charge-offs, the industry began to recover. As of the end of 2011, the percent of Noncurrent Loans sits at 4.1 percent, a 27 percent decrease from the 2009 high.

Although the level of Real Estate Loans that are Noncurrent is also below the 2009 highs, the overall level still remains above industry norms. These loans have only been reduced by 12 percent from their peak and still stand well above pre-crisis levels at 6.8 percent.

Moreover, Charge-offs on these types of loans never reached the level of Non-Real Estate Loans. These aggregates suggest that banks, while making progress, are still exposed to risks in this market (Exhibit 11).

Exhibit 11

TOTAL CHARGEOFFS AS A PERCENT OF TOTAL LOANS PEAKED IN 2010



Source: FDIC, SNL Financial

Net Charge-offs (NCOs) are the dollar amount representing the difference between gross charge-offs and any subsequent recoveries of delinquent debt.

$$Percent\ of\ Net\ Charge\ offs = \frac{Net\ Charge\ offs\ of\ Loans}{Average\ Loans}$$

In sum, the aggregates suggest that banks have worked through some of the bad loans on their books, but high levels of Noncurrent Real Estate loans show there is still exposure.

European Distress – U.S. Exposure to Europe

Although U.S. financial institutions have begun to pave a path to recovery, it is possible that over-exposure to European debt could lead to financial contagion in the event of a significant crisis.

Beginning in 2010, Greece's sovereign credit rating was downgraded by several ratings agencies. Sovereign credit ratings of several other European countries were also downgraded, namely those of Portugal, Ireland, Italy and Spain. Other countries around the globe also saw their sovereign credit rating downgraded, including the U.S.

U.S. banks have altered their portfolios to reduce their exposure to Europe's risky assets.

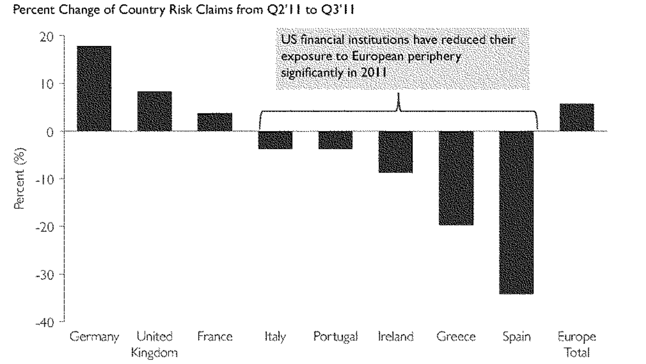
A number of actions have been taken place in recent periods to reduce both the likelihood and magnitude of a potential contagion event. While the European Central Bank and the International Monetary Fund have extended liquidity to help calm markets and avoid bank runs, U.S. banks have also altered their portfolios to reduce their exposure to Europe's risky assets.

While U.S. banks have *increased* their exposure to European countries by nearly 5.6 percent over the past quarter and nearly 10 percent since the start of 2011, U.S. banks have *decreased* exposure to the troubled periphery (Exhibit 12). The increase in exposure is focused on a few targeted countries, particularly Germany and Switzerland. Decreases occurred in Portugal (3.8 percent), Italy (3.8 percent), Ireland (8.7 percent), Greece (19.7 percent) and Spain (34.2 percent), among a host of others. Exposure to Spain saw the largest percentage decrease as of the third quarter of 2011.[7]

Exhibit 12

US FINANCIAL INSTITUTIONS HAVE REDUCED EXPOSURE TO THE EUROPEAN PERIPHERY

Percent Change of Country Risk Claims from Q2'11 to Q3'11



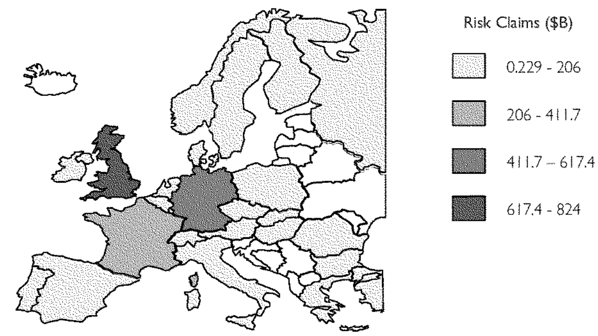
Source: FFIEC, HPSInsight

Switzerland and Germany are seen as Europe's safe havens. A flight to safety occurred over the last quarter as banks increased their exposure to these countries by 61.2 percent and 18 percent, respectively. The United Kingdom also saw a positive change of 8 percent (Exhibit 13).

Overall, exposure to Greece is small. U.S. commercial banks have roughly 100 times less exposure to Greek risk claims than they do the United Kingdom. In fact, of total U.S. bank exposure to European claims; Germany, France and the United Kingdom account for 68 percent, while Greece accounts for less than 1 percent.

Exhibit 13

US BANKS HAVE LESS EXPOSURE TO THE EUROPEAN PERIPHERY THAN CORE



Source: FFIEC, HPSinsight

Data on non-U.S. exposures are reported on the Country Exposure Report (FFIEC 009). All data are on a fully consolidated basis and cover 71 U.S. banking organizations (including U.S. holding companies owned by foreign banks, but excluding U.S. branches of foreign banks). Respondents may file information on a bank only or consolidated bank holding company basis.

The group of institutions responding to the quarterly survey consists of a panel of 71 U.S. banking organizations each holding $30 million or more in claims on residents of foreign countries.

Safety and Soundness Summary

Our analysis shows that while people may not be aware of the changes that have taken place, banks as well as insurance companies are significantly safer than in the years leading up to the crisis. The Hamilton Financial Index shows significant improvement. Loans and deposits have returned to healthier levels. Insurance companies, which were strong throughout the crisis, now have historically high C&S ratios despite record payouts for P&C insurers.

The financial services sector is still working through troubled loans, and the European crisis continues to threaten recovery. While these concerns should be noted, the industry is clearly moving in the right direction and is stronger than any time in recent history.

Value to the Economy:
Safe Haven During the Recession

The value of financial services is so integrated into our everyday lives that we often forget how highly developed and beneficial our system has become. In 1995, only 17.7 percent of households owned a debit card. Today, over 76 percent of households have cards[8]. Online banking was negligible ten years ago. Now, consumers have the ability to check balances and deposit checks on their smart phones. We've come a long way in a short amount of time.

Beyond consumer banking, the financial services sector contributes in a host of ways. Apple's global supply chain needs banks to manage their foreign exchange. Our favorite time-waster, Zynga (gaming), requires an investment bank to underwrite its IPO so that it can raise more capital for a better version of Words with Friends. Insurance products are widespread and can protect our homes, cars and loved ones from unexpected tragedies. Retirement security has increased dramatically with the rise of new fund types, better life insurance and accessibility to expert advisory services.

Key Findings:

- Deposit accounts acted as a shelter during the recession as total deposits increased 25 percent from 2008 to 2011
- Property & Casualty Insurers paid a record $350 billion annualized in claims through the third quarter of 2011, helping people cope with disasters
- The total U.S. retirement market reached $17 trillion by the third quarter of 2011, 21 percent above 2008 levels

Covering all the benefits of modern financial services would take a library to explore. For this report, we will focus on the core functions of financial services:

- Serving as a financial shelter
- Extending credit to businesses and individuals
- Insuring against risks
- Saving for the future

Financial Shelters

The primary function of a bank is lending. In order to lend, banks take deposits; and in times of economic distress, these deposits are a shield from market volatility for individuals. Our analysis of the volume, composition and growth rates in deposits shows that U.S. bank deposits are seen as a safe haven in volatile times.

