

# How the Repeal of Regulation Q Will Impact Your Banking Relationships

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Account analysis, which is already a very intricate issue, is about to get even trickier with the probable repeal of Federal Reserve Regulation Q. Regulation Q prohibits banks from paying interest on corporate checking accounts and has a number of other restrictions that have long had a major impact on the banking industry and its corporate customers. The House of Representatives has passed H.R. 947 to eliminate this regulation and the odds are that the Senate will pass the bill within the next year or so. When repeal occurs, most banks will begin paying hard interest on at least a portion of the balances in corporate accounts, significantly changing account analysis calculations. This article will explore some of the complications that Regulation Q is likely to introduce into account analysis and provide some ideas on how to take advantage of its impact to reduce overall banking expenses.

First, let's look at the history of Regulation Q. Up to the 1930s, the vast majority of corporate funds were deposited in demand accounts in banks. During the depression, lawmakers had the idea that they could improve economic growth if they could force companies to invest their funds in areas that they felt would have more impact on economic growth, such as new plant and equipment or stocks and bonds. Congress passed a series of laws designed to make bank accounts less attractive. The most important provision prohibits banks from paying interest on demand deposit accounts (DDAs), which include nearly all corporate checking accounts. In the early '80s, Regulation Q was modified to prevent companies from moving funds between a checking account and one that pays interest. As a result, no more than, six transfers of funds per month are allowed between a non-interest bearing account and an interest bearing account. Several other provisions prohibit Federal Reserve banks from paying interest on reserve deposits of member banks and limit how low the Federal Reserve can reduce the reserve requirements for member banks.

## The banking picture today

Now, let's flash forward and look at the banking picture in the U.S. today. There are now over 15,000 banking institutions and competition is stiff. Banks can now cross state lines and the bank's customers, both corporate and retail, have many more places to keep their money besides checking accounts. The huge amount of cash that used to be available to banks from corporate deposits is nearly gone. The vast majority of corporate funds are now invested in the stock, bond and money markets, and other non-bank alternatives. This environment makes it difficult for any but the largest banks to survive in the corporate market. On top of that, banks are required by law to keep a percentage of all of their deposits, which constitute their working capital, sitting in a sterile reserve that they can't touch. This reserve amounts to a tax that is placed on the capital of the banks, since they can't touch the money and they don't get any return on it.

The huge reduction in corporate deposits in banks has also had a major impact on the Federal Reserve System. With lower deposit balances in banks, the amount of actual dollars held by the Fed is reduced. Those reserve balances are important because they comprise the float that the Fed uses to clear checks, process wire transfers and perform other functions. In 1993, the Fed system maintained approximately \$28 billion in reserves and today only about \$6 billion is left.

Some economists have expressed concern that these reserves could be completely depleted on a particular day and bring the whole system to a halt before reserve balances could be increased at the end of the day when banks are required to make good on their reserve deposits.

### **Banks have adapted to the rules**

Of course, banks haven't just stood still and watched their deposits totally disappear. Years ago, they began to provide interest on the balances in business DDA accounts in the form of an analysis earnings credit that can be used to offset service charges generated by the business account owner. The earnings credit interest rate is typically less than that offered by a "hard" interest-earning vehicle and any unused earnings credits typically do not carry forward from month to month – they are lost. Banks have also offered services such as zero balance accounts and controlled disbursement accounts that are designed to allow companies to maintain balances in their corporate DDA accounts that are close to zero. Banks have also developed the negotiated order of withdrawal (NOW) account which pays interest but limits the amount of transactional activity. Under current law, NOW accounts can only be held by individuals and small companies and are limited to six transfers a month, preventing small companies from efficiently moving excess cash into investment vehicles.

The bill to repeal Regulation Q, officially called the "Small Business Interest Checking Act" is designed to help the banks compete more effectively for corporate funds and improve the liquidity situation of the Federal Reserve. If this bill passes the Senate and is signed into law, as nearly everyone expects, banks will be allowed to provide "hard" interest at a competitive rate on corporate accounts and companies would begin keeping larger balances in their DDAs. Companies will also be able to save money on bank fees since they may no longer need sweep-related services. The bill proposes a two-year delay after passage before banks are allowed to pay interest in DDAs. During this period the bill increases the maximum number of transfers in a NOW account to 24 per month, allowing companies to transfer excess cash into their NOW account every day of the month.

### **How will the banks respond?**

Banks will have a number of options in fashioning their response to passage of the bill. They can pay hard interest on the entire average account balance in which case they will eliminate the soft interest credit and charge hard dollars for services rendered. Another alternative is to continue paying a soft earnings credit on that portion of the average balance required to offset service charges and then pay hard interest on any excess balances. Finally, banks can simply maintain the status quo and pay no hard interest at all. How individual banks respond will have a major impact in the evaluation of the banking relationship. More so than ever, evaluations are based on the fees charged by the banks. In some organizations, treasury staff members make a monthly effort to manually compare the fees of the different banks for reasonableness and screen individual statements for possible discrepancies. But the magnitude of the task means that usually the best that can be done is comparing summary fees for each bank that don't break out charges for individual accounts, not to mention line item detail.

For that reason, many companies have begun to use new software tools that streamline the evaluation of analysis fees. These software packages are typically based on the service codes developed by the Association for Financial Professionals (AFP) to standardize the references and terms that identify bank services and their associated charges. The software captures account statements electronically from banks that support ANSI X12/822 transmissions and provides for manual input of statements from banks that provide paper statements only. Automated tools included in the software interrogate the statements to check that prices match the rates that have been negotiated with each bank, that services match the ones that were ordered and that volume is in line with recent months. Tools such as these are the first step towards reducing banking fees

because they provide a clear picture of where account analysis fees are being spent and a direct comparison between the fees charged by different banks for the same services. Almost as soon as they are implemented, they usually help managers identify areas where large amounts of money are being spent on quite mundane banking services.

### **Effects on account analysis**

Companies that have implemented account analysis software typically use the reports to compare charges for different accounts within a single bank and to perform cross-bank comparisons. Once they have a clear understanding of what fees they are paying for which services, most companies can achieve even greater cost savings by negotiating with banks for reduced rates. Typically, treasury office personnel use reports to do cross-bank comparisons, such as a typical one that allows them to evaluate the return on balances maintained in each of their accounts by looking at the earned credit rate and balance performance. The information generated in these reports can be used to initiate contacts with banks concerning pricing.

The elimination of Regulation Q will significantly alter the calculations involved in verifying account analysis fees and comparing the fees charged by different banks for a given level of activity. The payment of hard interest will have a major impact that must be considered along with analysis fees. Additional variables that must be considered include the interest rates and the amount of interest that is paid in hard versus soft dollars. Companies will also need to take a much closer look at the amount of funds that they are maintaining in each account because, with competitive interest rates being paid, this decision will have an important impact on cross bank comparisons. Tax considerations will also begin to play a role in these calculations since hard interest dollars, unlike the soft earnings credit that is currently paid, are taxable. In addition, services that are paid for with hard dollars can be expensed. Both companies and banks would be well advised to explore the many new banking alternatives and tax implications that will emerge with the repeal of Regulation Q.

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