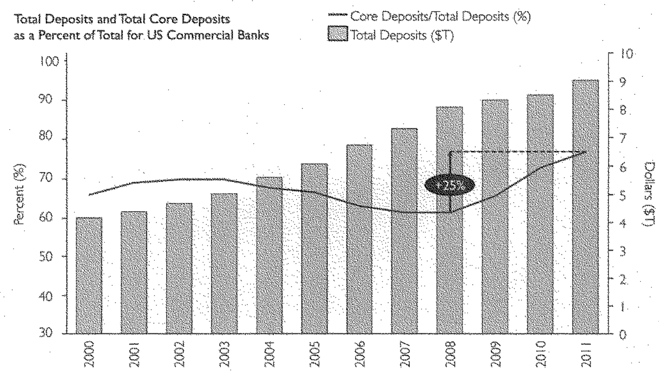
Deposits as a Flight to Safety

In the fall of 2008 the FDIC took steps to shore up the safety of consumer deposits by temporarily increasing insurance coverage up to $250,000 per depositor. In the spring of 2009, Congress extended the $250,000 insurance coverage through 2013; and in the summer of 2010, the extension became permanent. Even further, the Dodd-Frank Deposit Insurance Provision states that the FDIC will insure unlimited deposit amounts in non-interest bearing accounts until the end of 2012.

Although the crisis has been quelled and strengthening the recovery is now the foremost issue, bank deposits are still increasing. Per 2011 year-end filings, bank deposits grew 8.5 percent to roughly $9.04 trillion from 2009 to 2011(Exhibit 14).

Exhibit 14

DEPOSITS CONTINUED TO CLIMB THROUGHOUT THE RECESSION AND RECOVERY



Source: FDIC, SNL Financial

Many industry observers attribute the rise in deposits to a reaction to stock-market volatility, and see the increase in U.S. bank deposits as a flight to safety. There are several types of deposits that make up the total composition of deposits. The bulk of the deposit base is known as "core deposits." These deposits are made up of accounts holding $250,000 or less, excluding brokered deposits. These deposits are seen as highly liquid. Clients can add or withdraw with ease, and they cost little for a bank to hold. Core deposits are the basis for lending.

The ratio of core deposits to total deposits was at a decade low of 61.4 percent in both 2007 and 2008. Core deposits at 2011 year-end now represent nearly 76.8 percent of the total amount for U.S. banks. There is no question that economic volatility and the increase in FDIC insurance coverage have influenced these values.

The market is giving the financial services industry a vote of confidence with regard to safety.

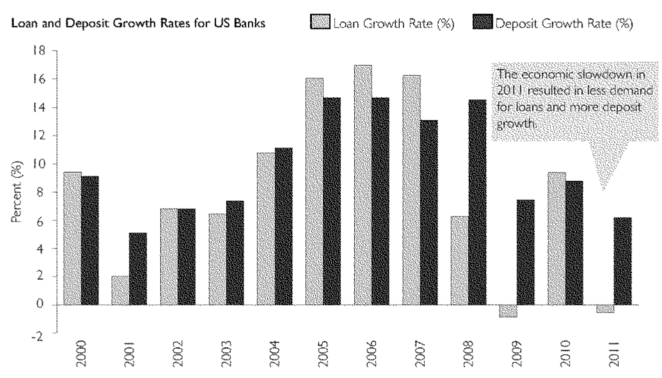
Although the increase in core deposits is a sign that individuals and businesses are taking less risk, it speaks well of U.S. banks, as the market is giving the financial services industry a vote of confidence with regard to safety.

Deposit and Loan Growth Rates

The dynamics between loan and deposit growth rates further illustrate the role deposits played during the crisis. The negative loan growth rate for 2009 and continued growth of deposits reflects the U.S. economic contraction. Loan growth was strong in the years leading up to the crisis, topping out at 16.98 percent in 2006 and 16.26 percent in 2007. In fact, loan growth outpaced deposit growth in both years (Exhibit 15).

Exhibit 15

LOAN AND DEPOSIT GROWTH RATES BOUNCE BACK POST-RECESSION



Source: FDIC, SNL Financial

During the financial crisis, this relationship reversed. Loan growth slowed to 6.23 percent in 2008, and then collapsed in 2009 to negative 0.83 percent. After an increase in 2010, loan growth dipped slightly throughout 2011. Meanwhile, the deposit growth rate increased over 14 percent in 2008 and stayed positive through 2011.

As the economy continues to recover and loan demand increases, the rise in deposits will position U.S. banks to increase lending at growth rates seen in the years prior to the crisis.

Providing Credit

While banks safeguard money through deposits, which are insured up to $250,000, their primary purpose is to route savings into investments. By collecting small pools of idle money and lending to consumers and businesses for investment, banks solve a major coordination problem in economies. On the consumer side, loans are available for buying homes, purchasing automobiles and obtaining the necessary funds for education. Businesses use loans to aid in growth and expansion.

Acting as boosts when the economy is growing, credit can also be a lifeline when the economy is faltering. An existing company may request a loan for the necessary funds to weather a crisis. Individuals may draw on credit to bridge financing gaps for essential needs.

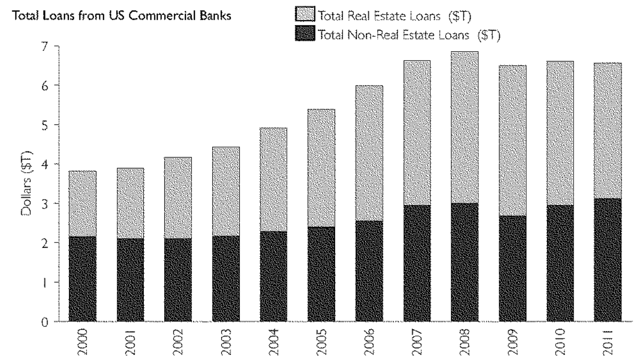
However, as credit helps to support an economy, high debt levels can endanger an economy. Prior to the recession, the U.S. private sector built up tremendous debt levels that left families and businesses underwater when the economy collapsed. This section will examine both the levels of credit provided to businesses and consumers, as well as private sector debt levels to evaluate the overall health of commercial banks' credit provision.

Total Loans

Total loans and leases for 2011 year-end were over $6.6 trillion, just below $6.84 trillion in 2008 but above 2009 levels.

Exhibit 16

REAL ESTATE LOANS HAVE CONTINUED TO FALL WHILE OTHER LOANS HAVE GROWN

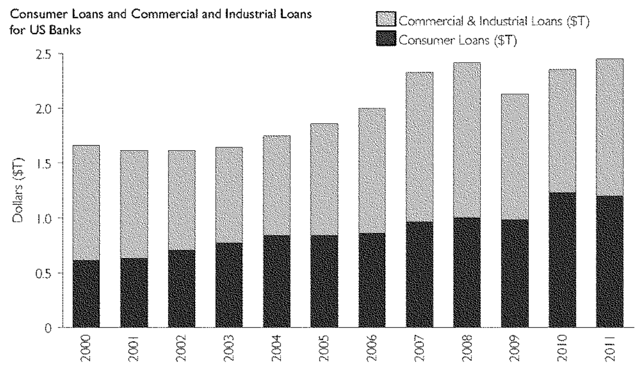


Loans outlined in Exhibit 16 are broken down into two main categories: Real Estate and Non-Real Estate. Given the weakness of the housing market, Real Estate loans have continued to decline. Meanwhile, Non-Real Estate loans rebounded quickly and are now above pre-recession highs. At the end of 2011, commercial banks held $3.1 trillion of Non-Real Estate loans, up from $2.7 trillion in 2009 and the pre-recession peak of $3 trillion in 2008.

A deeper examination of Non-Real Estate loans shows that consumer loans have been the main driver of growth (Exhibit 17). The two main categories of Non-Real Estate loans are Commercial and Industrial loans and Consumer loans. Consumer loans increased above pre-recession highs in 2010 and have slightly dipped in 2011. This trend within consumer loans is explained by the rise in credit card loans (Exhibit 18).

Exhibit 17

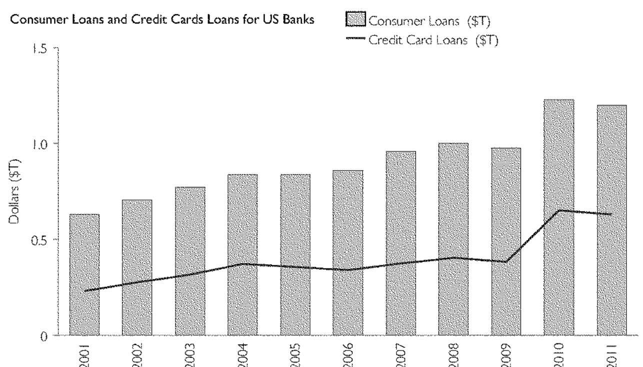
CONSUMER LOAN GROWTH HAS DRIVEN NON-REAL ESTATE LOANS TO NEW HIGHS



Source: FDIC, SNL Financial

Exhibit 18

CONSUMER CREDIT WAS EXTENDED TO AN ALL-TIME HIGH DURING THE RECESSION



Source: FDIC, SNL Financial

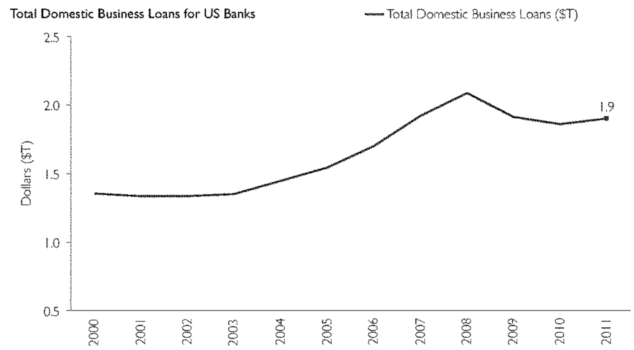
This breakdown shows the role U.S. commercial banks play during a recession. Individuals still have bills to pay and families to feed. With reduced income, individuals require credit to get over the hump in bad times, and data shows U.S. commercial banks have dramatically increased credit to those in need. In fact, credit card loans rose to an all-time high over 2009 and have decreased as the economy slowly recovers.

Business Loans

As detailed above, a recession followed by a slow recovery will reduce the demand for business loans. Total business loans are trending up but have not quite reached their pre-recession peak (Exhibit 19).

Exhibit 19

TOTAL DOMESTIC BUSINESS LOANS HAVE INCREASED IN 2011 TO $1.9 TRILLION



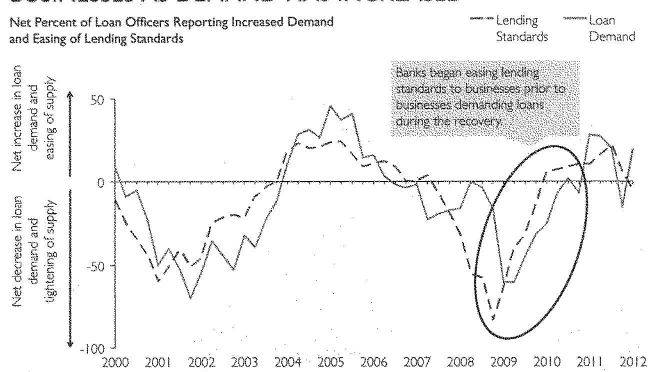
Source: FDIC, SNL Financial

This lag is a function of the economy. For medium and large firms, loan officers reported less demand for loans throughout the crisis (Exhibit 20). Meanwhile, more loan officers reported that lending standards remained eased prior to the collapse and before the rise in demand. These measures suggest that while U.S. commercial banks responsibly tightened lending during the economic recession, lending standards tightened after demand fell and eased before demand rose. Thus, U.S. commercial banks remained supportive to U.S. business borrowing needs.

Exhibit 20

BANKS HAVE EASED LENDING STANDARDS FOR BUSINESSES AS DEMAND HAS INCREASED

Net Percent of Loan Officers Reporting Increased Demand and Easing of Lending Standards



Source: Federal Reserve Senior Loan Officer Survey

Spotlight: Support for St. Paul Stamp Works

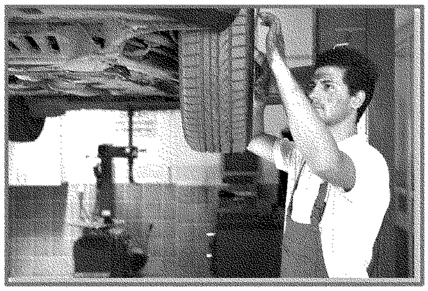
America's small businesses rely on the financial sector for support, regularly seeking loans they need to grow and hire. Consider St. Paul Stamp Works, a fifth generation small business in Minnesota that locals go to for their stamping, embossing and printing needs.

St. Paul Stamp Works' current President is 62-year-old Ed Mellgren, a direct descendent of the Scandinavian immigrant who founded the company 140 years ago. "I'm convinced you need to have a good relationship with your bank," he says, referring to his lender, U.S. Bank, a subsidiary of Minneapolis-based U.S. Bancorp. "They have always been there and always provided financing for us, even in 2008 and 2009."

Recently, Mellgren used a U.S. Bank loan to purchase a laser cutter and high-tech digital printer that has helped the company cut costs and hire three new workers. He says that although profitable and financially sound, the company sometimes needs loans when its cash is not in a readily available form. Mellgren's relationship with U.S. Bank proved fruitful, as his business was able to receive loans during the economic downturn.

Mellgren also offers high praise for Milwaukee-based Northwestern Mutual Life Insurance Corp. Securing life insurance has given Mellgren and others peace of mind that the family business will have the necessary funding to continue in the event of an unexpected illness or death. The comfort in knowing that future events will not bankrupt the business allows St. Paul Stamp Works to focus on enhancing their products and growing its customer base.

Small Business Lending



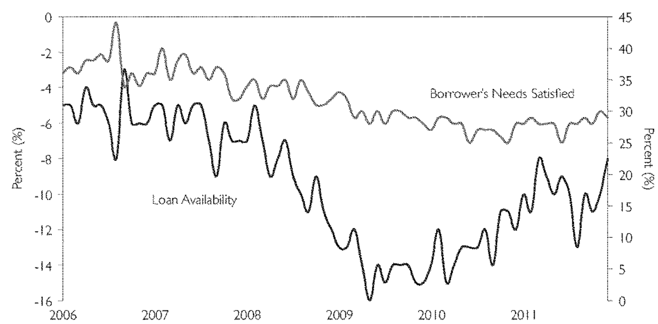
In the fourth quarter of 2011, the Thomson Reuters/Paynet Small Business Lending Index jumped to levels not seen since the beginning of 2008. Similar to medium and large firm lending, small business lending increased slowly during the recession. But, like large and medium firms, our analysis of the Federal Reserve's latest Senior Loan Officer Survey shows that lending standards have eased faster than loan demand has increased.

Surveys of small business owners also report greater levels of borrower satisfaction and loan availability as the economy has recovered (Exhibit 21).

Exhibit 21

SMALL BUSINESSES LOAN AVAILABILITY AND BORROWER SATISFACTION ARE TRENDING UP

Net Small Business Owners Responding Loan Availability is Increasing vs. Decreasing and That Borrowing Needs Are Satisfied



Source: NFIB Small Business Optimism Survey

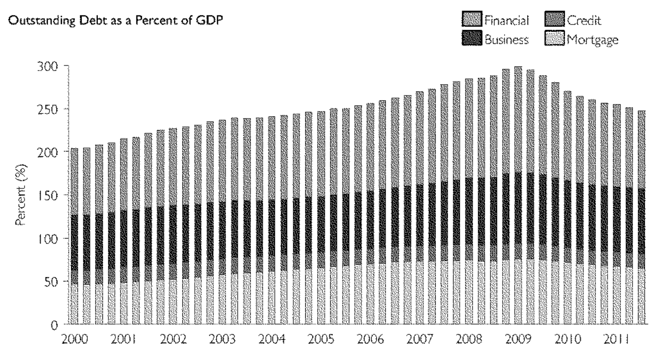
Private Sector Debt Level

As detailed above, while overall lending is still down from pre-recession levels due to reduced demand in the housing market, U.S. commercial banks are still providing credit in the form of business and consumer loans. The extension of consumer credit has been remarkable during the recession. However, recent experience shows that while lending and credit can finance booms, too much can make for painful busts. Prior to 2008, private sector debt levels rose to unsustainable levels. Therefore, rather than just tracking the level of credit provision, it is important to monitor private sector debt levels to see the overall health of this sector. Our analysis shows that the U.S. private sector continues to deleverage, albeit at a slower pace over the past year (Exhibit 22).

> The U.S. private sector continues to deleverage albeit at a slower pace over the past year.

Exhibit 22

PRIVATE SECTOR DEBT HAS DECLINED SIGNIFICANTLY SINCE ITS 2009 PEAK



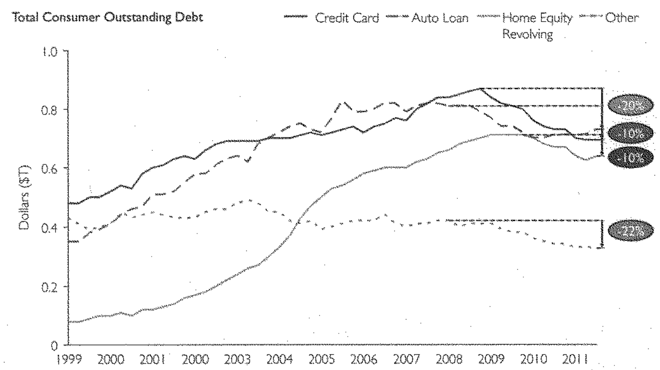
Source: Federal Reserve Flow of Funds

Outstanding debt in the financial and non-financial business sectors is down 26 percent and eight percent since their respective 2009 peaks. On a consumer level, total outstanding debt is down 11 percent from its peak in 2008, according to the New York Federal Reserve Consumer Credit Conditions.

Moreover, this decline extends throughout various loan types such as auto, home equity and credit card (Exhibit 23). Mortgage and home equity outstanding debt are down 10 percent from their peak, credit card debt is down 20 percent, auto loan debt is down 10 percent and other non-student loan categories are down 22 percent from their respective peaks. These numbers suggest that individual balance sheets are stronger on the liability side. While an estimated 60 percent of this reduction is due to defaults, the scope and magnitude of deleveraging are promising. In fact, a McKinsey Global Institute study recently found that the United States has reduced its overall debt burden (including federal government debt) more than Germany, France and the United Kingdom.[9]

Exhibit 23

PRIVATE SECTOR CONTINUES TO SHED NON-MORTGAGE DEBT SINCE RECESSION

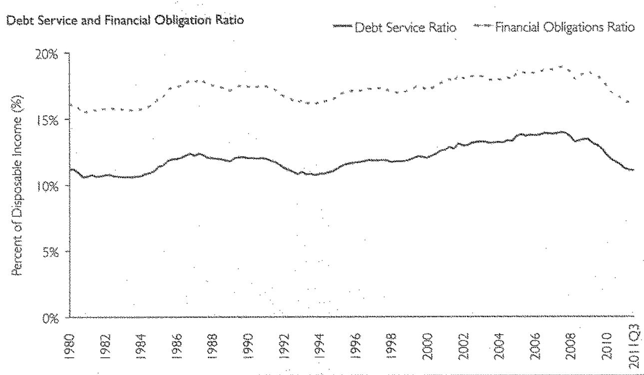


Source: NY Federal Reserve

While debt is down, unemployment is up and wages are stagnant. These dynamics may have counteracted individuals' debt reduction over the past several years. Yet, there is a third variable: interest rates. Interest rates have plummeted during the recession and the subsequent stagnant recovery. Individuals have been able to refinance into lower rates across a number of debt instruments. The ability to refinance lowers monthly payments. In fact, on average, individuals now face the lowest monthly payments as a percentage of their income since the early 1990s (Exhibit 24).

Exhibit 24

MONTHLY DEBT AND FINANCIAL OBLIGATIONS ARE AT EARLY 1990 LEVELS



Source: Federal Reserve

The debt service ratio is the amount of monthly debt service as a percentage of personal disposable income. The financial obligations ratio adds rent, homeowner's insurance, property tax and auto payments. Both are down to 1994 levels as of the third quarter of 2011.

These trends suggest that the private sector has adjusted since the recession. Debt levels are falling and monthly debt burdens are at historic lows. Healthier household balance sheets improve the safety and soundness of the financial sector as well as lay the foundation for future credit provision in two ways: 1) Outstanding loans are less likely to default as these levels continue to decline; 2) As economic growth returns, individuals will be in a stronger position to afford new loans to invest in real estate or make purchases.

Examining trends in lending shows the role of financial services' extension of credit during the recession. While businesses required less in loans, individuals needing to finance essential purchases received record levels of credit. Moreover, in the most recent quarters in which business demand increased, loan officers reported easing lending standards, and small businesses access to credit and borrower satisfaction increased.

Protection from Loss

While banks act as financial shelters, insurance companies act to hedge risk, compensating the insured party in the event of loss. Insurance companies pool clients' risks to make payments more affordable for the insured.

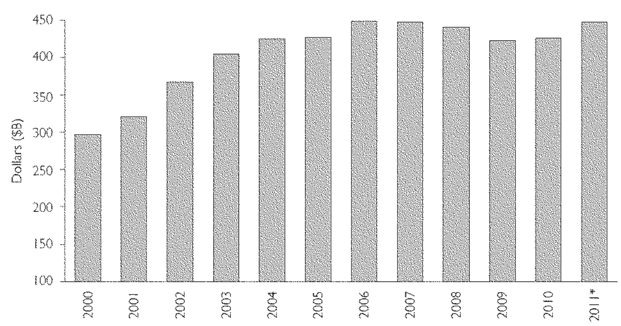
The P&C insurance industry insures homes, automobiles, individuals and businesses in case of loss, injury or legal claims. There are a host of other insurance products for both personal (individual) and commercial (business) lines.

Premiums are the dollar value paid to the insurance company in exchange for coverage. As of the third quarter of 2011 year-to-date, net premiums written for the P&C industry totaled $335.7 billion. On an annualized basis, 2011 year-end premiums are roughly $447.6 billion. Industry totals have not reached that mark since 2007 (Exhibit 25).

Exhibit 25

P&C INSURERS PREMIUM REMAINED STRONG THROUGHOUT THE RECESSION

Net Premiums Written for P&C Insurers



* Annualized based on third quarter year-to-date

Source: FDIC, SNL Financial

Net premiums written for a specific line of business is an insurers' retained premium income, which is either direct business or assumed reinsurance minus payments made for reinsurance ceded, for this specific line of business.

Spotlight: Support in Joplin, MO

One place where the insurance system worked as well as expected – in fact even better than expected – was Joplin, Missouri. The southwestern Missouri city was devastated on May 22, 2011by a massive tornado that claimed more than 150 lives and tore apart 7,000 homes and 2,000 buildings.

The deadly tornado produced more than 15,000 insurance claims, and Missouri's insurers were lauded for the quick, helpful and compassionate work they did in the aftermath. "This is the largest insurance event in Missouri history," said John Huff, Director of Missouri's Department of Insurance, Financial Institutions and Professional Registration. "The industry should be commended for the response thus far. Within 100 days after the event, they had paid out $1 billion to policyholders."[10]

> "The industry should be commended for the response thus far. Within 100 days after the event, they had paid out $1 billion to policyholders."

Loretta Bailey is an Allstate agent who experienced the tornado first-hand and played an integral role in helping her customers rebuild their lives. Hearing sirens indicating bad weather is common in this area of the U.S. This time was different, as the warnings advised that the tornado was headed straight into Joplin. Bailey rushed home, parked her car in the garage, and joined her boyfriend in the basement just as the tornado was close enough to make the fans in the home's furnace rapidly spin.

The damage was catastrophic. While Bailey survived the tornado, her house and car did not. She decided to head to the Allstate office, which she initially couldn't get to due to the town's wreckage. Eventually, she and some of her colleagues set up shop with laptops in a nearby business, and immediately started giving their fellow community members the checks they needed to get basic necessities in addition to funding for new residences and cars. Allstate was widely praised for its efficiency in the days and weeks after the tornado.

Bailey proudly tells the story of one elderly couple that rode the tornado out inside a fireplace. Significant damage was done to their residence, and within seven days they were given a claim check and the ability to purchase a permanent home. "I realized why I do what I do," she says. "I realized what I am giving back to the community. People would come in, and I would tell them what their policy pays them, and see the relief on their faces and the words 'we're going to be ok. It's going to be alright.'"

"People ask, 'How can you help others when you're hurt yourself?' I told them that when I signed on to be an Allstate agent, I signed on to help people. People were coming to us and saying, 'My neighbors had [Allstate] as an agent, and had a check in their hand so quickly. You were out there, you weren't just sitting in the office waiting to be called.'"

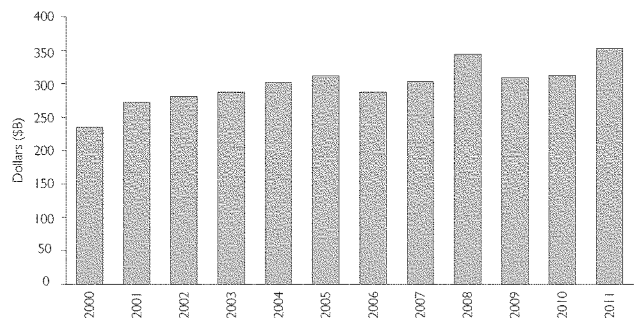
Based on policy coverage, when the insured party experiences a loss, the insurer must reimburse in the form of a monetary benefit. Total benefit or "payouts" for the P&C industry amounted to $264.6 billion year-to-date as of the third quarter of 2011, for an annualized amount of roughly $352.8 billion. If year-end values prove to be around the annualized amount, payouts in 2011 would be the highest on record (Exhibit 26).

2011 was a bleak year for catastrophic events, and this contributed to the large amount of payouts. While these losses are not favorable to the industry, they are extremely helpful to the insured parties, providing monetary benefit in time of need.

Exhibit 26

P&C INDUSTRY PAYOUTS WERE AT AN ALL-TIME HIGH IN 2011

Loan & Loss Adjusted Expense



* Annualized based on third quarter year-to-date

Source: FDIC, SNL Financial

Also affected by the large amount of losses due to catastrophic events was the reinsurance industry. In order to reduce risk, insurance companies transfer risk to a reinsurance company, which assumes all or part of the risk. This reduces the overall amount one company can pay for a specific claim. Instead, the premiums and losses are shared. The process is known as 'reinsurance'.

Although 2011 produced record losses that affected reinsurance performance, as a whole, the industry remains strong with stable capital and performance ratios well situated.[11]

Whereas the P&C industry covers losses on physical and economic assets along with other liabilities, the Life industry provides coverage to a decedent's family or other beneficiaries in the case of loss of life, illness/disability and other events. Life insurance can provide those left behind with a lifetime of financial security.

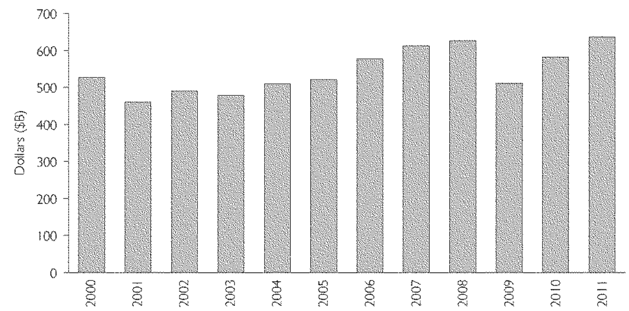
The method of obtaining a policy follows the same process as it does for the P&C industry – payment of premiums (annuities or deposits) in exchange for coverage.

The Life industry had Premiums, Consideration and Deposits (a comparable metric to Net Premiums for the P&C industry) of $476.8 billion as of the third quarter of 2011, and an annualized amount of roughly $635.7 billion (Exhibit 27). Given three consecutive quarters of growth in 2011, the year-end value would represent the highest amount for the industry on record.

Exhibit 27

LIFE INSURERS' ANNUITY AND LIFE INSURANCE PREMIUMS HAVE STRONGLY REBOUNDED

Net Premiums, Considerations and Deposits for Life Insurance



* Annualized based on third quarter year-to-date

Source: FDIC, SNL Financial

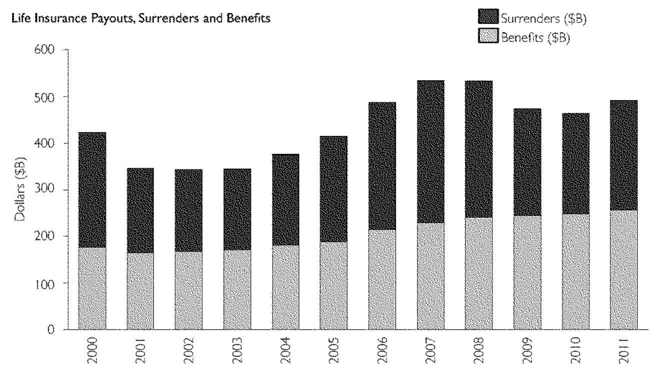
Life insurance payouts are measured in the form of Benefits and Surrenders. Year-to-date payouts as of third quarter of 2011 for the industry amounted to $368.3 billion, with an annualized amount of $491.1 billion, which is in line with historical levels (Exhibit 28).

Benefits include death benefits, matured endowments, annuity benefits, accident & health benefits, guarantees, group conversions, and life contingent contract pay.

Surrender benefits and withdrawals for life contracts include all surrender or other withdrawal benefit amounts incurred in connection with contract provisions for surrender or withdrawal.

Exhibit 28

LIFE INSURERS HAVE INCREASED PAYOUTS SINCE 2010



Source: FDIC, SNL Financial

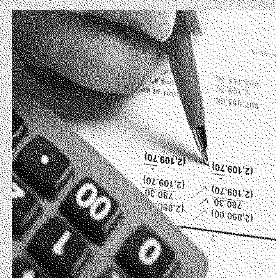
The industry's main role is to provide coverage in the event of loss; however, investments made by the P&C and Life industries in stock markets, bonds and other asset classes contribute to economic growth.

The benefit of investment income is vast. In short, companies are able to use invested funds to expand (increase employment) and increase shareholder value, while governments at the national, state and local levels are able to use the funds to the benefit of the taxpayer.

As a whole, the insurance industry (including Health insurers) had cash and investments of $4.65 trillion in 2011. These investments are used to generate earnings, which are then used to provide payouts to insured parties and pay dividends to investors and policyholders.

Spotlight: Financial Planning

One particular bright spot in the financial services industry is the planning and advisory sector. Retiring Americans are increasingly reporting positive, comforting results when it comes time to leave the workforce and enjoy the next phase of their lives.



David L. Blaydes, CFP, MS says his clients are regularly surprised and relieved to see that their retirement packages withstood the recent recession and will indeed allow them and their loved ones a pleasant retirement. Blaydes, a Certified Financial Planner with a Masters in Financial Planning is Founder and President of his own firm, Retirement Planners International, Inc. in Naperville, IL. He tells a particularly powerful story of one such client.

Blaydes' client was a successful Chicago-area attorney who planned to retire on his 65th birthday in 2011. This client had invested wisely, heeding Blaydes' advice about how much to invest in his 401(K), and how to diversify it according to the rate of return needed to accomplish his goals. Importantly, this resulted in a substantial reduction of risk before the 2008 market downturn. The client was pleased with his retirement plan, and told Blaydes he was ready to cash out on his life insurance policy and start making use of that money.

Blaydes advised his client against this decision and used data from the client's own plan to show him why the insurance was, from a planning perspective, still a wise investment. The client took the advice, which Blaydes was able to objectively offer as a financial planner, not an insurance underwriter. Within a month, the client asked Blaydes to visit him at his home. House visits are not in the typical course of business, and this caused Blaydes some anxiety as to what the issue could be. Upon arrival, Blaydes was given the sad news that his client had just learned he had only six months to live. He asked Blaydes to assure his wife that she would have what she needed without him, and thanked Blaydes for the counsel. He has since passed away, and the $1,000,000 of insurance he decided to keep, based on Blaydes' recommendation, has allowed his spouse to maintain her financial independence for the rest of her life, just as he wanted.

Blaydes believes that his industry has fundamentally changed for the better over the past 30 years, and is now focused not just on selling a financial product, but on compassionate caring for clients and acquiring the technical skills that are demanded by complex planning.

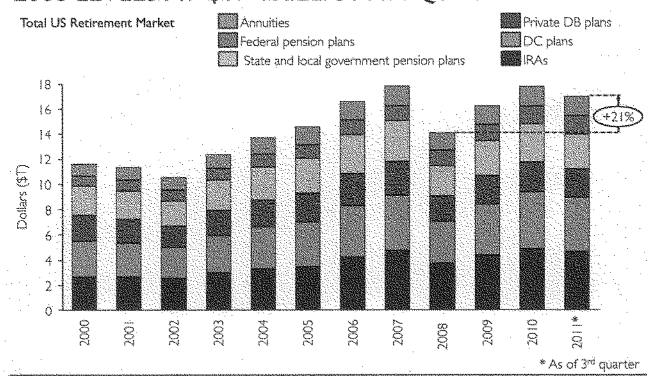
Saving for the Future

Having adequate retirement savings is vital to personal financial security and a big component of our financial services. According to the Investment Company Institute (ICI), as of the third quarter of 2011, retirement savings accounted for 36 percent of all household financial assets in the United States, equal to roughly $17 trillion (Exhibit 29). This level amounts to a 21 percent increase since 2008 with increases in all retirement financial vehicles.

Total retirement savings are aggregated using six plan types: Annuity Reserves, Federal pension plans, State and Local pension plans, Private Defined Benefit Plans, DC Plans and IRAs. All plan types fell from 2007 to 2008; however, IRAs took the largest hit, going from $4.7 trillion to $3.7 trillion, a 22 percent decrease. As of the third quarter of 2011, IRAs represent 4.6 trillion of the U.S. total retirement market, a 25 percent increase since 2008.

Exhibit 29

TOTAL RETIREMENT MARKET STANDS ABOVE 2006 LEVELS AT $17 TRILLION IN Q3'11



Source: Investment Company Institute

Much of the planning aspect behind retirement advisory involves the balancing of a portfolio. Known as "asset allocation," investors must make a choice of tradeoffs between risk and reward. Risk is determined by a variety of factors, but is most often associated with age of the account holder. As individuals near retirement and their personal risk aversion rises, the dollar proportion of bonds (fixed income) will replace holdings of equities.[12]

Value to the Economy Summary

The core functions of our financial institutions are critical to our economy. Deposits, while a simple service, provided a safe place for our finances during volatile times. Consumer loans increased to help our financing needs during the crisis and, more recently as our economic recovery has picked up, loans have increased to small businesses to finance job creation. Insurance is there to support us during the most difficult times, and the full range of our financial services support us as we plan for the future.

Regulatory Spotlight:
The Durbin Amendment

The least understood aspect of regulatory policymaking in Washington is unintended consequences. Unforeseen costs and unexpected outcomes are inevitable given the current scale and scope of new regulations.

In the midst of a slow recovery, these costs should be at the forefront of the debate. For example, higher capital requirements associated with Basel III may result in less credit growth, higher interest rates and slower economic growth in the short-run.

Congress and regulators do not develop rules with the intention of reducing economic growth or unnecessarily hurting American companies. However, by imposing overly burdensome costs and creating unintended consequences, poorly crafted regulatory policy can do just that. The poster child for this type of counterproductive regulation is the Durbin Amendment.

This section of the report will evaluate the merits and outcomes of the Durbin Amendment. We will evaluate the claims made by both sides of the debate based on what has been seen over the first four months of the law's enforcement. While the Durbin Amendment is unlikely to be changed in the near future, this analysis can inform future regulatory debates.

Key Findings:

- The enforcement of the Durbin Amendment in the fall of 2011 has resulted in a rollback of consumer benefits with no retail price reductions
- The percent of checking accounts that are free has dropped by 30 percent
- A study found that retail prices actually increased 1.7 percent after the Durbin Amendment took effect
- Small businesses specializing in small-ticket items have seen costs rise significantly due to the Durbin Amendment

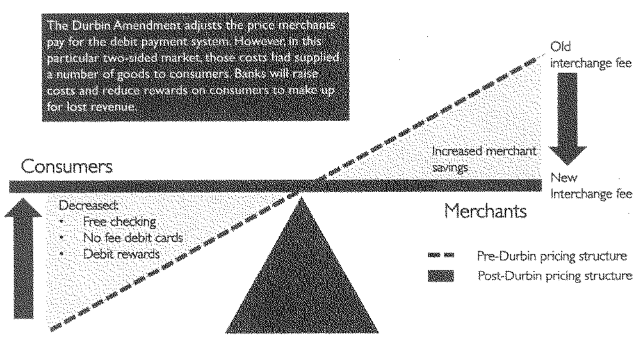
The Durbin Amendment pitted merchants against banks over approximately $17 billion in annual interchange fees, the cost merchants pay banks for processing debit card transactions. While the lobbying battle was business against business, consumers are impacted as well. Unfortunately, our analysis finds that the Durbin Amendment has made consumers worse off.

The Immediate Effects of the Durbin Amendment

In the first four months of its implementation, the Durbin Amendment has led to profound changes on the merchant and consumer side of the market. Just as increased interchange fees in the 2000s helped increase the availability of free checking, no-fee debit cards and rewards programs, reduced interchange fees will cause benefits to be scaled back. Meanwhile, there is no evidence that merchants, who received a major windfall, have lowered prices (Exhibit 30). The price controls in the Durbin Amendment completely ignore the economic incentives facing both banks and merchants.

Exhibit 30

REDUCING INTERCHANGE FEE SHIFTS COSTS TO CONSUMERS

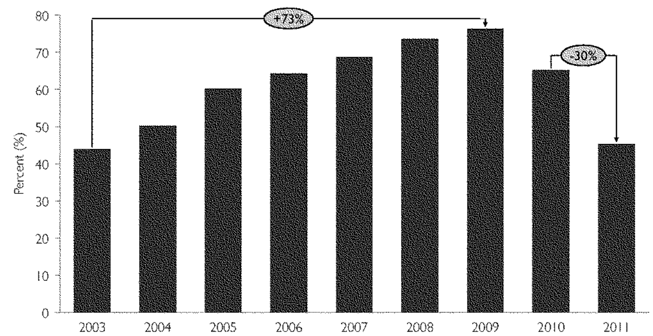


Bankrate data shows that the amount of free, non-interest bearing checking accounts peaked in 2009 at 76 percent, fell to 65 percent in 2010 due to the regulation of overdraft fees, and then fell even further to 45 percent due to the Durbin Amendment. (Exhibit 31). Free checking is less available now than it has been in the past six years. The cost in terms of access to traditional banking services is steep. One estimate found that approximately one million people may forego checking accounts at traditional banks.[13]

Exhibit 31

FREE CHECKING OFFERS HAVE DECREASED 30 PERCENT SINCE 2010

Percent of Non-Interest Checking Accounts that are Free



Source: Bankrate.com

While interchange fee revenues helped support no-fee debit cards, the Durbin Amendment has led to banks attempting to make up the lost revenue elsewhere. Consumers pushed back against banks that tried to charge debit card fees, but a reduction of previously free benefits on other services have not drawn such protest.

Increasingly, debit rewards programs are being terminated as the revenue used to support them evaporates. According to Pulse Network's 2011 Debit Issuance study, which took place prior to the Amendment's implementation, 54 percent of institutions were looking to re-structure or terminate rewards programs due to Durbin.[14] Bankrate's Fall 2011 Check Card survey found that 30 percent of banks surveyed the year before had terminated their debit rewards programs in 2011. The early results are clear; the Durbin Amendment has reversed the trend of lower consumer costs for debit cards and other bank services.

"The banks will charge you more, and I don't think the retailers are going to charge you less, which is why I didn't want to put it in the first place."
-Rep. Barney Frank

While banks have had to recoup lost revenue, merchants have not passed on savings to customers to offset their gains. A study by the Electronic Payments Coalition (EPC) surveyed the cost of a set basket of goods before and after the Durbin Amendment went into effect. The EPC study found that the cost of this basket of goods actually rose 1.7 percent.[15]

The result of this study is not surprising. International experience in Australia found no evidence of price reductions due to reduced interchange fees.[16]

The economics behind these results are simple. While the banking industry is highly competitive, merchants face various levels of competition. Prices tend to be sticky for merchants.[17] Merchants tend to price items around focal points such as $9.99 and face menu costs, the actual cost to changing prices. As a result, we have a situation where banks are reacting to price controls by cutting costs, while merchants have little incentive to reduce prices.

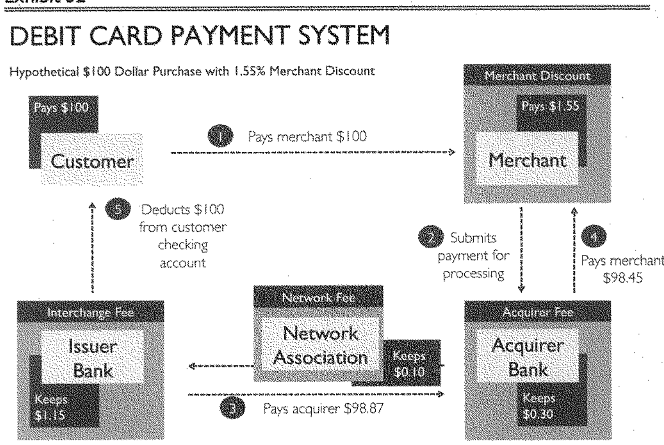
This situation was not lost on some legislators. Representative Barney Frank (D-MA-4) stated "The banks will charge you more, and I don't think the retailers are going to charge you less, which is why I didn't want to put it in the first place."[18]

The Durbin Amendment has led to a significant reduction in free checking, fewer rewards programs and consumers have not seen lower prices from merchants. Consumers are clearly worse off. This outcome should be no surprise if we consider the history of payment options and the economics of these systems.

Durbin Amendment 101

When a customer swipes a debit card to purchase an item, the merchant, two banks and the network association all process the transaction (Exhibit 32).

Exhibit 32



Source: GAO, Congressional Research Service

After the card swipe, the merchant submits the payment for processing by routing the card information through an acquirer bank to the card issuer bank. The merchant contracts with the acquirer bank, while the issuer bank is responsible for the card. After the process is approved, the money, minus the interchange fee and the acquirer fee, is transferred back to the merchant. The issuing bank deducts the full cost of the item purchased from the customer's account.[19]

The Durbin Amendment capped interchange fees at 21 cents to 24 cents per transaction, depending on anti-fraud investments by issuers. The cap was intended to keep fees at cost.

Prior to the Durbin Amendment, the average debit purchase was $38 with an interchange fee of 44 cents.[20] Therefore, banks will lose 45 to 52 percent of their potential revenue from reduced debit interchange fee if benefits, behaviors and purchase patterns hold constant.

Central to complaints made by merchants was that over the same time period of rising interchange fees, the cost of processing transactions and mitigating fraud fell. Merchants argued that the rise in fees above the cost of providing the service was an anticompetitive practice in need of price control. The merchants' argument was that due to Visa and MasterCard's market power, they could present "take it or leave it" offers that merchants had to go along with.[21]

While this argument might sound intuitively correct, it rests on the theories of one-sided markets where the seller is producing a good for one buyer. The payment card system, however, is a two-sided market where the seller is balancing the demands of both consumers and merchants. Evaluating what is a "fair" price in a two-sided market requires a different framework than that of a one-sided market.

Debit Card Payment as a Two-Sided Market

In the debit card payment system, there is a two-sided market, where network associations must balance the demands of consumers and merchants. Consumers enjoy the convenience, organization and rewards of paying with a debit card, while merchants benefit from increased sales due to these consumer incentives, as well as more efficient checkout and accounting processes.

Like the debit card payment system, news sources must balance the demands of both consumers and advertisers. Consumers want low-cost (if not free) news. Advertisers want to reach a large audience. The challenge for the news source is to price both sides accordingly to maximize the use of the product. In this instance, charging advertisers more and consumers less benefits both readers and advertisers. Readers get low-cost content and advertisers, while bearing most of the cost, reach a larger audience. These types of markets, where sellers balance the demands of two buyers, exist throughout the economy and in almost every situation where one buyer subsidizes the other.

When lobbying for regulatory action, merchants have highlighted the rising costs of the payment system on one side of the market. Very little attention, however, has been paid to the other side. As outlined above, one must examine the overall price of the payment structure to determine competitiveness, not just one side. We find three concrete cost reductions over the past decade: free checking, the introduction of no annual fee debit cards and debit rewards programs.

According to Bankrate's Fall Checking Studies, in 2003 only 44 percent of non-interest checking accounts were free. By 2009, 76 percent of non-interest checking accounts were free (Exhibit 33). This rise of free checking has helped lower consumer costs and brought more people into the formal banking system.

Beyond free checking, banks have reduced costs for holding debit cards. In the early 2000s it was common for debit cards, especially PIN debit cards, to carry a swipe fee for consumers. Now, according to a Bankrate Check Card study, 95 percent of the top 100 depository institutions offer debit cards with no usage fees.

In addition, card-issuing banks have instituted debit card rewards programs, such as airline miles and cash back incentives. According to Pulse Network data, the number of institutions offering debit rewards increased from 36 to 58 percent from 2005[22] to 2011.[23] Consumers have not just seen lower overall costs, but have many options to maximize their personal benefit from the card.

The Durbin Amendment Summary

The Durbin Amendment represents an attempt to legislate against economics and the loser has been the consumer. The Amendment's intrusion into the payment market through instituting price controls has led to distortions that have raised costs to consumers and small business while reducing innovation. As we look at future regulatory proposals, the experience of the Durbin Amendment should be a cautionary reminder to carefully weigh the costs and benefits of regulation and to be wary of unintended consequences.

[1] "Reflections on Dodd-Frank, A Look Back and a Look Forward," Simpson Thacher & Bartlett LLP, July 21, 2011.
[2] Data provided by SNL Financial LC unless otherwise noted.
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[4] "Property & Casualty Insurance Services: Competitive Conditions in Foreign Markets," United States International Trade Commission, March 2009
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INDEPENDENT COMMUNITY BANKERS *of* AMERICA®

March 1, 2012

Keeping Small Business and Municipal Deposits in the Community

On behalf of its nearly 5,000 community bank members, ICBA is pleased to submit this statement for the record for the House Financial Services Subcommittee on Financial Institutions and Consumer Credit's March 1 hearing titled: "Understanding the Effects of Repeal of Regulation Q on Financial Institutions and Small Businesses." We appreciate the opportunity to share our perspective on Regulation Q and on a related topic, full FDIC coverage of non-interest bearing transaction accounts.

Regulation Q

Since 1933, Federal Reserve Regulation Q has prohibited the payment of interest on business checking accounts. Designed to reduce volatility in bank funding costs, Regulation Q has served our communities well for 70 years. Regulation Q was repealed as part of the Dodd-Frank Act, with little discussion or debate, effective July 21, 2011. We anticipate the following effects of Regulation Q repeal:

- As community banks are forced to pay interest on business checking accounts to stay competitive with larger banks, and as interest rates inevitably rise from their historic lows, a stable, fixed-rate source of funding will be replaced with more expensive, volatile funding, potentially putting the safety and soundness of thousands of community banks at risk and reducing their franchise value.
- Repeal of Regulation Q will increase the cost of borrowing for most small business customers as community banks are forced to pass along the increased cost of funding business deposits. In those areas where loan demand is not strong, community bank margins will be further squeezed since the banks will have to absorb the costs.
- Fixed-rate funding, made possible by Regulation Q, allows community banks to invest in fixed-rate municipal debt without incurring interest rate risk. Regulation Q repeal will deprive many struggling municipalities of an important source of funding and force them to pay more for their borrowing.
- Ultimately, repeal of Regulation Q could cause community banks to lose market share to larger banks who can afford to pay more interest on deposits and lead to further consolidation of the financial industry, creating greater systemic risk.

Regulation Q was put into place for a reason. Stable, reliable funding strengthens banks and helps them to serve local economies. If Regulation Q were to be reinstated, there is an alternative solution that would allow business depositors to earn interest without violating the prohibitions of Regulation Q: Amend Federal Reserve Regulation D to exempt from the definition of "demand deposit" a money market deposit account (or MMDA) that allows up to 24 transactions a month for entities not eligible for NOW accounts. This would allow community banks to sweep daily between a business checking account and the new MMDA without having to establish expensive sweep programs or using overnight repos. An expanded MMDA would not be as volatile as an interest-bearing demand deposit and would not pose as much risk to the banking system. A solution that pairs reinstatement of Regulation Q with reform of Regulation D would address concerns that led to Regulation Q repeal, without the significant and adverse impact on community banks.

Transaction Account Insurance

ICBA supports a short-term, five-year extension of full FDIC coverage of non-interest bearing transaction accounts. With $1.4 trillion (or 20% of all domestic deposits) insured under this coverage, Congress should not ignore the danger of the sudden withdrawal of insurance if the program expires as scheduled at year-end 2012. In the absence of Regulation Q, those deposits are eligible to earn interest. Once-stable deposits will become "hot money" that could flee an institution at the click of a mouse in pursuit of a higher interest rate or the implicit government guarantee of a too-big-to-fail institution. The abrupt shift in funds could destabilize the recovering banking system, curtail credit, and threaten the fragile economic recovery.

Transaction accounts, which have no restrictions on withdrawals, are typically used by businesses of all sizes as well as municipalities, hospitals and other nonprofit organizations to meet payroll and operating expenses. Prior to the financial crisis, deposit insurance coverage of transaction accounts was limited to $100,000, the same limit that applied to other types of deposit accounts. In October 2008, following the onset of the credit market crisis, the FDIC temporarily established full insurance coverage of transaction accounts, provided the accounts paid no more than a limited amount of interest. This action was needed to prevent the sudden withdrawal of deposits which may have destabilized the banking system and exacerbated the crisis. The program, which was extended for two years by Congress and modified to prohibit any payment of interest, has been successful in minimizing disruption in the banking system. If the current program is allowed to expire December 31, 2012, coverage for transaction accounts will revert to the current limit for all deposit accounts, $250,000.

Transaction account coverage is fully paid for by FDIC-insured banks through their deposit insurance premiums, at no cost to taxpayers. The FDIC takes into account the cost of the additional coverage in determining the assessment rate schedule. In absence of this program, the largest banks, because of their systemic importance, will continue to enjoy an implicit *and cost-free* government guarantee. The cost of deposit insurance should reflect the true risk – including explicit or implicit guarantees – borne by taxpayers. The FDIC program shifts the cost of insurance from taxpayers to the banks. It promotes transparency and reduces taxpayer risk.

The FDIC program has been successful in promoting confidence among small business and municipal depositors, allowing community banks to retain these deposits so that they can be reinvested in the community. The U.S. economy is only beginning to emerge from an historic recession. The global banking system remains fragile and depositors remain risk adverse as demonstrated by the $1.4 trillion placed into non-interest bearing transactions accounts that carry FDIC insurance. The financial crisis in Europe and the geopolitical crisis in the Middle East are but two factors that could shock the financial system and reverse the economic recovery. Full

FDIC coverage of transactions accounts continues to play a significant role in preserving financial stability. ICBA urges Congress to continue the program for an additional five years.

Thank you for convening this hearing and for the opportunity to submit this statement for the record.

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